

# **A REVIEW OF THE STRUCTURE OF THE LISTING REGIME**

**Submission by The Association of Investment Companies (AIC)**

**March 2008**

## Executive summary

Concerns about the standards applying to UK listings stem from the low standards allowed under the CARD and, the absence of standards that are essential to secure an appropriate level of consumer protection. The review of the listing rules for investment entities demonstrated that it is possible to combine appropriate standards with sufficient commercial flexibility to deliver a listing regime that is attractive both to issuers and to investors, while still maintaining the competitiveness of the UK market.

The AIC **recommends** that the FSA prioritise renegotiating the CARD as a medium/long-term objective. In advance of this, effective market segmentation is critical. Broadly speaking, the AIC **recommends** that the UKLA adopt the approach set out in option 1, that is it should:

- Introduce a single super-equivalent segment for listed equities;
- Remove directive minimum listings from the Official List;
- Allow 'de-listed' equities and GDRs to be traded through regulated markets (where the FSA imposes standards arising from the Prospectus Directive, Transparency Directive and Market Abuse Directive).

This will deliver various benefits including:

- supporting investor confidence and the UK's reputation as an orderly, fair and robust market for listed shares;
- providing a clear differentiation for marketing the UK as a listing destination;
- treating UK issuers fairly in comparison with overseas companies;
- ensuring that issuers cannot secure the cachet of a 'UK listing' unless they apply the standards required to deliver an appropriate level of investor protection;
- allow securities adopting a range of standards to be available in the UK while still maximising the brand value of a 'UK listing'.

Adopting this approach could create a need to change investment mandates. This will be beneficial for institutional fund governance as the process of mandate review will focus the attention of clients on the regulatory risks which their funds are exposed to and ensure that their approach takes account of changing market circumstances.

Tax reform may also be required as a result of adopting this approach to market segmentation. However, there is no public policy reason for relevant changes not to be made and, with suitable transitional periods in place; it should be possible to make any required adjustments.

The FSA should also introduce super-equivalent rules for non-equity securities, which would allow them to adopt UK listed status.

These measures will maintain UK standards and the international attractions of UK markets. Adopting the proposed approach will be critical to ensuring the FSA delivers its regulatory objectives in its capacity as the UKLA.

## **Overview**

The Association of Investment Companies (AIC) welcomes the opportunity to contribute to the debate over the structure of the UK's listing regime.

Investment companies are closed-ended funds that invest in a portfolio of assets to provide shareholders with an investment return. The vast majority of our members are UK listed, although some are quoted on other markets, such as AIM. Investment companies compete with other collective investment vehicles (such as authorised unit trusts and OEICs) and allow retail investors to diversify their investment risk and secure capital growth and income. They are widely held by retail investors – we estimate far more than any other sector of the stock market.

The AIC anticipates that it will have a unique view on this debate as our members are both issuers of, and investors in, UK shares.

The need for this debate has been stimulated by the application of different standards across the listed securities market. These differences create problems because the minimum standards allowed, which are based on the rules required by CARD, offer insufficient consumer protection.

The FSA agreed with this view when it closed the minimum standards regime Chapter 14) to investment companies on 6 March 2008. It is difficult to see why the same regulatory position would not be adopted in other listed markets, particularly where listed equities are concerned.

As the CARD sets such low regulatory standards in listed markets, it risks allowing significant regulatory problems to emerge in the future – not only in the UK, but also across Europe. A key AIC **recommendation** is therefore that an early priority of the FSA/UKLA should be to secure a commitment from the European Commission to review and revise CARD to implement appropriate standards. This will reduce pressures across Europe to chase down standards –

a process which if not checked could ultimately damage both investors and the goal of developing a single market single market for capital and investment.

Implementing proper regulatory standards will not result in the UK becoming a less attractive regime for listing. The AIC is convinced that maintaining the traditional standards for a UK listing, particularly where equity securities are concerned, can maintain the commercial attractions of the market. During the debate over the regulatory standards for investment companies the AIC worked closely with the UKLA to ensure proper standards and an attractive commercial regime were both achieved.

The results of this process have been very positive. The new investment company listing rules have deleted a number of detailed provisions which were commercially restrictive (but provided no regulatory value) and the rulebook is now rooted in a 'principles-based' approach. The rules are more clearly focussed on desired regulatory outcomes, namely investor protection and market quality, while allowing commercial flexibility.

This ensures that the investment company listing rules are relevant and proportionate. It means that companies with newer types of investment policies are not automatically excluded from a UK listing, which was a problem with the old regime. Where investment companies are prepared to comply with the standards required, they can list and take advantage of the benefits that this delivers.

The reforms introduced have already had an impact on the commercial attractions of the UK's Official List. Since November 2007 (after the first step of reforms were introduced and the shape of the final regime became clearer) a number of investment companies have decided to move to the new investment company rules. At least two have moved straight from AIM to the Official List. Two more have announced that they are considering the same switch. BH Macro and Dexion Trading, which are UK listed, have decided to move from the minimum standards regime (Chapter 14) to the super-equivalent regime (Chapter 15). Most significantly, a Euronext traded investment company (which had been listed under the minimum standards allowed by CARD) has also announced that it intends to dual-list in the UK and list under the new investment company rules.

