ABI verdict on equity capital markets: not broken but room for improvement

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On 11 July 2013, the Association of British Insurers (ABI) published its report "Encouraging Equity Investment" following an extensive review of the processes for initial public offerings (IPOs) and secondary offerings. The review involved interviews with a wide range of market participants, including institutional investors, investment banks, lawyers and accountants. The report comes at a time in which the London equity capital markets have been subject to close scrutiny. Last summer, the Kay report was published which identified "short termism" issues in the equity markets and a decline in trust and confidence. The market is also eagerly anticipating the outcome of consultation paper 12/25 published last Autumn by the Financial Services Authority (replaced by the Financial Conduct Authority (FCA)), which proposed various changes to tighten up the corporate governance structure of the London listing regime.

Overall, the ABI concludes that the UK equity capital markets model is 'not fundamentally broken' but there are certain areas which should be addressed to improve the efficiency of the route to market. As one would expect, the ABI recommendations broadly favour investors and suggest that the current process model is biased towards issuers and their advisers.

Here is a summary of the ABI's key recommendations in relation to the deal process for IPOs and secondary offerings.

1. IPOs

Information "asymmetry" and price discovery

The ABI reports that there is an information "asymmetry" which exists in favour of issuers and vendors, at the expense of investors. In particular, investors believe that the current process is not structured to allow them sufficient time to properly consider and digest the investment case before making a decision on whether to invest, which has a significant impact on the success of the IPO. Consequently, the ABI makes the following recommendations:

Early engagement with investors

The ABI recommends that issuers and vendors should engage with investors up to a year or more before a planned IPO. This will enable investors to become familiar with the business and establish a relationship with management. Additionally, issuers, vendors and advisers have time to build upon this engagement to develop the investment case and prepare the company and management for the public market. Investors however, must ensure that they have appropriate resources committed to early engagement with issuers. In theory, this seems like a sensible proposal. Some companies, however, may be reluctant to engage with investors so early in the process. For example, certain issuers may wish to accelerate their route to market to take advantage of favourable market

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conditions and may not have the time to engage with investors a year in advance.

Earlier publication of the prospectus

Stakeholders note that the prospectus is crucial to the price discovery process. The report reveals, however, that investors believe that there is insufficient time in the IPO process for the prospectus to be properly considered. Consequently, this hinders their ability to provide incisive feedback to the banks so that a price range can be set. In light of these concerns, the ABI recommends that the prospectus is published a week earlier in the IPO process. If the prospectus is published and approved by the UKLA earlier in the process, there is likely to be more published independent analysis ahead of pricing. In order to achieve an earlier publication of the prospectus however, it is necessary to shorten the "black-out period". This is an established market practice which separates the publication of pre-deal research from the publication of the prospectus, in order to minimise the risk that the pre-deal research is seen as the product of the company. The ABI believes that issuers and advisers will be comfortable with this in relation to the UK regulatory risk, provided that the FCA provides specific confirmations to the market. These include that it will not regard connected research, if prepared and identified appropriately, as part of the prospectus and that the publication of research close to the time of the publication of the prospectus will not necessarily compromise its independence.

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Some might view these proposals as a radical shift in current market practice as the risk of liability for issuers and advisers, particularly in the US, cannot be completely eliminated. The ABI notes, however, that all parties it has consulted believe that the temporal separation should not be viewed as necessary if all other steps are taken to preserve the independence of the research. It will be interesting to see whether the FCA agrees to provide these confirmations which will assist in shortening the "black-out period" across the market. Even if the FCA did provide these confirmations, there is no guarantee that for those deals marketed into the US, issuers and underwriters' legal counsel would feel comfortable with shortening the period in order to reduce the timetable by one week, particularly, if the issuer has already engaged with investors from an early stage. The ABI notes that as far as they are aware, for US marketed deals, there have been no instances of actions by institutional investors. However, of course, past performance is no guarantee of future results as the ABI's members should be well aware.

Availability of independent research

Whilst connected research is seen as valuable, most investors would like to see more non-connected research written by independent analysts to address the balance of the research made available to them. However, there are restrictions in the current IPO process on independent analysts accessing and distributing their research before pricing. The ABI recommends that non-connected analysts have greater access to IPO analysts presentations (or similar presentations) so that they have the same information as the connected analysts. The ABI believes that the FCA clarifications mentioned above in relation to the shortening of the "black-out period" will mitigate any risks that companies may be liable for the content of such research. Alternatively, non-connected analysts should be able to publish and distribute research with reference to a prospectus published immediately after the UKLA approved intention to float announcement, which further supports the proposal for the earlier publication of the prospectus.

