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Treasury Committee
House of Commons
London
SW1A 0AA

Monday 15 February 2021

Dear Treasury Committee members,

The Future of the UK's Financial Services

The Quoted Companies Alliance welcomes the opportunity to respond to your call for evidence on the future of the UK's financial services.

As the independent membership organisation that represents the interests of small to mid-sized quoted companies, we support the Treasury Committee's inquiry into the future of financial services. We have over 200 quoted companies as members, drawn from across the Main Market, AIM and the Aquis Stock Exchange, as well as over 80 advisory members, including market participants, such as investors, brokers, Nominated Advisers, accountants, and law firms.

There are approximately 1,250 small and mid-sized quoted companies in the UK, representing 93 per cent of all quoted companies. These companies employ over 3 million people, constituting 11 per cent of private sector employment in the UK and contribute £26.5 billion in annual taxes[1].

The value of small and mid-sized quoted companies to the UK economy is vast, and we seek to create an environment where their potential can be fulfilled. 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.

Please note that, as the independent membership organisation representing the interests of small and mid-sized quoted companies, our response is only concerned with issues that relate to companies listed on public equity markets.

If you would like to discuss our response in more detail, please do not hesitate to contact us.

[1] Hardman & CO. and the QCA, May 2019, How small and mid-cap quoted companies make a substantial contribution to markets, employment and tax revenues, available at: 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

Yours sincerely,

Tim Ward
Chief Executive

Summary

It is important to consider the context of the decline of the UK's equity markets.

Since 2007, the number of companies quoted on the Main Market has declined by 25% and the number of companies quoted on AIM has declined by 49%[2]. Studies, such as the *QCA/Peel Hunt Mid and Small-Cap Survey*, have suggested reasons for this decline, with 60% of respondents attributing this to overly burdensome listing requirements[3]. Appendices 1 to 4 reveal the extent of decline in the number of companies on the Main Market and AIM and the decline in number of companies coming to these markets.

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 to 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[4].

The fact that the number of total quoted companies has been falling for so long is evidence that significant reform is necessary. In this response, we present a number of potential solutions to the key issues with financial services regulations and the regulatory framework.

In particular, we propose that:

- The UK should take the opportunity presented to it following the withdrawal from the European Union (EU) to ensure that regulation is calibrated specifically for UK markets and that it is proportionate in its scope and application. This includes amending the:
    - Markets in Financial Instruments Directive II;
    - Prospectus Regulation; and
    - Market Abuse Regulation.
- To facilitate the emergence of new growth for the financial services sector, the UK should address the current gap in the public equity market offering by reinventing the Standard Listing segment.
- In order to effectively influence financial services regulation, Parliament needs to develop a better understanding of the nature and benefits of public equity markets.
- Financial services regulation should be scrutinsed by conducting a cost-benefit analysis on a segmented basis and the regulators must be held to account.

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[2] Report by Hardman & Co and the QCA of May 2020: *Are the public markets closing to smaller companies – The evidence from the past 20 years in London*

[3] QCA/Peel Hunt Mid and Small Cap Survey, conducted by YouGov: *To be or not to be….a public company – the growing de-equitisation crisis.*

[4] 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

Responses to specific questions

Q What changes should be made to the UK's financial services regulations and regulatory framework once the UK is independent of the European Union?

In respect of the changes that should be made to the UK's financial services regulations and regulatory framework now that the UK is independent of the EU, we have two overarching general comments. Firstly, that financial services regulation and the regulatory framework are amended so that they are calibrated specifically for UK markets and, secondly, that any regulation is proportionate in its scope and application.

We believe that the Government should take the unique opportunity presented to it to diverge from EU-driven legislation that is not fit for purpose for UK markets.

An example of such positive action is the announcement by the Chancellor that the EU settlement discipline regime (as contained in the Central Securities Depositories Regulation (CSDR)) is not being implemented in the UK. The QCA has already welcomed this, however, more needs to be done.

Specifically, we believe that recalibrating certain pieces of legislation, such as the Markets in Financial Instruments Directive II (MiFID II), the Prospectus Regulation and the Market Abuse Regulation would help to optimise their suitability and appropriateness for UK markets.