The AIC commends the review of the investment company Listing Rules as an excellent example of proportionate and flexible regulation. With this in mind, the AIC **recommends** that, where possible, principles-based rules should be extended to the rest of the listing framework. To accomplish this, the FSA, in its capacity as the UKLA, would review all the listing chapters, on a rolling basis, with a view to introducing principles-based rules which maintain the quality of the regime while making it more outcome-focussed and commercially flexible.

While the AIC believes the recommendations made above should be a priority for the FSA/UKLA, it also recognises that they are relatively long-term aspirations. It is clear that the current debate on market structure will be taken forward before these processes could be completed. With this in mind, the current review of the structure of the listing regime should seek to combine the advantages of creating a market with standards which satisfy the long-term needs of investors with rules that are as attractive as possible for issuers – particularly new issuers considering their choice of listing/trading venue.

In striking the correct balance between these competing priorities, the long-term needs of investors, and their desire for an orderly and fair market based on clear standards, must rank as the highest priority. After all, if market forces alone were sufficient to support appropriate standards there would be no need for regulation.

The UK market's reputation for quality, stability and fairness has been built over many years with rules evolving to meet investor needs. The FSA needs to be mindful of this and ensure that short-term commercial pressures are not allowed to dominate the debate as this could result in an unacceptable erosion of standards. Such an outcome could lead to problems arising in the market which would take many years to put right. Ultimately, a lack of appropriate regulation is likely to be more damaging to the UK's commercial positioning than a failure to attract a few new listings from issuers who are unwilling to submit themselves even to standards which are reasonable and flexible.

The needs of the investor community will be critical in successfully concluding this review. Investors who have confidence in UK standards will create the depth and continuity of demand that make the UK so attractive to other market participants – not least issuers. Maintaining that confidence should be central to creating an appropriate regulatory framework.

Regulation provides an important underpinning to investor confidence – both for institutions and the retail market. There is a view in some quarters that institutional investors do not rely on regulation because they have the capacity to make detailed risk assessments. This suggests that institutional investors always develop a detailed understanding of whether or not the shares in a particular company offer suitable levels of investor protection and make detailed assessments in relation to regulatory issues. The AIC believes that this view is false.

Of course large institutions are potentially well placed to take such a view on standards. However, in many cases, instead of making detailed assessments about the regulatory standards applying to particular companies (by, for example, examining articles and other constitutional documents) they instead rely (at least in part) on the perceived protection provided by general regulatory standards. AIC stakeholders with an investment remit have confirmed that, where a share quoted on a UK market is not listed, it 'raises a flag' which means that more due

diligence will be undertaken before an investment decision is taken. Where companies are listed, detailed investigations of that nature might not be undertaken. This is despite the fact that standards across the listed equity segment vary.

The debate over whether or not investment companies should be allowed to list under Chapter 14 (the minimum standards regime) also highlighted that there was widespread misunderstanding of what standards applied to 'secondary' listings. One view, expressed on a number of occasions by market professionals, was that a 'secondary listing' under Chapter 14 meant that a company listed under those rules must also have a 'primary' listing elsewhere. This was despite the fact that the requirements had changed some two years before. While this misunderstanding was likely to have been exacerbated by the fact that the rule changes were not accompanied by a change in terminology, we anticipate that similar misconceptions are likely to pervade the market in relation to trading companies listed under Chapter 14. This is not surprising, as even the term 'listed' is often misapplied by industry professionals (for example, by referring to companies traded on AIM as 'listed'). This illustrates the importance of getting market labelling correct and the dangers of making assumptions about the knowledge levels of the investing community.

Creating a suitable market framework that supports investor confidence and minimises the scope for unsatisfactory governance and legal standards to damage their interests is a vital regulatory function. The AIC does not agree with voices favouring a purist caveat emptor approach. Particularly where retail investors are concerned (but also, potentially, with institutions) basic features of the market – notably asymmetries in power and information – make it important that basic standards are maintained through regulation. Of course, while there is a need for regulation, it should be delivered with as little impact as possible on competition between investment propositions.

Where minimum standards are concerned, the FSA/UKLA cannot 'sub-contract' its regulatory obligations to third parties. If it concludes that the CARD does not provide sufficient protection for investors in trading companies (as it did in the debate over listing standards for investment companies) it cannot allow UK listed markets to operate in accordance with CARD requirements and not introduce super-equivalent rules. It is not sufficient to substitute basic regulatory standards with commercial mechanisms – such as indexes based on governance standards. Of course, if they wish, commercial providers are free to establish standard-related indexes (where issuers have to, say, comply or explain against the Combined Code or apply other investor protection measures, such as pre-emption rights to gain entry), but these initiatives do not of themselves have any regulatory weight. This is because investors are not obliged to use them when making investment decisions. As discussed above, the very existence of the UKLA reflects the fact that market forces alone cannot be relied upon to deliver the standards required to allow the market to operate fairly and to flourish.