Syndicate size and allocation

Smaller syndicates

The ABI reports that overall, nearly all investors, investment banks and lawyers recognise the disadvantages of having larger bank syndicates and would favour a move towards smaller syndicates.

The ABI states that larger syndicates can be difficult to manage and amongst other things, can create a lack of clarity amongst the syndicate banks on their respective roles, with some banks not adding value to the process but simply being added with a view to develop future relationships with the issuer or as compensation for past advice rendered. Consequently, the ABI recommends that no more than three bookrunners should be appointed for transactions with value of £250 million or above, excluding any over-allotment option. Below this issue size, there should be no more than two members. Any additional members must add value to the process due to their sector expertise or distributional reach. The ABI does acknowledge, however, that vendors and/or companies may need to appoint more banks to the syndicate due to on-going relationships. In such cases, issuers should clearly specify to each member their roles and responsibilities.

Retail offers

Some investors and independent advisers have expressed concern that too few IPOs in the Premium segment contain any form of retail participation. There is a perception that retail involvement provides stable ownership on the register and consequently, the ABI recommends that issuers and vendors consider including a retail tranche when listing in the Premium segment. This will clearly depend on the nature of the business coming to market. Issuers and advisers will be reluctant to include a retail tranche for a business with little or no public profile. Little uptake on the retail side may unfairly prejudice the perception of business coming to market and have an impact on the overall success of the IPO. As is currently the case, issuers and advisers will consider all possible structures, including whether a retail offering would be appropriate, but will ultimately adopt the correct structure for the business, which may or may not include a retail offering.

Fees

It comes as no surprise that the transparency of deal fees remains a concern for new investors.

Fee breakdown

The ABI recommends that, as a matter of good practice, there should be better disclosure of all the fees paid, including the maximum incentive fee. This includes a breakdown of fees as a percentage of the size of the offering and detail on advisers' fees together with individual syndicate member fees.

Incentive fees

The ABI further recommends that the final determination and payment of incentive fees on an IPO should be made at the later of the release of the first quarterly results of the issuer as a listed company and three months after the listing. The amount paid should be disclosed to the market at the time of the award. The ABI also suggests a mechanism should be re-established for investors to provide input into the allocation of the incentive fee on an anonymous basis through the investor relations team of the issuer.

Free float and corporate governance

Investors are broadly supportive of the proposals in relation to governance set out by the Financial Services Authority in its consultation paper 12/25. Click here to read our article on the consultation for further information.

Overall, the report supports the strengthening of corporate governance measures for companies with controlling shareholders. The ABI states that the minimum free float for Premium and Standard listings should be maintained at 25%. The report provides that no reduction in the free float for premium listed companies should be made until appropriate safeguards for minority shareholders are proven to be effective in practice. In respect of corporate governance measures, the ABI makes the following additional recommendations.

Controlling shareholders' prospectus liability

A controlling shareholder or shareholders acting in concert with holdings of 50% plus 1 pre-IPO and any pre-IPO shareholder who will be party to a relationship agreement post IPO, should have liability for the IPO prospectus for companies seeking a Premium listing. Furthermore, the prospectus should include a responsibility statement from the controlling shareholders covering certain statements regarding the future conduct of the business and their future relationship with the company. Such shareholders would be held liable to the same extent as the issuer unless they can establish they had acted in good faith and did not directly or indirectly induce the acts of the issuer which resulted in the violation. The ABI further suggests that the FCA could amend the Prospectus Rules to provide for controlling shareholders to be persons responsible for certain content in prospectuses in a wide range of circumstances.

Relationship agreement

The ABI agrees with the proposals in consultation paper 12/25 that a relationship agreement should be entered into by the company with its controlling shareholders. The agreement should require the controlling shareholders to comply with their respective responsibility statements included in the prospectus. The ABI also proposes that controlling shareholders should be directly responsible to the UKLA in respect of their obligations under the relationship agreement. In order to enforce these provisions, the ABI calls for additional Listing Rules (which would require additional primary legislation) to impose obligations on controlling shareholders and the UKLA being able to sanction any breaches accordingly.

These recommendations may seek better protection for the minority, however, there is a danger that the shift in protection comes at a price which could undermine the competitiveness of the London listing regime. Whilst it is recognised that there should be appropriate safeguards to ensure that controlling shareholders are kept in check, imposing additional regulation and liability directly on controlling shareholders may deter them from investing in the London markets. Similar concerns were raised in response to the proposals set out in consultation paper 12/25. It will be interesting to see how the FCA deals with the various responses, particularly in light of these recommendations.

