Quoted Companies Alliance

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Reforming Regulation Initiative
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To whom it may concern,

Reforming Regulation Initiative

We welcome the opportunity to respond to your Reforming Regulation Initiative consultation.

The Quoted Companies Alliance has advised on this response from the viewpoint of small and mid-size quoted companies.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

About you

Is your suggestion on behalf of an organisation?

- Yes
- No

Organisation information

Which of the following best describes the capacity in which you are responding to this survey?

- A representative of a company, charity, or voluntary sector organisation.
- A representative of a business advocacy body/group which represents the views of businesses.
- A third sector, advocacy, or academic organisation (e.g. trade union, issue-based advocacy group, think tanks, etc.)
- Other.

Please describe your business representative body

Approximately, how many businesses does your organisation represent?

- <50
- 50-500
- >500

What is the average number of employees of the businesses your organisation represents?

- Sole trader / self-employed
- <5
- <10
- 10-49
- 50-249
- 250 or more

Where in the UK are the businesses your organisation represents based?

- Nationally
- Scotland
- Northern Ireland
- North West
- North East
- Yorkshire and the Humber
- West Midlands
- East Midlands
- East of England
- Greater London
- Wales
- South West
- South East

- Overseas

What sectors do the businesses you represent operate in?

- Agriculture/mining/energy
- Manufacturing
- Construction
- Retail/distribution
- Transport and storage
- Hotel/catering
- Finance
- Property/management/business services
- Public administration
- Other (please specify below)

Is there anything else about your organisation that BEIS should be aware of?

We represent small and mid-size companies quoted on UK stock markets.

Your suggestion

Does your suggestion relate to the regulation of:

- Data protection
- The environment
- Farming or food
- Financial services
- Health and safety at work
- People's rights at work
- Workplace pensions
- Aviation and maritime
- Roads, vehicle standards and other transport
- How two or more of the above areas of regulation work together
- Something else (please specify below)

Corporate Governance

Please describe your suggestion below

Introduction

As the independent membership organisation that represents the interests of small to mid-size quoted companies, we support the Reforming Regulation Initiative's objective of helping to ensure that regulation is sensible and proportionate. The principle of *proportionality* is at the forefront of our policy work. We aim to ensure that any new regulatory or legislative action is appropriate in its approach, having regard to the smaller size and more limited resources of the companies we represent, as well as balancing the costs and benefits of these developments.

Recently, we welcomed both Sir John Kingman's and Sir Donald Brydon's recommendations in the *Independent Review of the Financial Reporting Council* and the *Independent Review into the Quality and Effectiveness of Audit*, respectively. The former recommended a reconditioning of the FRC's approach to place proportionality at the heart of regulation, whilst the latter expressed his commitment to ensuring a proportionate audit regime.

However, and notwithstanding these important developments, there is a considerable amount more that needs to be done in order to ensure a proportionate regulatory system.

The regulatory burden and de-equitisation

Given the vast differences in size and resources of public companies, regulation should be commensurate to these differences in order to be proportionate. By way of illustrating the size differences, we commissioned independent research provider, Hardman & Co., to conduct a study into the make-up of the UK's public markets. The study found that the largest 100 companies on the UK's markets account for 80 per cent of total market capitalisation, with the other 1,249 small and mid-size quoted companies accounting for just 20 per cent[1]. The smallest company in the FTSE All-Share is just 0.02% of the size of the largest, with a market cap of £35 million, compared to the largest at £111,641 million (as at 31 January 2020).

Despite the small size of these companies, their importance to the UK economy is significant. Small and mid-size quoted companies employ approximately 3 million people, representing 11 per cent of private sector employment in the UK, and contribute over £26.5 billion annually in taxes[2].