Regulation must set a proper floor – upon which commercial organisations can build if they wish. However, complying with basic regulatory requirements (which create systemic advantages for the market as a whole) should not be a matter for discretion.

The AIC's policy conclusions also take into account the fact that, although the term 'listing' has a specific technical meaning, it also has a wider commercial resonance which is valuable to both issuers and the market more generally. A 'UK listing' has traditionally provided assurance to investors that basic standards of investor protection are being observed. This assurance has supported the UK's competitive advantage over a long period of time. It has arisen from rules now incorporated solely in the so-called 'super-equivalent' regime.

The deployment of varying standards, which apply to different types of security which are all 'listed', has confused this picture. This confusion carries with it reputational risk for the position of a 'UK listing'. Shares which are listed under the directive minimum requirements of CARD do not deliver traditional UK standards. Despite this, they have been able to piggy-back on the traditional reputation of the UK market. This situation should be a key concern for the FSA/UKLA because failures in the minimum standard segment of the market would have much broader effects. Misplaced confidence in minimum standard listings could easily be translated into a lack of confidence across the whole UK listed market.

Of course, it is rational for issuers to promote themselves as 'UK listed' when they do not adhere to the super-equivalent standards which apply to others. They are able to minimise their costs and regulatory obligations while maximising their own reputation and potential demand for their stock. It is also understandable that advisors seek to attract issuers to the UK on this basis. However, allowing practices of this nature ignores the systemic damage that a few companies could bring to the whole market if a scandal damages confidence.

To deliver an appropriate listing framework the AIC **recommends** that the FSA/UKLA must create common standards for issuers and investors irrespective of their domicile. Capital markets are increasingly international. The fairest and most efficient regulatory system, with the greatest potential to support investor confidence, will be created where there is consistency of treatment for all market participants. Imposing 'country-blind' standards at the right level offers the best prospect of protecting and enhancing the UK's position as an international financial centre.

These considerations have been critical in determining the AIC's conclusion on this review and its overall **recommendation** that 'option 1' should be adopted by the FSA. This would involve:

- A single listed segment for listed equities based on 'super-equivalent' standards;
- Removing 'secondary listed' equities (directive minimum listings) and GDRs from the Official List;
- Allowing 'de-listed' equities and GDRs to be traded through regulated markets (where the FSA imposes standards arising from the Prospectus Directive, Transparency Directive and Market Abuse Directive).

Under this regime UK and overseas issuers would be treated equally. Access to the UK's official list would be reserved for issuers of equities adopting super-equivalent standards. Other issuers could secure a quotation for their equities on a regulated market or unregulated market segment. There would be no impediment to doing business in the UK – but this framework would give the opportunity to label the market (particularly the 'listed' segment) so that investors have a clearer idea of what each segment represents.

We have no doubt that market participants will be able to exploit the clarity offered by option 1 to promote the UK listed market. However, the AIC also **recommends** that the FSA should itself consider what else it and the UK Government can do to promote the unique benefits of UK listed standards to potential issuers and the investment community once the framework has been clarified by the review.

### **Specific questions**

**Q1: Do you consider that the UK super-equivalent Listing standards should be retained?**

Yes, the UK should maintain its super-equivalent Listing standards. The AIC recently supported their continuation for investment companies and **recommends** that they should also be kept for trading company equities. There is also a case for extending them to other securities listed in the UK.

The super-equivalent standards include a number of provisions that ensure basic standards are maintained. These support the needs of investors, maintain the reputation of the market, and ensure the FSA (in its capacity as the UKLA) is able to enforce appropriate standards.

A good example of valuable additional provisions included in the super-equivalent regime are the listing principles. These require, amongst other things, that listed companies:

- have systems and procedures in place to meet their obligations;
- communicate in a way which avoids the creation of a false market;
- treat holders of the same class of shares in the same position in the same way with respect to the rights attaching to those shares; and,
- deal cooperatively with the FSA.

Rules of this nature are important in sustaining the UK's reputation as a fair and orderly market and provide for sensible minimum standards which meet the UKLA's regulatory objectives. Particularly in a principles-based regulatory environment (which the AIC would like to see extended throughout the UK listing regime), they create a regime where investors can have confidence in the quality of UK markets. The AIC **recommends** that issuers who are not required to comply with rules such as these should not be part of the UK's listed market segment.

The AIC's main priority is listed equities. If super-equivalent standards – at a minimum, including the FSA's listing principles – are not to be adopted for all listed securities, the AIC **recommends** that, at the very least, they should be required for all listed equities.

Although the AIC supports rules which guarantee an appropriate level of investor protection (and thus go beyond the requirements of CARD) it also recognises that there is scope for the super-equivalent rules to be improved. The AIC therefore **recommends** that, on a rolling basis, each chapter of the Listing Rules should be reviewed and the continued relevance of their provisions should be assessed. This review should include making an assessment of whether or not the rules can be liberalised and/or moved to a principles-based approach (bearing in mind the need to maintain adequate consumer protection).