We have the following proposals to make regarding the aforementioned regulations:

<u>MiFID II</u>

Since its introduction in 2018, MiFID II has had a detrimental impact on small and mid-sized quoted companies (SMQCs). Most significantly, MiFID II has:

- Heightened the lack of availability of research on SMQCs, both in terms of reducing the quantity and quality of research produced;
- Limited SMQC visibility, which has inhibited price discovery and reduced trading in their shares;
- Potentially contributed to greater share price volatility and higher-bid offer spreads;
- Led many to believe that it is the reason for the reduced number of brokers participating in the small-cap segment of the market;
- Impeded engagement between brokers and investors;
- Increased costs associated with raising finance coupled with a lack of institutional and retail investor appetite for the financial instruments of SMQCs; and
- Arguably had an adverse impact on liquidity within SMQC securities.

The QCA/Peel Hunt *Mid and Small Cap Survey*[5] demonstrates this. 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% in 2017, to 63% in 2018, to 79% in 2019.

The survey, which took soundings from 110 small and mid-sized quoted companies and 155 UK-based fund managers, also found that:

- 54% of small and mid-cap companies experienced a decrease in the amount of research produced on their company under MiFID II;
- 82% of UK fund managers saw less research being produced on mid and small-caps as a result of MiFID II;
- 70% believed that MiFID II had had a negative impact on small and mid-cap liquidity;
- 89% of investors and 90% of companies believe that there will be fewer brokers in the next three years; and
- 99% of companies believe that MiFID II will be part of the cause of fewer brokers.

As a result of the above, we believe that future UK legislation should be amended to exempt small and mid-sized quoted companies from certain aspects of the regulation to make it more proportionate and not be a deterrent to companies of varying sizes using the UK's capital markets effectively. The current COVID-19 pandemic and the UK's withdrawal from the EU make it even more important to alleviate unnecessary burdens, increase visibility and provide liquidity opportunities for UK PLC.

Specifically, we propose that small and mid-sized quoted companies should be exempted from the unbundling rules in MiFID II. When research is exclusively on small and mid-cap issuers, investment firms should be able to choose not to apply the current requirement to set up a research payment account or pay for research with its own resources. This should be available for research and services relating to small and mid-cap issuers that do not exceed a market capitalisation threshold of £1 billion. The freedom to bundle or unbundle will increase choice and allow brokers and fund managers to adopt a variety of acceptable business models.

Furthermore, we would also propose a review of the Financial Promotion rules that currently inhibit the distribution of small and mid-cap research so as to allow research to be distributed to a wider group of investors, subject to the incorporation of appropriate safeguards.

In addition, we would like to make the following comments:

1. It is not only the receipt of research that has been impacted as a result of MiFID II. It has also impeded broker engagement with companies and investors in restricting a brokers' ability to organise company meetings and for an investor to speak to an analyst about a company or piece of research. These conversations already take place within a regulated environment, covered by MAR, other MiFID II and FCA rules and should not be dependent on having a research agreement.

[5] QCA/Peel Hunt, February 2020, Mid and Small-Cap Survey, available at: https://www.theqca.com/article_assets/articledir_395/197511/To_Be_or_Not_To_Be_QCA_PeelHunt_Survey_Booklet_2020.pdf

2. Whilst changes to the rules may help increase the availability and distribution of research, we believe that the impact of such changes is unlikely to be significant since brokers will continue to be reluctant to cover companies (in particular many SMEs) where there is little commercial benefit in doing so. As a result, such companies may have to direct their focus on issuer paid (sponsored) research. We believe that the quality and therefore status of that research could be significantly improved by the establishment by the regulator of a code of conduct for issuer-paid (sponsored) research, whether it be by a broker or sponsored house. The requirement to comply with such a code would increase confidence in issuer paid research and thereby make it more effective.

3. The retail investment community is of paramount importance to SME companies. The key issue that brokers have is that distribution of their research is restricted to a limited class of investors, and it is difficult for brokers to engage with retail investors who are key to liquidity in SME stocks. The issue is compounded by the fact that, where a broker is charging institutions for its research, it is difficult to justify that charge if the research is also being distributed free of charge to retail investors. Any solution will need to accommodate this and other commercial issues presented by the current rules.

Prospectus Regulation

The QCA does not believe that the prospectus requirements and situations in which prospectuses are required are appropriate for the UK's equity markets.

We believe the volume and complexity of these requirements actively inhibit access to the public equity markets, for smaller companies in particular. These requirements have increased the initial and ongoing costs of securing and maintaining a listing/quotation on the UK's exchanges. As a result of the UK's withdrawal from the EU, we are presented with the opportunity to recalibrate our securities markets and tailor them to address these flaws.