These companies require the appropriate platform to scale-up, grow, and create jobs and wealth across society. Yet, they too often find themselves overburdened by regulation that is targeted at larger companies but encompasses them too. The significant volume of regulation, combined with a one-size-fits-all approach to it, has been enormously damaging to public equity markets in the UK in recent years. The overall decline in use of public equity markets in the last few decades is stark and deeply concerning. Statistics issued by the London Stock Exchange and reproduced in Appendices I and II[3] of this document, reveal the extent of that decline over the last two decades. Furthermore, since 2007, the number of companies quoted on the Main

[1] Report by Hardman & Co. and the QCA, May 2019, *How small and mid-cap quoted companies make a substantial contribution to markets, employment and tax revenues,* https://www.hardmanandco.com/wp-content/uploads/2019/05/How-small-and-mid-cap-quoted-companies-make-a-substantial-contribution-to-markets-employment-and-tax-revenues.pdf

[2] Ibid.

[3] Appendix I: Number of Companies on AIM 1995-2019 and Appendix II: Number of Companies on the Main Market 2001-2019

Market has decreased by 25 per cent and the number of companies quoted on AIM has decreased by 49 per cent[4].

The de-equitisation crisis – that is, the rapid decline in the number of companies accessing public equity markets – has given rise to frequent commentary, with many commentators expressing their concern. In a survey published by the QCA and corporate finance and broking firm, Peel Hunt, this concern is evident. The survey, which took soundings from 110 small and mid-size quoted companies and 155 UK-based fund managers, found that 75 percent of respondents were concerned by the de-equitisation of UK stock markets[5].

Many studies have analysed and suggested reasons for this decline. The rise of private equity and low interest rates are often cited as contributory factors in the decline of public markets. However, to a much larger extent, the answer most frequently given is the regulatory burden of public markets. The QCA's Small and Mid-Cap Sentiment Index, produced in conjunction with YouGov, found that nearly three quarters (72%) of respondents deemed the regulatory burden to be the main reason for the decline in number of companies on public equity markets[6].

The importance of public equity and reducing the regulatory burden

Reversing the de-equitisation crisis, and thus, increasing the number of companies accessing public equity markets will be hugely beneficial to the UK economy. Public equity markets have the ability to exhibit resilience and adaptability in difficult circumstances due to the many advantages permanent equity has over temporary bank debt. A higher dependence on debt corresponds to higher levels of economic volatility, unstable financial systems and slower growth.

The current crisis relating to the outbreak of Covid-19 has undoubtedly necessitated an appreciable increase in corporate debt issuance through the various Government schemes. As the UK begins to emerge from the pandemic, there should be a gradual shift towards stimulating demand and building further resilience to future economic shocks. It is important that we recognise that small and mid-size companies – and equity finance in general – are critical in meeting the challenges of the current crisis, as well as any future crises.

One of the key obstacles to a V-shaped recovery is a persistent debt overhang that inhibits companies, and the economy as a whole, from reducing indebtedness, which would only serve to dissuade investment. It will become more and more important to lessen the primacy of debt, as well as introduce greater convertibility of debt to equity, in order to help assist a rapid recovery. In addition to this, and noting the importance of strong corporate balance sheets as vital to being resilient to further outbreaks, there comes a need to level the playing field between the incentives of raising debt finance and equity finance.

As such, and in order to stimulate a rapid recovery, the depth of the UK's public markets needs to be maintained and expanded on. It is, therefore, critical that public equity markets and the companies that reside on them are not crowded out by overburdensome regulation. With this in mind, and whilst the crisis

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[4] Report by Hardman & Co. and the QCA, May 2020, *Are the public markets closing to smaller companies: The evidence from the past 20 years in London,* https://www.theqca.com/article_assets/articledir_404/202121/Hardman-Insight-Are-public-market-closing-to-smaller-companies-May-2020.pdf

[5] QCA/Peel Hunt Mid and Small-Cap Survey, conducted by YouGov, February 2020, *To be or not to be a public company: The growing de-equitisation crisis,* https://www.theqca.com/article_assets/articledir_395/197511/To_Be_or_Not_To_Be_QCA_PeelHunt_Survey_Booklet_2020.pdf

[6] QCA/YouGov, Small and Mid-cap Sentiment Index, June 2019, *Regulatory burden and small and mid-size quoted companies in the UK*, https://www.theqca.com/article_assets/articledir_374/187271/QCA%20Small%20and%20Mid-Cap%20Sentiment%20Index%20Regulation%20analysis%20July%202019.pdf

has demonstrated that it is important not to increase the regulatory burden further, it has also highlighted elements of regulation that are inappropriate and not fit for purpose.