**Q2: Do you consider that the super-equivalent Listing standards should continue to be set by the FSA or should they be determined by the market (exchanges, trade associations or other independent body)?**

The AIC **recommends** that the super-equivalent Listing standards should continue to be set by the FSA in its capacity as the UKLA. The FSA has statutory objectives, notably to maintain market confidence and protect consumers, which complement the UKLA's regulatory objectives. The UKLA's objectives differ slightly but they cover much of the same ground, including maintaining appropriate standards in the listed market segment.

The CARD provisions do not create sufficient standards from either the UKLA's or FSA's perspective – particularly where retail investors are concerned. This argument was critical in the debate over investment companies. The same issues apply to the whole listed market. The FSA should not seek to recuse itself from its responsibilities as the UKLA simply because the listing authority's objectives do not have the same statutory basis or because they differ slightly in construction. There is strong regulatory logic in maintaining the UKLA's function within the ambit of the FSA because the health of listed markets is vital to many of the businesses which the FSA does regulate (fund managers, investment banks, investment advisors etc). It should not transfer its competence in relation to super-equivalent Listing Rules to external bodies.

There should be no confusion about the nature of a super-equivalent regime. It should not incorporate 'rules for rules sake'. It should be focussed on potential market failures, particularly those which: fragment the market and threaten liquidity, lead to poor price formation, or prevent investors taking informed investment decisions. Super-equivalent rules should only be established where they will prevent market failures. Using super-equivalent rules in this way will avoid, for example, problems similar to those created by Sarbanes-Oxley. These rules have lessened the attractions of US markets and created costs but have not delivered sufficient value for investors to make compliance worthwhile for many new issuers considering their listing options. If, once the UK's basic standards have been achieved, individual parts of the market want to go further than the standards delivered by the super-equivalent regime, then this is a commercial, not a regulatory, matter.

The UKLA's current regulatory responsibilities mean that it is not possible for it to step back from oversight of a super-equivalent regime designed to deliver required standards and it should not seek to do so. That said, one challenge is to work out what the minimum regulatory threshold is. The FSA/UKLA is best positioned to canvass views from the market, take a view on what is required and subsequently set and enforce the resulting rules.

Certainly, if the FSA/UKLA wants to support the notion of a 'UK listing' (in line, perhaps, with its remit to support competitiveness) it needs to be the sole arbiter of listing standards in the UK to ensure a clear distinction between standards in listed and other market segments.

The discussion paper asks whether or not 'comply or explain' could be used as a mechanism to allow the FSA to resile from the task of setting super-equivalent standards. It does not. There may be cases where appropriate super-equivalent rules incorporate an element of 'comply or explain' but, if a comply or explain rule is appropriate, it should be set and enforced by the FSA in its capacity as the UKLA.

**Q3: Should we allow equity securities to be admitted to the Official List if they are only to be admitted to trading on a MTF operated by an RIE or an investment firm and not on a Regulated Market of an RIE? If so, on what basis?**

The status of different equity securities listed in the UK should be equivalent as far as possible. This is why the AIC supports removing the availability of a secondary (minimum standard) listing in the UK for foreign equity issuers.

The AIC does not support the development of a 'platform neutral' approach to UK listed securities. The AIC **recommends** that all UK listed shares should be subject to the Prospectus, Transparency and Market Abuse directives and traded on a regulated market (as defined by MiFID) plus the super-equivalent listing rules.

Where issuers choose not to meet these standards they would still be able to trade on other platforms, according to the rules they feel appropriate, but would not legitimately be able to describe themselves as 'UK listed'. However, if they believe that a 'UK listing' (backed by standards as set out) is of value – for example, because it attracts liquidity – they will have to submit to the rules which secure those advantages.

**Q4: Which of the options described above do you consider to be optimal? Please provide the reasons for your chosen option.**

The discussion paper rightly recognises the role that 'primary', or super-equivalent, listings have played in securing the UK's reputation as an international market. The growth of directive minimum listings is recent (and has largely taken place during a relatively benign period for markets). It is not clear that all market participants fully appreciate how these new types of listing have affected the quality of UK listings or the standards investors can rely on - although, if economic conditions become less favourable, this issue could be of increasing importance.

The AIC **recommends** that the approach to market segmentation set out in option 1 be adopted. It would:

- maintain the minimum standards required to maintain investor confidence and the UK's reputation as an orderly, fair and robust market for listed shares;
- provide a clear platform for marketing the UK as a destination for equity listings. In this context, we note that MW Tops, a Euronext-listed hedge fund (which prior to the review of the listing rules for investment entities was unable to take a Chapter 15 listing) is now expected to move to the UK's super-equivalent investment entities rules in the near future. This

demonstrates that minimum standards are not necessarily the most attractive and that a suitable super-equivalent regime can compete with CARD – thus meeting the needs of both issuers and investors.