We believe that fixing the current imbalance between these requirements and investor protection on the one hand and workability and competitiveness on the other will have a significant positive impact for smaller companies and the UK economy as a whole.

We have developed a proposal for the creation of a domestic securities offering regime, which seeks to reduce the costs of entry to our domestic public markets for companies and facilitate the participation of retail investors in initial and secondary equity issues. This proposal has been shared with the FCA.

Companies which use the new disclosure regime would be able to offer securities directly to the public through an offering document without the need to marshal the considerable resources and accommodate the extended timetable required for the production of a vetted and approved prospectus under the Prospectus Regulation. The Offering Document would operate alongside, and as an alternative to, the Prospectus Regulation.

This Offering Document could be made available as a means to IPO and raise further funds for companies on AIM and the Aquis Stock Exchange (AQSE), as well as smaller companies on the Main Market. It would not be required to be pre-vetted provided that an adviser took responsibility for ensuring that all aspects had been addressed.

The adoption of the domestic securities offering regime would promote and facilitate the use of public offers across all these market segments and increase the number of retail investors holding shares in companies with benefits for liquidity and price formation. This would markedly increase the attraction of the UK's markets.

If you wish to view our full proposal, we can send this to you separately. This was submitted to the FCA in August and it is currently under discussion.

In addition, we believe that the current threshold requirements that mean a prospectus has to be produced could be changed to better reflect the nature of the UK's markets rather than be the result of negotiation between 28 very different market environments.

The thresholds that dictate when a prospectus is required are a significant obstacle, for example, when raising funds over €8 million, or if securities are offered to more than 150 non-qualified investors.

For many years the QCA has championed raising the threshold from €8 million to £50 million, which is considered to be better calibrated to the UK market because the UK has, uniquely, financial promotion rules to protect investors in addition to those required by EU law. The €8 million level is an EU compromise amongst 28 different markets.

Similarly, the requirement to produce a prospectus if securities are offered to more than 150 non-qualified investors is artificial and overly restrictive. This rule is especially restrictive for smaller companies, where a larger percentage of their investors are from the retail community. In light of this, we would suggest removing increasing the threshold of 150 non-qualified investors entirely and instead allow any number of investors to invest subject to a requirement that they can certify that they have sufficient knowledge and aptitude to invest in certain stocks. Existing shareholders should be excluded from any calculation.

Whilst these changes may seem significant, it is fundamentally important that they are meaningful, so as to have a worthwhile impact.

There should also be no need to produce a prospectus when a company is conducting a secondary fundraising, including a rights issue or where the company's share capital has increased by more than 20% in any 12-month period. Instead, there should be a confirmation that all the necessary information is in the market unless otherwise disclosed in the announcement of the fundraising.

Market Abuse Regulation

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-sized 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 high-cost internal systems and processes. Whilst small and mid-sized quoted companies listed on AIM are exempt from the requirement to create and maintain an insider list, many small and mid-sized 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 at any time.

- **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 comprising 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. A more proportionate approach should be allowed to develop as good market practice.

- **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.

In order to overcome these issues, we propose:

- **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.

Q How can Government policy and the UK regulators facilitate the emergence of FinTech and new competition; develop new areas of growth for the financial services sector; and promote the UK as the best place to incubate new financial technologies and firms?

It is widely recognised that there currently exists a significant gap in the UK's public equity market offering. This is inhibiting the growth and progression of companies, as well as resulting in UK-based companies considering listing on foreign stock markets. As highlighted above, the number of companies on the UK's exchanges has been decreasing alarmingly year-on-year and the number of initial public offerings (IPOs) has also been dwindling.

This partly reflects the choice of many companies to stay private for longer, sell up or float on overseas exchanges such as those in the US or Asia. At present, the UK is failing to be the automatic choice of the new wave of companies growing in industries such as digital, fintech and green finance, with London often losing out to the US and Asia for the most significant IPOs.

The Government and regulators must work with market operators and key intermediaries to encourage more companies to list on UK exchanges. In order to address this and attract more fast-growth and founder-led companies, significant reform that goes beyond simply tweaking regulation is necessary so that the UK can remain competitive and enhance its position as a global financial centre.

The QCA recently welcomed Lord Hill's Call for Evidence into the UK's listing regime and submitted a detailed response which we believe provides a solution to the current gap in the UK's offering. Namely, we believe that the UK should reframe the "EU minimum" Standard Listing segment of the Main Market to emulate the success of the growth-focussed Nasdaq market in the United States. This would become the middle tier of the stock market and would offer a progressive path for companies that have outgrown AIM and are not yet well-suited to the disproportionately higher levels of regulation on the Premium Listing segment.