Independent board in place

The report notes that investors are concerned that a number of IPO applicants appoint their independent board members very late in the IPO process. The ABI also notes that vendors prefer to retain the option of appointing a fully independent board relatively late in the process as apparently there is a concern that undoing such appointments in the event that the IPO fails can be cumbersome. Consequently, the ABI has recommended a compromise by recommending that there should be a phased appointment of independent directors in the months leading up to the IPO but that in any event, the independent board should be in place by at least one month ahead of announcing the intention to float.

Prospectus – less is more

In line with the concerns regarding the amount of time available to investors to properly digest the investment case, the ABI calls for the amount of generic information (for example, generic and boiler plate risk factors; complex detail not suitable for retail investors) to be reduced. All stakeholders should work with the UKLA to achieve a more succinct document for investors. This recommendation is in line with the current movement to "de-clutter" annual reports in the market, so it is logical that the same approach is adopted in relation to offering documents, provided that all disclosure requirements are met. However, given the resistance to proportionate disclosure from many market participants, it will be interesting to see whether this recommendation does in fact lead to shorter prospectuses.

Sponsors and Independent Advisers

The report notes that investors tend not to differentiate between the role of the sponsor and the lead bookrunner. If a deal is unsuccessful, bookrunners are typically held responsible, irrespective of whether they are the sponsor. The report also states that the sponsor is usually one of the lead distributors of an IPO and may be conflicted if there are any contentious issues with issuer. The ABI notes that this has raised the possibility of other firms such as lawyers and accountants taking the role of sponsor, however, the ABI is silent on its own position on the matter. The ABI further notes that independent advisers are important in ensuring that the syndicate is well managed and that the interests of both the syndicate and the issuer are protected – a view that is not necessarily shared by all syndicate members.

2. Secondary offers

The ABI notes that the UK system is generally fit for listed issuers raising new equity capital but there are areas that can be addressed to improve the efficiency of the process.

Pre-emption rights

The report notes that investors remain concerned about the dilutive effects of non-pre-emptive issues. In particular, in all issues, investors are keen to be consulted ahead of non-pre-emptive placings. Consequently, the ABI will clarify its existing guidance on non-pre-emptive placings, open offers and rights issues. The ABI also recommends that the Pre-emption Group should reconvene and assess its Statement of Principles in light of recent market practice.

In particular, the revised guidance and Statement of Principles should provide clarity on:

- the limit for cash placings (including aggregate issuance for a period for longer than one year) and associated discount,
- the limit for vendor placings conducted on a non-pre-emptive basis and associated discount,
- the acceptability of the cash box structure when not used for acquisition funding,
- acceptable levels of capital raised and associated discounts for open offers,
- the reference price when calculating discounts and whether fees associated with such issues should be included, and
- the application of the guidance for the Standard segment and AIM.

The report further recommends that major existing institutional shareholders should be consulted in advance of non-pre-emptive placings.

Fees and discounts

Transparency of fees remains a concern for investors in respect of secondary offerings. The report reveals that investors are keen for greater transparency of fees and discounts of transactions. Consequently, the ABI recommends that the overall fee for rights issues and open offers should be "unbundled" so that amounts for advice, including document preparation, primary and sub-underwriting are shown separately in the offering documents, together with the deal fees for other advisers, including lawyers and accountants. It is hoped that this transparency will lead to competitive fees and ultimate value for investors. Furthermore, whilst there is no legal requirement for the disclosure of disaggregated fees, investors would like to see such disclosure as best practice. Other recommendations include that tendering for both primary and sub-underwriting should be pursued only if the unbundling of fees does not lead to a lowering of the overall fee levels; "buy-side" and "sell- side" should work towards developing standard sub-underwriting agreements; and aggregate fees charged and the discounts to the mid-market price at the time of agreeing the placing should be disclosed in the pricing announcements for non-pre-emptive placings.

Timetable

The ABI welcomes initiatives to shorten the pre-emptive offering timetable. In particular, it calls for the UKLA to investigate whether it would be feasible to introduce a fast-track review process for time critical offerings.

Too radical for the market or a voice of reason?

Some of the ABI recommendations should come as no surprise to the market. Greater transparency of fees and less clutter in offering documents, for example, have been items for change on investors' agenda in recent times. Other recommendations, however, such as the call to the FCA to provide prescribed confirmations to go towards shortening the established "black-out period" may be viewed as too radical by some market participants. The ABI, whose members are responsible for investment in 26% of the UK's total net worth, has significant influence over market practice and public policy concerning the equity capital markets. Consequently, the recommendations are likely to have some impact on the markets in due course – or at least open up a lively debate amongst stakeholders on how to implement them. It will be interesting to see if, and how the FCA addresses the ABI recommendations in its response to the feedback received to consultation paper 12/25 which it expects to publish at the end of the summer.