- avoid the complications inherent in option 2, which includes a two-tier listing regime for equities and which is likely to result in confusion in the market over the standards which apply to listed equities offered in the UK.
- treat UK issuers fairly in comparison with overseas companies. This is sensible from a policy perspective. There are no reasons why UK markets should offer easier access to foreign issuers over UK companies. Equality of treatment is also required as treating UK companies differently on the basis of their domicile is contrary to the requirements of European law.
- ensure that issuers are not able to secure the cachet of a 'UK listing' unless they apply the standards which investors expect to accompany the 'UK listed' brand. This is critical as free-riding of this nature creates potential threats to the reputation of other companies which have adopted super-equivalent standards.
- create a clear distinction between listed equities and the lower standards applying to GDRs.
- allow securities adopting a range of standards to be available in the UK while still maximising the brand value of a 'UK listing'.

We note the Discussion Paper's consideration of the possible impact which option 1 might have on investment mandates. Investment mandates are used to set investment parameters and are one element in balancing risk with return. The scope of mandates is a commercial issue for the parties involved. How clients who have instructed managers to operate on their behalf manage any changes resulting from this review is a matter for them – and not central to the UKLA's objective of ensuring an appropriate environment for UK listed securities.

However, it seems likely that changes in Listing Rules since 2005 – notably the introduction of directive minimum listings – may have already influenced the risks which individual investment mandates are exposed to. This may have occurred where investment portfolios now include companies listed under Chapter 14 which adopt lower standards than envisaged when the mandate was originally drawn up. In the absence of changes in mandates, adopting option 1 will simply return the level of regulatory risk to a pre-2005 position (in relation to UK equities) unless the mandate is changed to allow exposure to unlisted equities. If anything, adopting option 1 should help focus the attention of clients on the true nature of the regulatory risk that they wish to be exposed to.

The impact of option 1 on the governance of investment funds could well be positive. Deciding against this option to accommodate existing investment mandates simply risks an unintended drift of standards, where mandates designed to manage risk through their exposure to traditional UK listing standards no longer achieve their original intention.

The AIC is cautious about claims that adopting option 1 would be too disruptive for investment funds which can only invest in listed securities. Equities listed in the UK have only been able to adopt directive minimum standards since 2005 – these stocks make up a minority of the market both by market size and number. Adopting option 1 will therefore change the scope for investment by funds with ‘listed’ mandates in a small minority of investments. This limits the amount of potential portfolio turnover that would be required if option 1 were adopted and investment mandates were not adjusted to allow exposure to a broader range of UK-traded equities.

The impact of adopting option 1 would be limited even further if a sensible transitional arrangements were put in place – giving time for mandates to be changed or stock to be sold. Any objection on the basis that investment mandates could not accommodate a change in designation of equities previously listed under the minimum standards regime is unconvincing.

More convincing might be objections based around the tax rules. The AIC understands that a number of tax-wrappers and other tax legislation use the term ‘listing’. However, this factor should also not determine the UKLA’s final decision over market segmentation.

It is true that changes to UK tax legislation may be required to ensure that adopting option 1 does not inappropriately limit the range of securities which can be purchased by tax-favoured investment vehicles. However, we anticipate that it should be possible to negotiate these issues with the HM Treasury. There are unlikely to be any serious policy issues which preclude such a change.

The term ‘listing’ is likely to have been used originally to reflect a preference for traditional UK super-equivalent standards. If so, the term no longer achieves its objective. UK vehicles with investment remits driven by tax rules based on the term ‘listed’ can invest in: UK listed equities (adopting super-equivalent standards), CARD (minimum-standard) listed securities available in UK and across Europe, and ‘listed’ stocks traded internationally outside Europe (where the term ‘listing’ is likely to involve still other standards). Certainly, the term ‘listed’, on its own, no longer guarantees the sort of regulatory standards which it might traditionally have done.

If the FSA concludes that option 1 would be the best solution for market segmentation, but is concerned about the tax implications, it should approach HM Treasury on this matter. HM Treasury should be prepared to reconsider why

it decided to use the term 'listing' and make adjustments to the rules as appropriate.

There is a very strong case to be made that the term 'listing' should no longer be utilised within the relevant tax legislation. Indeed, the fact that the term now allows investment in certain securities which do not adopt traditional UK standards demonstrates that it no longer delivers the 'quality' the rules may originally have been designed to achieve. This has even been recognised by the Government. HMRC's website notes, for example, that the eligibility of shares for inclusion in ISAs is not a reflection of the standards that they adopt. It says that the rules make no judgement on the level of regulatory protection inherent in the underlying securities.

With this in mind, the use of the term 'listed' in this legislation is simply limiting the availability of eligible shares for ISAs (such as AIM stocks) and in turn reducing the ability of investors to manage their asset allocation in a way which best suits their investment needs.