This market would be attractive for companies considering a flotation to accelerate their growth and would be designed to attract foreign companies as well as retaining UK-founded companies. Whilst it is likely that this market will have significant appeal for tech companies, we envisage that the market will provide listing opportunities for a range of companies in all sectors of the economy and across geographical regions. It is not the intention of this proposal to copy the Nasdaq model identically, but to build a market that is designed specifically for the UK environment. This will encourage accelerated growth companies – tech, e-commerce and science in particular – to remain in the UK and create wealth and jobs.

You can view our full proposal here.

Q What role does Parliament have to play in influencing new financial services regulations?

The QCA believes that Parliament has an important role to play in influencing new financial services regulation in order to ensure that it is appropriate, fit for purpose and proportionate. However, in order to effectively influence financial services regulation, it is first important that Parliament develops a deeper understanding of public equity markets and the companies that operate on them.

Firstly, it is important to ensure that there is a common understanding of the significant size differences between the companies on the UK's exchanges. There are vast differences in size and resources of public companies and regulation should be considerate of 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[6].

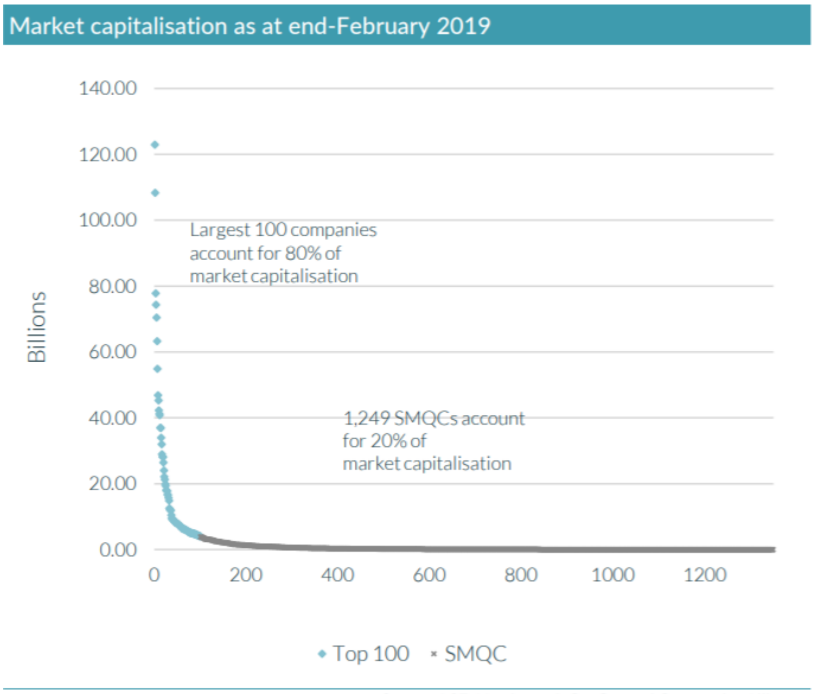
The smallest company in the FTSE All-Share is just 0.025% of the size of the largest with a market cap of £27 million. The largest company has a market cap of £107,720 million[7].

[6] 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

[7] FTSE Russell, January 2021, FTSE All-Share Indexes, available at: https://www.ftserussell.com/analytics/factsheets/home/search

These smaller companies find themselves too often overburdened by regulation that is targeted at larger companies but which encompasses them too. The significant volume of regulation, combined with a one-size-fits-all approach, 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.

This chart shows all companies quoted on London Stock Exchange's Main Market and AIM by market capitalisation. It illustrates the huge disparities in size between the largest 100 companies and the remaining 1,249 small and mid-sized quoted companies:



Source: LSE. Hardman & Co. Quoted Companies Alliance

Secondly, it is important to stress the social and economic benefits of public equity markets. The UK should seek to celebrate and encourage the role of public companies and their significant contribution, both regionally and nationally, to the UK economy.

We have already highlighted in our introductory letter the significant contribution of public equity markets to private sector employment and the Exchequer's tax take. In addition to this, it is estimated that the small and mid-sized quoted company community alone directly employs nearly 1.5 million people outside London and across the UK's nations and regions[8]. This demonstrates their potential importance in addressing regional inequality, and creating jobs and wealth throughout the economy.

