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Wide-Ranging Reforms of UK Capital Markets: A Watershed Moment?

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Takeaways

- Responding to a decline in the London Stock Exchange's global market share of IPOs and other fundraising, a string of government-commissioned reports prompted proposals to reform the U.K.'s listing rules and other legal requirements.
- The rules now make it more attractive to list SPACs in London, and companies with dual-class share structures will be allowed to list on the Premium Segment. The minimum free float requirement has also been lowered.
- Rules for secondary issuances are also being revisited so companies can raise new equity without cumbersome rights offerings made to all existing shareholders.

Regulatory Reforms Aim To Attract More Listings to London

Following a year in which activity in the London primary equity markets was depressed by the pandemic, global lockdowns and volatility, the London Stock Exchange (LSE) saw more IPOs completed in the first quarter of 2021 than in the whole of 2020. By December 2021, the figure was around three times the previous 12 months. A number of notable technology firms contributed to this wave, including Deliveroo (at a £7.5 billion valuation), Darktrace (£1.7 billion), Wise (£7.95 billion) and Oxford Nanopore Technologies (£3.38 billion).

Nonetheless, over time the U.K. has lost ground to other capital markets, and its withdrawal from the European Union (EU) has created uncertainty about London's future as a global financial center.

Against this background, in March 2021, Lord Jonathan Hill published his review of the U.K. listing regime, with recommendations for reforms. That followed a report the month before by Ron Kalifa, also commissioned by the U.K. Treasury, that put forth proposals to promote fintech. According to those reviews, London accounted for less than 5% of global IPOs between 2015 and 2020, a 40% reduction since 2008. The New York Stock Exchange and Nasdaq accounted for almost 39% in the same period.

Lord Hill's recommendations, aimed at attracting more listings in London and making capital raisings easier, quickly prompted three significant revisions to the rules:

- In August 2021, the U.K. Financial Conduct Authority (FCA) amended the U.K. Listing Rules to accommodate special purpose acquisition companies (SPACs) and, in late November, the first one listed on the LSE.
- In December 2021, the FCA effected a major overhaul of the U.K. Listing Rules to permit dual-class share structures (DCSS) for new listings in the Premium Segment, provided that (1) the structure survives for a maximum of five years and the extra-weighted shares are only held by or on behalf of a director, (2) the maximum weighted voting ratio is 20:1, and (3) weighted voting can only be exercised on removal of a director or after a change of control. The third condition means that DCSS can deter unwanted takeovers.
- Another major reform reduces the free float requirement from 25% to 10%.

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Listing Rule Changes Are Well Received

Public responses to the FCA's reforms have been generally positive. Overall, allowing companies with dual-class share structures to be listed on the Premium Segment is seen as making London more competitive as a listing venue by bringing its rules in line with global competitors. New York has long permitted DCSS, and Hong Kong reversed its previous prohibition in 2018, helping attract a wave of Chinese IPOs.

Technology and other high-growth firms ought to welcome relaxation of the "one share, one vote" principle on the Premium Segment, because DCSS effectively act as poison pills against unwanted takeovers at a critical stage in companies' growth by maintaining control with founders. Thus, DCSS should not only attract new listings, but help retain a deep roster of high-quality issuers on the Premium Segment.

The reduction in free float requirements to 10% would have a similar effect and remove barriers for prospective issuers. This reform is very significant because London's previous requirements limited many companies' ability to list there. Lowering the threshold should give the LSE a significant competitive advantage against European exchanges that retain a 25% minimum. Whether the EU matches London's change remains to be seen.

Further Rule Changes Expected for Secondary Issuances in 2022

The first half of 2022 will also bring the U.K. Treasury's Secondary Capital Raising Review, begun in October 2021 in response to Lord Hill's recommendation that secondary fundraising be made cheaper and faster. Proposals included a permanent increase in the preemption limit to 20% and facilitating equity capital raisings without the need for full rights offerings open to all existing shareholders, which can be costly and time-consuming, and introduce uncertainty.

Additionally, the U.K. Treasury's Prospectus Regime Review proposed streamlining prospectuses for secondary issuances, which would make it easier and more attractive for issuers to publish forward-looking information such as profit forecasts.

How Much Will the Changes Alter the Market?

The key question is whether market practices will follow these reforms in 2022.

Listing companies with DCSS serves as an example. The structure, which has always been permitted for a Standard Listing, was used in some notable 2021 IPOs, including Deliveroo, THG and Wise. However, the market was not completely receptive. It was reported in the financial press that some institutional investors did not participate in the Deliveroo IPO because of its DCSS and, about a year after THG completed its initial public offering, its founder announced that he would give up his special share rights, in the wake of concerns about the company's corporate governance.

Investor attitudes — not the permissibility of DCSS — drove these events. Each company experienced unique circumstances, but the market's skepticism about DCSS reflected a common theme.

Similarly, any change to the preemption rights may encounter resistance. They entitle existing shareholders to participate in new fundraisings so they are not diluted, and have been described as "sacrosanct." Thus, even if preemption limits are made less restrictive, market practice may not follow.

The Big Picture: Making London More Competitive

Whether the upcoming reforms result in a boom in U.K. IPOs or capital raisings remains to be seen. The new rules concerning special purpose acquisition companies may have come at the tail end of the SPAC wave. Equity markets could be dampened in the near term by rising interest rates, inflationary pressures and continuing uncertainty around the pandemic. Furthermore, regulatory divergence between the U.K. and EU, particularly regarding proposed changes to the prospectus rules, may make it more difficult for U.K. issuers to raise capital from European investors in the coming years.

Nevertheless, the reforms should enable London to capitalize on future waves of market activity and better compete with other major financial centers. Moreover, regulatory change may help shape investor attitudes, make companies with DCSS more attractive and even increase investor-rights groups' receptivity to lowering the preemption limits.

Above all, the rapid response to Lord Hill's review shows that U.K. authorities are committed to ensuring London remains a key financial center and that the U.K. regulatory environment stays nimble. It is difficult to predict how quickly these reforms will bear fruit, but they provide good reasons to be optimistic for the London market in the long run.

See "Hong Kong Encourages Listings by Foreign Companies, SPACs."