As tax rules are not designed to provide investor protection (and, given the diverse standards which apply to 'listed' securities, they are not delivering it) they should be adjusted to a more inclusive, neutral term, such as 'admitted to trading'. Investor protection should then be provided by other mechanisms explicitly designed to achieve these outcomes. The AIC **recommends** that the FSA should raise this debate with HM Treasury with a view to removing impediments to adopting option 1 which may arise from the tax regime.

On the other hand, if the HM Treasury does want to be 'standard-specific' in using the term 'listing', then adopting option 1 is likely to fit in with this agenda as it will ensure that, at least where UK stocks are concerned, the tax rules are supporting sufficient regulatory standards in the underlying stocks where they are purchased in the UK. Disruption to affected portfolios will be limited as most UK listed equities were admitted to trading before 2005 and will already adopt super-equivalent standards.

The AIC **recommends** that the FSA should not reject option 1 on tax grounds. Tax considerations are not central to its role – maintaining appropriate market standards are. Also, it should be able to raise these matters with HM Treasury and make suitable changes (perhaps in the Finance Bill 2009) which would allow relevant reforms to be made to the tax regime to coincide with the implementation timetable for a new market segmentation approach.

The AIC is keen to participate in any review of the tax legislation which follows on from the conclusion of the market segmentation debate. Our initial **recommendation** is that the term 'listing' could be usefully replaced with a more neutral phrase, such as 'admitted to trading', but of course, this matter would require proper consultation and consideration of the implications before any terminology is agreed.

Given issues relating to investment mandates and the need for possible tax reform, the AIC **recommends** that, in introducing suitable market segmentation measures (ideally option 1), the FSA must allow for a sufficient transitional period. This would allow investment mandates and tax rules to be adjusted. It would also give companies who have issued their equity under minimum standards rules (i.e. Chapter 14) time to consider their position. They will have three possible options. They can

- adjust their practices to adopt the standards required of a 'UK-listing'; or,
- decide to change their status from being 'listed' to being admitted on a regulated market; or,
- move their listing to another European country.

We anticipate that the least likely option is moving their listing to another European country, as this will remove many of the benefits afforded to them by being available on UK markets. However, if they do choose to leave, this should not be problematic for the UKLA.

Issuers who might choose to leave will not be meeting the basic standards required by the UKLA to deliver its regulatory objectives. Also, any movement of this nature will reduce the force of the arguments of those who oppose option 1.

There will be, for example, less need to change investment mandates because mandates would not have to be changed to allow investors to continue to invest in these securities, which have moved to another 'listed' market. At the same time, the quality of the UK markets will be sustained – which should support a virtuous cycle of attracting investors and, as a consequence, other issuers.

The AIC also notes the observations made in the Discussion Paper regarding terminology – and the fact that the UKLA/FSA cannot control use of the term 'listing'. This should not be an impediment to adopting option 1. Creating a clear system, as set out in option 1, increases the likelihood that over time terminology will be used correctly. Certainly, the risk of confusion in terminology is less under option 1 than option 2 – which includes complications regarding proposed 'first' and 'second' tier listings in the equity market segment.

We also have some inherent scepticism about those arguing that terminology is misused so this reduces the benefits of introducing clearer market labelling and standards. On one hand it is suggested that the terms 'listed' or 'UK-listed' are used loosely by market participants. The implication being that the term 'listing' has little real value. On the other hand, the same parties object to changing the technical definition of the term 'listed' because it will somehow harm the competitiveness of the market. Both arguments are used, often by the same

parties and despite their contradictions, in an effort to support (as far as possible) the status quo.

This suggests that, in reality, the ability to claim to be 'UK listed' (and for this to be an accurate description of an issuer's circumstances) really does have value to issuers. It also suggests that it is also commercially convenient for some parties to take advantage of current ambiguity when they are not, in fact, implementing traditional 'UK-listed' standards. Adopting option 1 will reduce the ability of market participants to confuse the status of a 'UK listing' and erode the potential for free-riding.

The AIC's primary interest in this debate is the position of equities and secondarily (but only marginally so) GDRs, which, in many ways, act as an equivalent to shares. However, the debate also covers debt securities and securitised derivatives, which are part of the Official List, under directive minimum standards. For the moment, there is little retail exposure to these securities and, we would anticipate, there is likely to be relatively sound understanding among investment professionals that these securities involve a lower level of regulatory protection.

Nevertheless, as institutional investors are likely to value having a suitable 'floor' of regulatory standards, it is difficult to believe that these securities should not either be a) de-listed or b) subject to some super-equivalent rules.

For example, it is unconvincing that any issuer should be allowed to list their securities if they do not apply the listing principles set out in Chapter 7. If issuers of debt securities cannot commit to have systems in place to meet their obligations and deal co-operatively with the listing authority, why is the UKLA prepared to allow them to list at all?

The AIC therefore **recommends** that the UKLA should consider adjusting option 1 so that either:

- all securities which are not subject to appropriate super-equivalent standards are de-listed; or,
- it imposes relevant super-equivalent standards to create an acceptable regulatory baseline.