In light of this, the role of Parliament should be to influence new financial services regulation to ensure that any new requirements are proportionate. That is, the extent to which a company is expected to adhere to new requirements or comply with regulation should be commensurate to size, complexity and available resources. Parliament must take into consideration the additional administrative burden and costs that new regulation would have on smaller companies. Failing to bear this in mind could limit the growth of these

[8] Hardman & CO. and the QCA, May 2019, How small and mid-cap quoted companies make a substantial contribution to markets, employment and tax revenues, available at: 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

companies, and, ultimately, result in companies delisting to seek less-burdensome means of gaining access to finance.

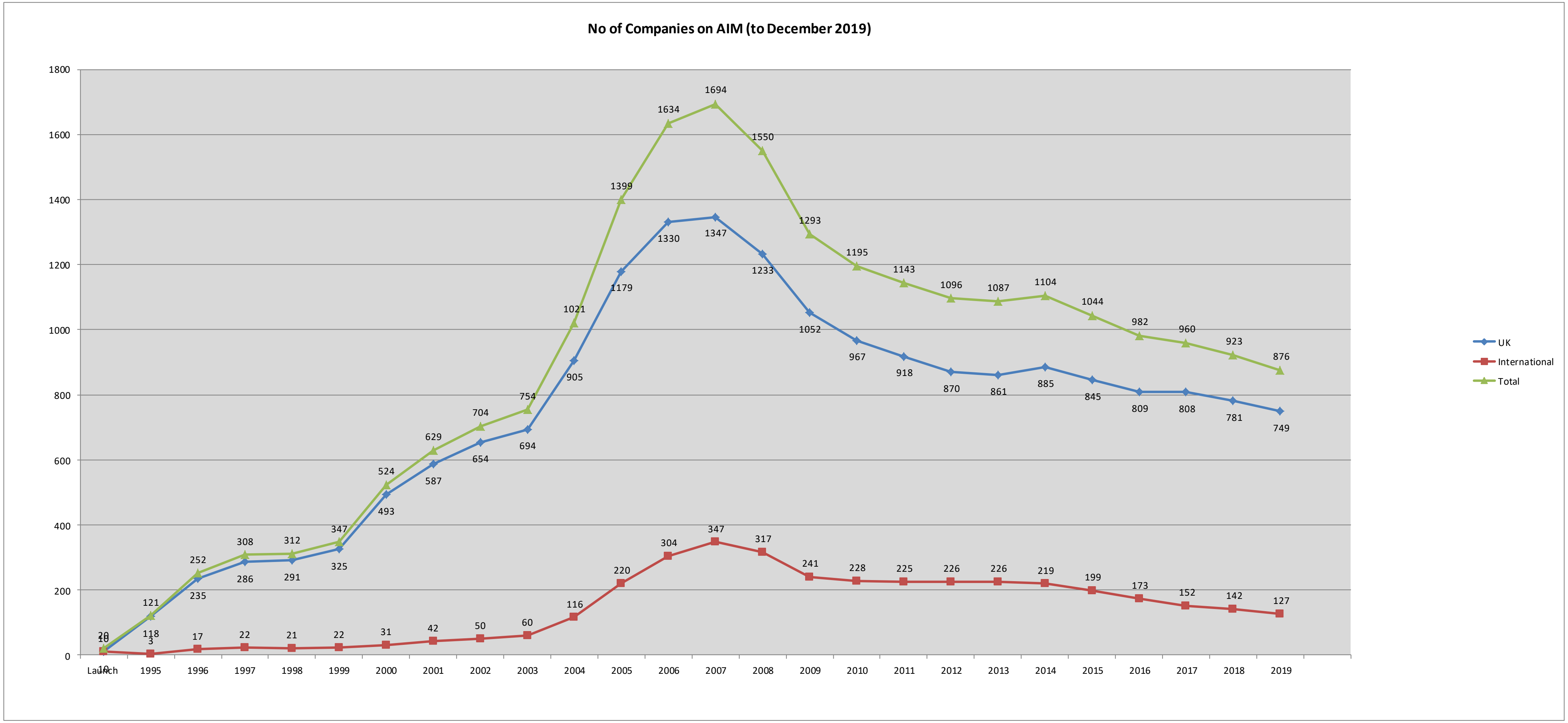
We believe that there is merit in considering whether a relevant Minister should be required to account to Parliament annually as to the quality and integrity of the public equity markets taking into account the need for a proportionate approach. This would help to inform Parliament of the nature of markets as well as exert pressure on the market players to consider the social and economic benefits of the UK's public equity markets.

Q How should new UK financial regulations be scrutinised?