To this end, we have identified three overarching objectives that would help facilitate an early recovery and support small and mid-size quoted companies, which include: stimulating investment in the economy; enhancing the ability of companies to recapitalise; and permitting easy access to the public markets for new companies. These objectives can be achieved through reform and adjusting and/or relaxing certain provisions within certain pieces of regulation.

Proposals for regulatory change

As the UK begins to emerge from the crisis and leave the European Union, the Government is presented with the unique opportunity to diverge from EU-driven legislation that is not fit for purpose in UK markets. Specific pieces of legislation, such as the Market Abuse Regulation (MAR), Markets in Financial Instruments Directive II (MiFID II), the Central Securities Depositories Regulation (CSDR) and the Prospectus Regulation, amongst others, should be recalibrated in order to maximise their suitability and appropriateness for UK markets.

We have the following proposals to make regarding the aforementioned pieces of legislation.

MiFID II

How is MiFID II damaging the UK s public markets?

MiFID II has exacerbated the reduction in both the quantity and quality of investment research. We believe that this is particularly the case for research on small cap-securities, which has, as a result, had an adverse impact on liquidity within these securities.

As a general comment, we note that independent research on small and mid-size quoted companies is essential for increasing visibility and stimulating trading in their shares. Research eases price discovery and enhances liquidity, which in turn reduces the cost of capital for companies and encourages their growth.

MiFID II has undoubtedly further reduced the amount of research on small-cap securities. The nature of small and mid-size quoted companies dictates that research coverage is the only realistic and affordable means by which they can increase their visibility to the market through the provision of quality investment research. This has been significantly impeded by the introduction of MiFID II. This viewpoint is exemplified by investors and companies alike who have particularly negative perceptions around MiFID II in the small-cap segment of the market. For instance, the results of the QCA/Peel Hunt *Mid and Small Cap Survey* reiterate this[7]. The percentage of investors that believe that MiFID II has had a negative impact on liquidity for small and mid-cap stocks has grown from 54 per cent in 2017, to 63 per cent in 2018, to 79 per cent in 2019. As a result of MiFID II, less research is being produced and there are fewer brokers participating in the small-cap segment of the market, which has led to lower liquidity, greater share price volatility and higher-bid offer spreads. This has resulted in increased costs associated with raising finance coupled with reduced institutional access.

How can MiFID II be amended to support the UK s recovery and its public markets?

[7] Quoted Companies Alliance and Peel Hunt, 2020, Mid and Small Cap Survey, https://www.theqca.com/article_assets/articledir_395/197511/To%20Be%20or%20Not%20To%20Be_QCA%20PeelHunt%20Survey%20Booklet%202020.pdf

We believe that MiFID II should be amended to exempt small and mid-size quoted companies from certain aspects of the regulation. Doing so will make the regulation more proportionate and will ensure that companies of varying sizes can access the UK's capital markets.

In general, and in order to increase investment flows and improve the ability of companies to recapitalise, certain regulatory changes can be made to facilitate this. This includes:

- **Amending the costs and charges disclosure requirements under Article 24(4)** – it is widely considered that, due to their standardised format, costs and charges disclosures are seldom used by either professional investors or experienced retail investors, and as such, should be confined to retail investors only.
- **Reducing the need to continually produce sustainability assessments as contained in Article 25(2)** – in cases where investors regularly trade in certain asset classes, the need to repeat a sustainability assessment should be limited.
- **Limiting the need for telephone recordings** – many investors believe that these recordings inhibit an open dialogue with their investment advisers. In light of this, investors could be provided with an option to limit telephone recordings, subject to them opting-out of receiving these recordings, which would help facilitate investment flows into companies.
- **Changing the requirement for ex ante information to be delivered before the trade is executed as contained in Article 24(4) –** allowing for ex post delivery of documents in time-sensitive transactions would enhance investment flows.
- **Making best execution reports more informative and useful –** many consider best execution reports to be of limited usefulness and a clearer mandate on what needs to be reported would make them more informative.
- **Confining the product governance requirements in Article 16(3) –** confining these requirements to only encompass complex products and allowing other investments to be made would enhance the recovery phase.
- **Streamline the investment process to remove paper as the default mode of transmitting client information and other reports as required in Article 24(4) and 25(6).**
- **Enlarging the category of execution only products –** to include non-complex equity-based alternative investment funds would streamline the investment process.
- **Removing the end-of-day loss reporting requirements –** as they are not often utilised as they are not conducive to help formulate a longer-term strategic view.