In reviewing super-equivalent standards which might be applied to debt securities and securitised derivatives the AIC **recommends** that the FSA/UKLA should consider, as a minimum, requiring issuers to comply with relevant listing principles (as set out in Chapter 7). It should also consider requiring warnings stating that these securities may not be suitable for all investors – particularly from the retail market. This might be done either as part of the selling process (for example, introducing COB rules which require intermediaries to supply

warnings) or via notifications included in published information (for example, attached to information distributed in the UK on the relevant securities).

Without adjustments to option 1 of this nature, the AIC is concerned that applying the term 'listed' to debt securities and securitised derivatives could dilute the value of a UK listing for equities, damage the reputation of the market, and potentially confuse investors.

The AIC also **recommends** that the FSA/UKLA consider whether or not a separate, dedicated, 'expert' market (which prevents access by retail investors) might have a place within the overall regulatory framework. Many (although not all) of the regulatory issues raised by this review arise from the fact that retail investors could potentially access listed securities. If there were explicit and robust exclusions of retail investors this might create options for the market which are currently inappropriate.

We would also comment briefly on the regulatory implications of adopting option 2. In particular, the notion that the FSA/UKLA could rely on labelling to distinguish different regulatory standards within the listed market segment. The AIC is unconvinced that this approach would allow it to successfully deliver its regulatory objectives.

If the CARD standards do not deliver an appropriate floor of regulatory protection, then it is not satisfactory to simply highlight that the tiers have different standards – the lower, inadequate tier should be withdrawn. If the higher tier includes requirements which go further than required to deliver the FSA/UKLA's objectives then these should also be withdrawn. It is not the FSA/UKLA's role to impose additional standards on the market over and above those needed to achieve its regulatory objectives.

The case for labelling different levels of protection within the listed sphere is unconvincing. The UKLA should simply set rules which achieve its required objectives, which all investors can rely upon within the listed segment.

**Q5: What are your views about opening up Secondary Listing for UK incorporated companies?**

There is no policy reason for treating UK companies differently from overseas issuers of equity. If the standards required by CARD are deemed appropriate for foreign companies then they are suitable for UK companies as well. The AIC does not believe that the CARD standards offer sufficient investor protection so would **recommend** that no companies be allowed to list in the UK using these rules. However, if this approach is not adopted the AIC **recommends** that all companies be treated the same regardless of domicile.

Discriminating against UK companies on the basis of their domicile is illegal under European law. As the CARD is designed to support the development of the European single market it is not credible to allow discrimination against companies according to which member state they are from. The AIC **recommends** that the UKLA should act to remedy this and grant UK and foreign companies equal treatment in relation to the Listing Rules.

**Q6: What are your views on how the provisions we have described above under core requirements should apply to overseas Primary Listed companies?**

The AIC **recommends** maintaining the current provisions in the Listing Rules regarding corporate governance as they deliver appropriate regulatory standards. They create an environment where overseas companies with a primary (super-equivalent) listing disclose their governance arrangements. This gives shareholders sufficient information to make an assessment of the company concerned (and make representations on governance as appropriate).

The AIC believes that pre-emption rights are a cornerstone of investor protection and that they make a major contribution to the positive reputation of the UK as a fair and orderly market. The AIC **recommends** that the Listing Rules should include provisions that require overseas issuers with a primary listing to offer their shareholders pre-emption rights. These rights are valued by all investors, both institutional and retail. Given the role that they play for the vast majority of shares which are UK listed, the lack of pre-emption rights for foreign issuers is likely to be an important source of investor confusion. Any costs for issuers associated with adopting these rights should be a reasonable exchange for the ability to secure the benefits of a 'UK listing' (i.e. deep and wide liquidity, favourable international reputation etc).

The AIC also recognises the value of the Takeover Code, as administered by the Takeover Panel, and the role it plays in maintaining the reputation of the UK market. This is an important part of the UK's shareholder protection architecture, and one which comes into play at a particularly sensitive time in the lifespan of a company. The AIC would therefore in principle support its application to all companies with a primary listing in the UK. However, there may be difficulties with this and any change would need careful consideration. We suggest that this is an issue for the Takeover Panel to consider and **recommend** that this is an agenda which the UKLA should raise with the Panel and work with it to see how these protections could be extended to all companies with a primary listing in the UK.

**Q7: Should we require the appointment of a sponsor for a transaction involving the issuance of GDRs? If not, are there any other responses to the significant growth in GDRs that are necessary?**

The AIC **recommends** that GDRs, which currently adopt the CARD standards, should be removed from the UK's official list. This will make their regulatory status clearer. It will differentiate them from securities adopting the standards traditionally applied to a 'UK listing'. This will be particularly helpful for retail investors but also for institutions.

It is not only the AIC which believes that there is investor confusion about the protections available when investing in GDRs. We note the recent public statements of Deloitte, which published an analysis of issues relating to GDRs. Its headline finding was that over a third of GDR issuers have admitted to weak financial controls. In commenting on the report, John Hammond, capital markets partner at Deloitte said, "*We believe there is a worryingly common misconception that GDRs are governed in the same manner as Primary Listings.*" (Deloitte News Release, 20<sup>th</sup> February 2008.)