It is important that the development and implementation of financial regulation is properly scrutinised. If we expect to see a new wave of growth companies joining our equity markets and developing into significant contributors to our economy, then any cost benefit analysis of a proposed regulation should be looked at with these companies in mind. The current weighting of the market where the largest 100 companies on the UK's markets account for 80 per cent of total market capitalisation means that any regulation aimed at constricting their behaviour will obviously be seen as a net benefit for the market overall. However, the impact on growth companies can often be seriously detrimental to the UK's growth prospects. Therefore, any cost benefit analysis, by law, should be conducted on a segmented basis as well as looking at the market as a whole. The impact of MiFID II could have been different if the impact analysis had been done as we suggest. As the UK has now left the EU, the regulatory regime must be less prescriptive and more agile than has been the case within the EU.

The regulators must be accountable and subject to an appropriate level of scrutiny. Additional mechanisms and controls are needed to ensure Government and regulators' policy decisions are made in the interests of the UK economy and that their actions in this regard are held to account. A framework should be established whereby both legislation and the performance of the regulators in looking at the market on a segmented basis are assessed. In addition to this, it is important to increase the transparency of Government and the regulators in their decision-making.

Appendix 1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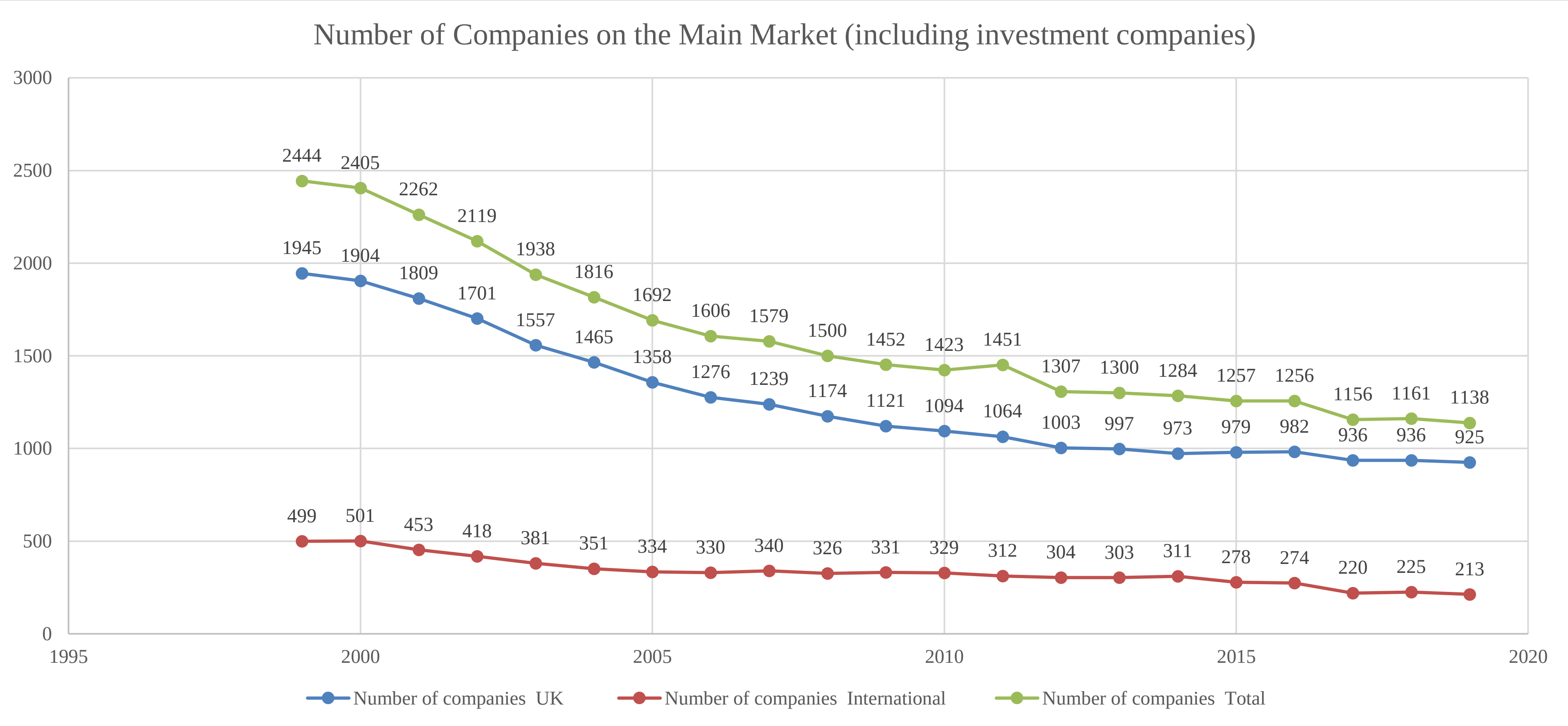
Appendix 2[9]