MAR

How has MAR impacted the UK s public markets?

The Market Abuse Regulation, which came into force in July 2016, has created several issues for quoted companies. We highlight a number of concerns most relevant to small and mid-size quoted companies:

- **Insider lists –** creating and maintaining insider lists in accordance with Article 18 of MAR considerably increases administrative burdens as it requires companies to establish highly costly internal systems and/or processes. Whilst small and mid-size quoted companies listed on AIM are exempt from the requirement to create and maintain an insider list, many small and mid-size quoted companies listed on the Main Market have to produce an insider list. The smaller size and more limited resources of these companies means that the requirements are particularly onerous and burdensome given the level of resources required to produce an insider list. In addition, and whilst seemingly positive that AIM listed

companies are exempt, this exemption is misleading. That is, many of these companies still need to have sufficient systems and procedures in place as they can be requested by the FCA to produce an insider list.

- **Market soundings –** the requirement to maintain internal procedures to deal with market soundings is overly burdensome for certain market sounding participants. The current market sounding regime contained within MAR provides for a detailed procedure on how issuers and investors can transmit and exchange information in order to gauge interest in a transaction. This involves a procedure compromising detailed record keeping obligations, as well as the need to obtain consent regarding being able to exchange information relating to a potential transaction. For certain market sounding recipients, such as small companies who do not have the appropriate measures in place, this can be particularly troubling.
- **Managers' transactions –** under MAR, companies are required to report to the FCA, as well as to the public, the transactions carried out by the managers in the company's shares. There is a lack of guidance on what type of transactions do and do not need to be disclosed, as well as the scope of the relevant provisions in the context of different types of transaction. In addition to this, the processing and recording of these transactions is time-consuming and creates a significant compliance burden.

How can MAR be amended to support the UK s recovery and its public markets?

- **Suspension of insider lists for new market entrants –** the need to create and/or maintain and update insider lists could be suspended for a period of five years after a company first lists. As a replacement for producing an insider lists, a company would be required to have its employees sign a simplified non-disclosure letter which would recognise the confidentiality of the information that they might have access to. This would serve to greatly increase the attractiveness of public markets for companies considering the option of listing as they would not be immediately subject to the full panoply of regulation.
- **Streamlining the market sounding regime –** more generally, record keeping requirements should be simplified and guidance on the steps to be taken when making a disclosure should be provided. However, in light of current circumstances, temporary alleviations, or even a temporary 5-year suspension, of the market sounding regime would be hugely beneficial. The market sounding regime is not conducive to raising capital or conducting an IPO, and thus, limits the ability of companies attracting investment and potential new market entrants seeking a listing.
- **Raising the threshold for managers 'transactions –** a potential alleviation to this would be to raise the threshold above which managers have to notify transactions in the issuers shares to the FCA.

CSDR

How will CSDR damage the UK s public markets?

The Central Securities Depositories Regulation came into force in September 2014, but many of the provisions, including in relation to settlement discipline, for instance, have been postponed, and will likely be implemented in February 2021.

We are highly concerned about the potential impact of CSDR on the liquidity of small-cap securities. If implemented unchanged, its introduction is likely to have a significant impact on the ability of smaller quoted companies to raise capital, as well as on the functioning of capital markets for these companies in the UK.

Under the current model, market makers provide an essential function for smaller companies with less liquid securities as they provide liquidity when there is an imbalance between buyers and sellers. This model

ensures the provision of continuous liquidity, investor confidence and access to capital markets for smaller companies.

However, CSDR threatens this model through the introduction of a fining regime which requires market participants to deliver securities by the intended settlement date or face penalties with an enforced and expensive buy-in process. These penalties will impact market makers to such an extent that making markets in less liquid securities becomes uneconomical. As a result, market makers are forced to widen spreads significantly or withdraw from making markets in a potentially significant number of illiquid securities. CSDR, therefore, will have severe implications on liquidity for smaller quoted companies, as well as leading to greater price volatility.