Given these low levels of investor understanding in the market, it seems unlikely that simply giving GDRs a different label within the listed segment (option 2) will be sufficient to achieve the UKLA's regulatory objectives. This strongly supports the adoption of option 1.

If option 1 is adopted, the UK will still be able to offer GDRs trading as non-listed securities. They will simply lose the cachet of a 'UK listing' which is not backed up by appropriate regulatory standards.

If GDRs are de-listed, the AIC sees no reason for them to have sponsors. If they remain listed in the UK, applying CARD level standards but on a 'junior' market tier, then there may be a case for requiring sponsors. However, as it is the Listing Rules themselves (rather than sponsors *per se*) which are critical to upholding quality in the listed segment, imposing sponsors on GDRs has limited value.

The AIC believes that the minimum standards required of GDRs under CARD should be reviewed at a European level and **recommends** that the UKLA/FSA pursue this option as a priority. However, this is likely to be a long-term agenda, and if GDRs (adopting CARD standards) do remain in the listed segment (which the AIC does not support) the AIC **recommends** that the UKLA/FSA should consider what scope there is to introduce mechanisms that will explicitly warn investors that a GDR is subject to lower standards than other UK listed securities and that they may not be suitable for all investors – particularly retail shareholders.

These warnings might be done either as part of the selling process (for example, introducing COB rules which require intermediaries to supply warnings) or in

published information (for example, requiring warnings to be included with company information distributed in the UK). This approach would involve the UKLA imposing some additional requirements (albeit in a limited way). However, as the case for rejecting full-super equivalence largely depends on retail investors not accessing these securities, it is difficult to see that imposing measures to reduce this risk can be seen as creating unjustifiable burdens on GDR issuers.

#### **Q8: Do you have views on the labelling options?**

The AIC does not favour the use of terminology such as tier 1 and tier 2 for either option 1 or option 2 (if it were adopted). This wording does not provide a sufficiently clear indication that there are substantial differences in the level of standards offered. Reference to a 'directive' is not particularly helpful in creating a market distinction as the vast majority of investors, including institutions, will not be familiar with the requirements of CARD. Instead the AIC **recommends** that the label adopted by the UKLA should make an explicit link to 'standards'.

The AIC would **recommend** that for option 1, the official listing segment, Tier 1 should be renamed, "(UK) Premium Standard Listing" and Tier 2 (only available to debt securities and securitised derivatives) should be renamed "(UK) Minimum Standard Listing".

As explored in previous answers, the AIC believes that option 1 should be adjusted. If it were adjusted so that suitable super-equivalent rules were introduced (for example, requiring adherence to the Listing Principles for all UK listed securities) it might be possible to dispense with the need for a (UK) Minimum Standard Listing label. However, whether or not this would be possible would have to depend on whether standards were raised substantively or simply involved the creation of investor warnings.

In the 'regulated market' segment the AIC **recommends** the requirements should be renamed "(UK) Minimum Regulatory Standard". The 'Premium' label would then clearly link to UK equities adopting the super-equivalent standards. This approach would support marketing the 'UK listing' brand as superior to other offerings, particularly where equities are concerned.

The AIC **recommends** that if option 2 is adopted (which it does not favour) the same proposed terminology should be used within the listed segment. That is, Tier 1 should be renamed, "(UK) Premium Standard Listing" and Tier 2 should be renamed "(UK) Minimum Standard Listing".

The AIC notes that its proposed nomenclature would fit well with the UKLA's work to revamp the official list. Under option 1 the notation for the list could be "PSL" ((UK) Premium Standard Listing); "MSL" ((UK) Minimum Standard Listing) and in the unlisted market it would be "MRS" ((UK) Minimum Regulatory Standard).

## **Conclusion**

The FSA's conclusions on market segmentation should be driven by its regulatory obligations – not the commercial interests of market participants who may have a shorter-term view and different objectives. Of course, the competitive position of the UK markets should be a consideration, as there is no point in having a perfectly regulated market which no one uses. However, delivering the standards required (no more and no less) to ensure adequate market stability and integrity and investor protection must be paramount.

As current market experience is showing, sustaining markets which are profitable in the short-term, but where investors end up not understanding their exposure (from an investment or regulatory perspective), can cause deep and systemic risks when things go wrong. Effective market segmentation cannot, of itself, prevent investment failures, but it can create a regulatory baseline which will help limit the worst outcomes arising where failures in the securities markets do become serious and prolonged.

These benefits may be more difficult for market participants to appreciate in rising markets where high levels of confidence and demand have helped to raise the value of stocks across the market. In less certain conditions, delivering clear regulatory standards which provide a basic guarantee of market quality becomes increasingly important. Indeed, it may be that it is the super-equivalent features of the UK market which become increasingly marketable if economic conditions become more difficult and there is a 'flight to quality' by both issuers and investors.

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