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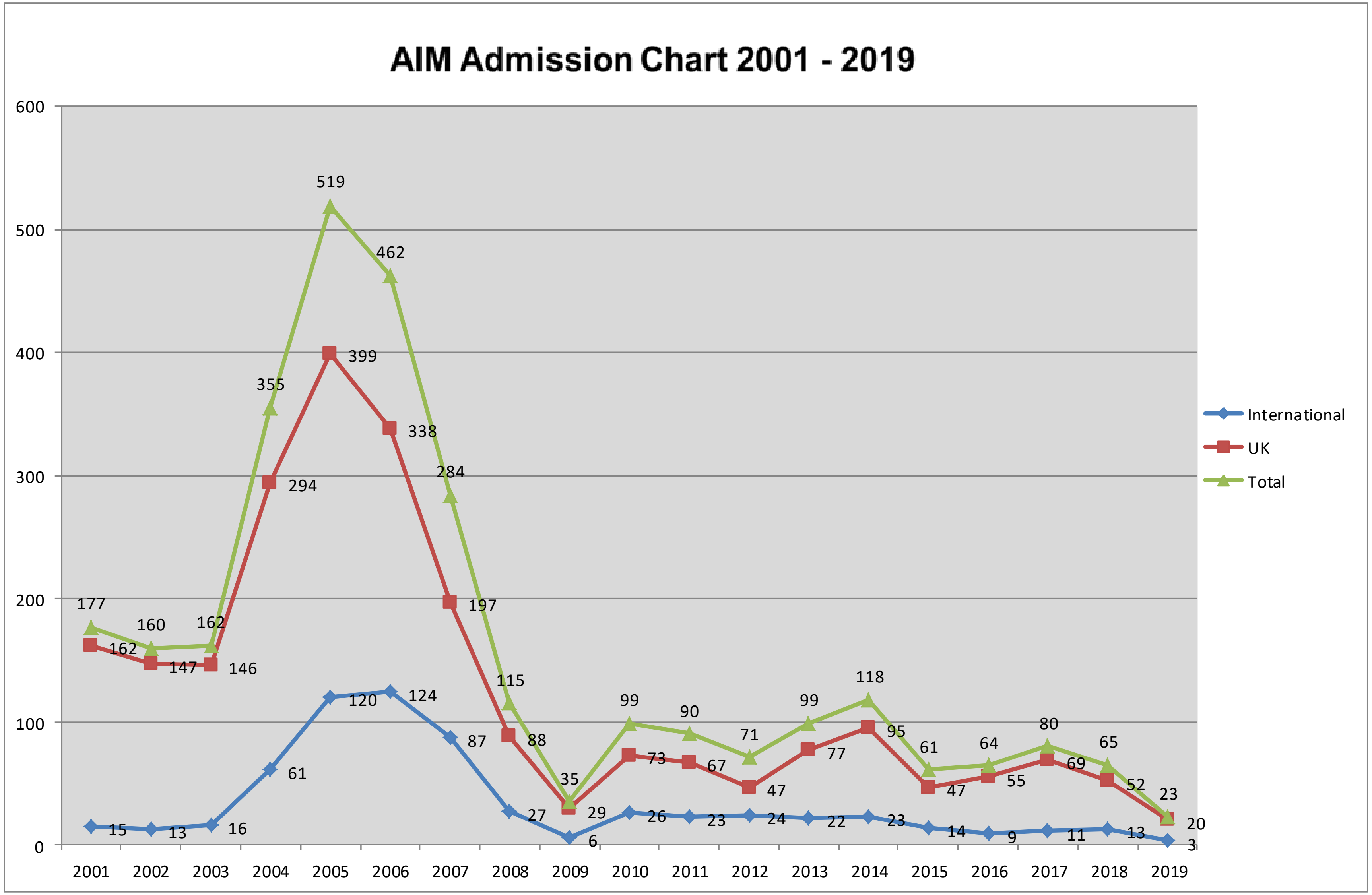
[9] Please note that these figures are gross and should be reduced by the number of investment companies that currently populate the market. Excluding these investment companies, the number of companies quoted on the Main Market has fallen by 60% since 1999. This compares with a 52% decline when financials are included. Furthermore, when looking below the largest 350 companies, the number of non-financial companies on the Main Market has fallen by 72% since 1999. By December 2019, the number had fallen to just 252. Further information can be found in a report by Hardman & Co. and the QCA here: https://www.theqca.com/article_assets/articledir_404/202121/Hardman-Insight-Are-public-market-closing-to-smaller-companies-May-2020.pdf