The prospect of reduced liquidity, higher price volatility and wider spreads are not only major disincentives for investors, but will also discourage companies seeking a listing, further increasing the decline in use of public equity markets.

What are the potential solutions that might be considered to help address the impact on liquidity and the UK s public markets?

- **Market-led solutions –** we believe that the UK should take the opportunity provided by Brexit to amend CSDR so as to:
    - Provide that the failure penalties will not apply in the context of SME/illiquid shares;
    - Provide a lighter-touch version of the failure penalties for market markers making markets in SME/illiquid shares (i.e. with some removed or lessened);
    - Make buy-ins optional in the case of SME/illiquid shares; or
    - Provide bespoke Settlement Obligations with much longer deadlines.
- **Alternative solutions –**
    - As Article 7(7) of CSDR states that "if the buy-in fails or is not possible, the receiving participant can choose to be paid cash compensation or to defer the execution of the buy-in to an appropriate later date", participants could agree at the beginning of the process that, should a buy-in fail, the receiving participant will defer the execution of the buy-in rather than receive cash compensation.
    - As the buy-in process does not preclude the possibility of the counterparties to a transaction bilaterally agreeing to cancel the transaction, it may be possible for market markers to introduce provisions into the contracts with their clients saying that the parties agree that transactions will be terminated before any breach of the Settlement Obligation.
    - There could be a choice for markets makers 'counterparties to opt out of the failure penalties.
    - Introduce compulsory stock-lending, so that CSDR-regulated late settlements would be replaced by exchange-regulated securities loans. If each UK market introduced a compulsory stock lending system whereby the relevant market administered a central stock lending facility through which participants (including market makers) could borrow stocks at reasonable rates then market makers would be able to borrow the relevant shares and deliver them to the relevant participant in order to satisfy the Settlement Obligation.

Prospectus Regulation

What are the issues regarding the Prospectus Regulation?

The complexity and cost of producing a prospectus means that it actively inhibits a company's access to the public equity markets in the UK. This is particularly pronounced for small and mid-size quoted companies, who extremely rarely offer shares to the public. In a survey conducted by Practical Law for its "*What s Market*" column, which focused on AIM companies with a market capitalisation of £25 million or more, found that only 34 such companies had issued a prospectus between 2008 and 2020.

As an alternative to raising capital, many small and mid-size quoted companies will conduct "placings" with institutional investors. However, this severely limits the participation of retail investors, who provide crucial liquidity in the public markets.

What solutions might be considered to better suit UK public markets?

We are currently in the process of formulating a proposal for a modified domestic securities offering regime that seeks to address the abovementioned issues for small and mid-size quoted companies. This regime will operate alongside, and as an alternative to, the existing prospectus regime. The proposal will be issued shortly.

In addition to diverging from the aforementioned pieces of EU-driven legislation, the Government also needs to ensure that domestic regulation/legislation is appropriate and proportionate.

