

# The Right Target Market

**SIMON W. HOLDEN**

Prescient souls at the London Stock Exchange (LSE) who, in the mid-1990s, foresaw the need for a stock market for younger growing companies, are probably hunkering down about now. The UK's stock exchanges, particularly AIM, the LSE junior market, have experienced a steep decline in market capitalisation. It was always going to be the case that those smaller, some would say riskier, quoted companies would bear the brunt of any economic malaise. AIM is comprised of such companies, having played host to companies focused on ventures ranging from exploration in far flung areas to online gaming companies.

Having been set up in June 1995, AIM grew from 10 quoted companies (all of which were based in the UK) to 1,694 companies by the end of 2007 (347 of which had an international focus, either being domiciled overseas

or having a business concentrated outside the UK). A more startling figure is the combined market value of the companies quoted on AIM. By the end of 2007, this figure stood at £97.5bn. Fast forward to the end of February this year, and that figure has been slashed to £37.9bn.

What of the LSE in these tough times? Perhaps it can rest on its laurels and hope that the market recovers sooner rather than later, and companies and investors are attracted back to AIM in the droves they were over the past few years. Not so. The LSE has a real job on its hands, now having to extol the virtues of three markets rather than two.

## COMPLEMENTS MAIN BOARD

On November 1st 2007, the LSE set up the Specialist Fund Market (SFM), to complement the main board and AIM. The idea behind SFM is to attract specialist investment funds that will target institutional and professional investors. Over the past few years AIM has attracted a number of funds with investments ranging from commercial property interests in Bulgaria and Ukraine to "fund of funds" focused on India. Unlike AIM, the LSE has stated that the SFM is not suitable for retail investors.

From a regulatory and trading perspective, the SFM sits between the main market and AIM. It has been designed to accommodate a broad array of funds including hedge funds, private equity funds, emerging country and specialist property funds. One could argue that these are funds in the true sense of the word, whereas those vehicles describing themselves as such on AIM are nothing more than companies established with an investment strategy.

Funds listed on AIM do not have the same complex structure typically associated with a private equity or hedge fund. Their constitutions are typically less rigid and they are structured to take advantage of the flexible regime offered by the AIM Rules, which are much less demanding than those of the SFM. Unlike AIM but like the main market, the SFM is an EU regulated

market as defined in the Markets in the Financial Instruments Directive (MiFID). However, unlike the main market, funds do not have to comply with the Financial Services Authority's (FSA) listing rules, which pre-suppose general retail investor participation and are not applicable for funds wishing to appeal to a more sophisticated, predominantly institutional, investor base.

Importantly, EU regulated market status is the baseline requirement for access to European institutional investment mandates without being subject to threshold limits. Securities quoted on the SFM are eligible for inclusion in insurance

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funds, occupational pension funds and other mutual funds such as Undertakings in Collective Investments in Transferable Securities (UCITs), something AIM cannot lay claim to. Given the more restricted scope of AIM investors and ultimately the lower investment thresholds of retail investors there is a strong argument that the SFM provides funds with a stronger liquidity platform than AIM.

The SFM is also capable of accepting more complex structures, governance models and security types. Limited partnerships, non-voting shares, and funds with concentrated investment policies and bespoke governance arrangements can be accommodated, attributes not applicable to AIM companies. In terms of the admission process, the SFM process is a lot more intensive than that of AIM. The LSE has been lauded in the past for its AIM admission process, which is geared towards smaller growing companies that neither have the maturity of operations nor, usually, the resources, to undertake such a process. Having delegated the AIM admission process to nominated advisers (Nomad), the LSE can maintain a suitable regulatory environment for smaller companies whilst ensuring the overall integrity of its markets.

Admission to trading on the SFM is a two stage process requiring production of a prospectus approved by the relevant European Economic Area (EEA) Competent Authority. In the UK, this is the FSA. Rules for approval and publication of prospectuses are contained in the prospectus rules. Following approval of a prospectus, an application is made to the LSE. Admission depends on compliance with the LSE's admission and disclosure standards.

The timescale for the production and approval of a prospectus (SFM) and an admission document (AIM) can vary. Since a prospectus needs to be approved by the FSA, some people think this will take longer than the process for a Nomad to approve an admission document. However, this is not strictly true as, typically, funds are incorporated with no pre-existing investments. Given that little due diligence is required as part of the admission process for a fund with no pre-existing investments, the timescale for producing a prospectus versus an admission document will

likely be very similar. Typically, the process would take between three and four months.

Operating companies require a lot more due diligence to be undertaken on them, especially in historical financial information, and therefore the admission process will inevitably be longer. The same would be true for funds with a prior operating history and existing investments. In this instance, the AIM admission process may be a quicker route to market than that for the SFM because of the Nomad versus FSA approval process.

## TRACK RECORDS

On May 29th 2008, hedge fund DaVinci CIS Private Sector Growth Fund became the first company to list on the SFM. The fund raised approximately \$110m to invest in unlisted equity and equity-related securities of companies located in Russia and other member countries of the Commonwealth of Independent States (CIS). Unfortunately, the fund's existence as a quoted company was short-lived and it de-listed from the SFM in January 2009. Guernsey domiciled investment company Marwyn Value Investors (MVI) de-listed from AIM in favour of the SFM on December 8th last year, in the hope of narrowing its discount to net asset value. At the time, MVI said it hoped to raise its profile and access a broader base of potential investors, as well as increasing transparency for investors.

Another company to follow the route of delisting from AIM in favour of the SFM is IRF European Finance Investments (IRF), which was admitted to trading on January 19th. Its directors stated that the SFM, as a regulated exchange, should provide access to a broader base of investors.

Despite the ongoing deterioration and volatility of market conditions, demographics dictate that the alternative funds industry will continue to be in demand, presumably increasing in the long term. With people living longer, traditional institutional investors increasingly have to make their assets work harder for longer. Investor demand for a range of alternative funds offering the discipline and secondary market potential that the public capital markets bring will also increase. London, with its choice of capital markets designed to suit the needs of companies and investors

alike, will continue to play a central role in meeting that demand.

Right now, only four securities are traded on the SFM, two for each of MVI and IRF. It is therefore too early to tell whether the SFM will be a success. However, given the LSE's track record in developing an alternative market and turning it into a world beater, the signs for the SFM are promising.

*Simon W. Holden is an associate at international law firm Faegre & Benson LLP, which specialises in providing services to AIM companies.*

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