Appendix 3


AIM Admission Chart 2001 - 2019
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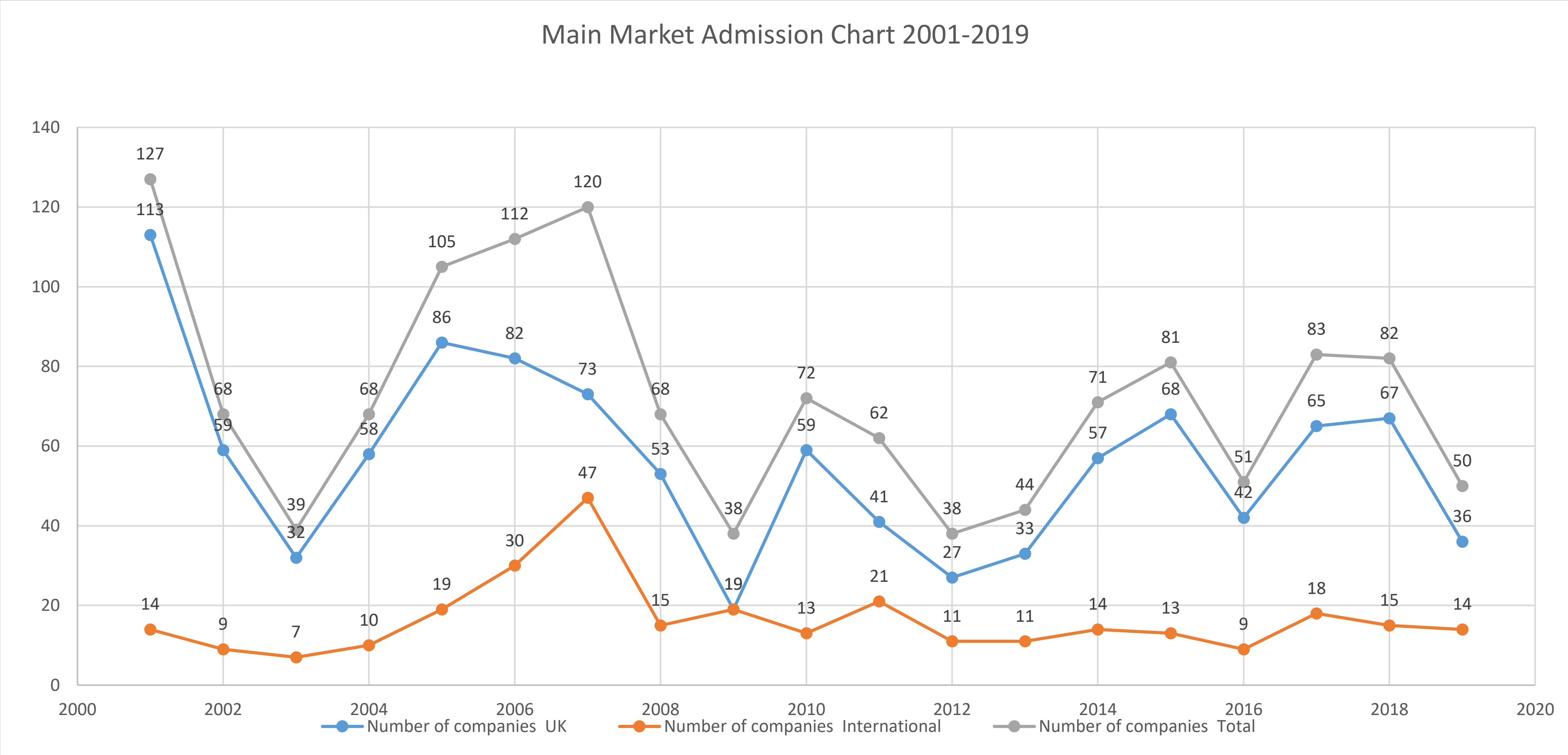
Appendix 4


Main Market Admission Chart 2001-2019
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