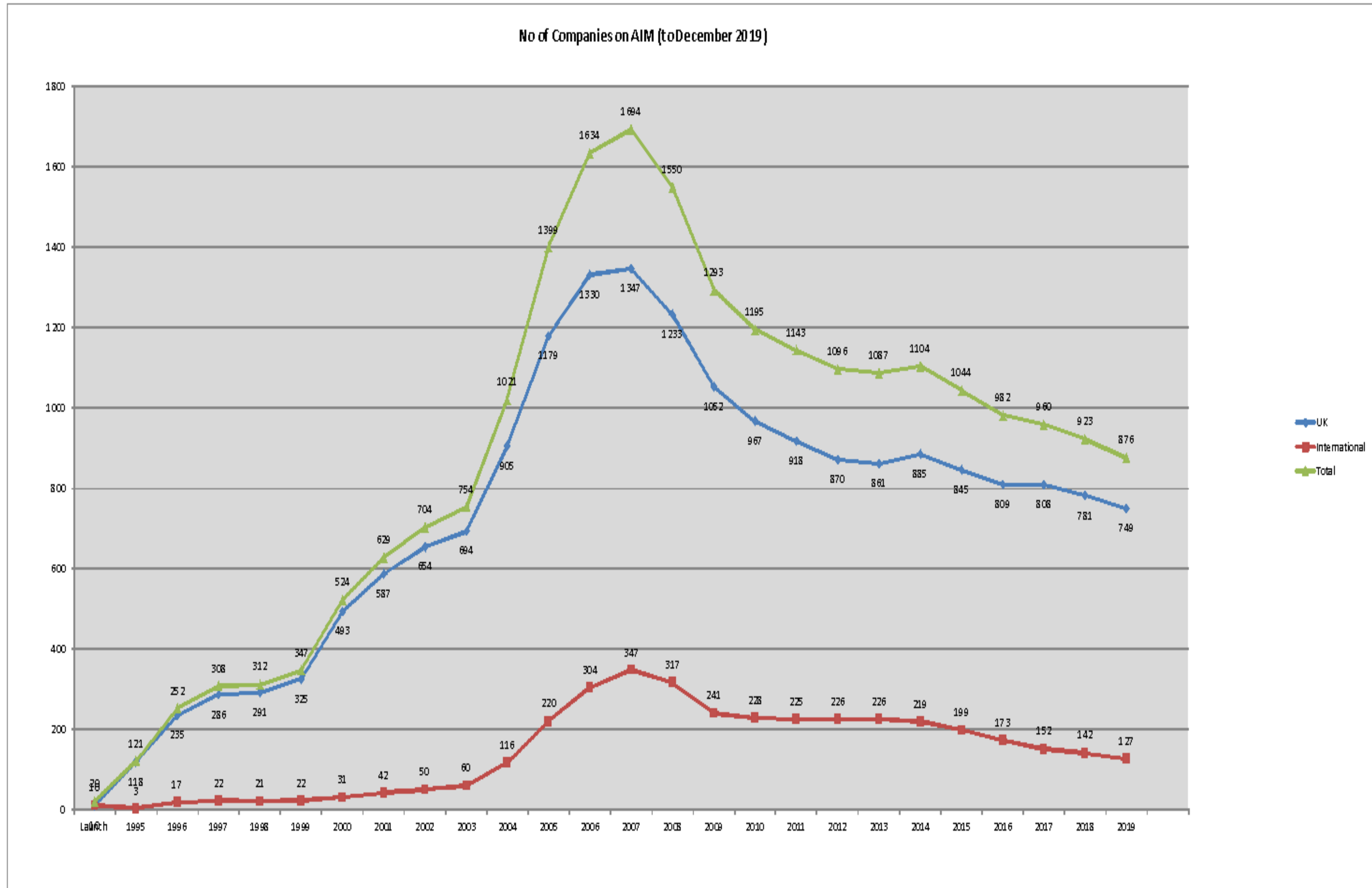
Corporate Governance and ESG

Firstly, we stress the importance of having a flexible, principles-based and outcome-oriented approach to corporate governance that allows smaller companies, with less resources, to communicate their governance arrangements without being overly burdened by prescriptive requirements. This will allow smaller companies to commit to their growth paths whilst simultaneously improving the perceptions that surround the governance practices of small-cap companies in the UK.

Secondly, and whilst we are supportive of the need for action to enhance Environmental, Social and Governance (ESG) practices, the Government must be mindful of the gulf in size between the largest and smallest companies. Any proposals should be proportionate to the size of the company. In order to ensure that smaller companies are not disproportionately impacted, the extent to which a company is expected to comply with additional ESG and/or reporting requirements should be commensurate to size, capacity and available resources.

There are significant disparities between smaller companies and larger companies, who typically have more mature and sophisticated processes and systems for analysing and quantifying ESG risks. The complexity of the developing ESG agenda is such that it requires significant technical resources for monitoring, researching and analysing in order to produce meaningful results for investors. Many smaller companies in their early developmental stages do not have the necessary systems in place, or even the capacity to put these systems in place, to make sophisticated environmental and social disclosures. As a result, we believe that smaller companies should be encouraged, but not required, to make ESG disclosures where they believe it necessary and appropriate for their stakeholders and without it being overly burdensome and detrimental to their business.

Appendix I



Appendix II