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8 September 2017

Dear Sirs,

**A joint submission on behalf of Private Investors from ShareSoc and UKSA**

**AIM Rules Review**

This is a joint response by ShareSoc and UKSA.

Underpinning our response is our belief that there should be

1. Better enforcement of the LSE AIM regulations and matters of company law relating to companies listed on AIM.
2. Greater personal accountability when problems arise. Too few people have been prosecuted or sanctioned.
3. Increased levels of trust in companies listed on AIM and in those who advise in this area.
4. The levying of fines on companies is a cost on share owners and not on those directors under whose watch the problems have arisen.
5. Greater transparency. This will increase levels of trust between companies, investors, NOMADs, other advisers, the LSE and regulators.
6. Better Directors. More diversity, at least one independent NED and max 2 quoted Chair roles per director.

We welcome the opportunity to respond to the London Stock Exchange's review of the AIM Rules. AIM companies make a substantial contribution to the economy. They contributed £14.7bn to UK GDP and directly supported more than 430,000 jobs in 2013. However, the number of companies accessing public markets has declined steadily; there are 41% fewer AIM companies than ten years ago. We are committed to ensuring that the AIM Rules remain relevant and effective so that they can facilitate a thriving market environment which encourages companies to seek capital on public markets.

### ShareSoc has been running a campaign to improve AIM.

This campaign is aimed at improving the quality of the companies listed on the AIM market managed by the London Stock Exchange and reforming some of its operations so that investors are less likely to lose money through fraud or other malpractice in AIM companies.

This campaign was launched in June 2016 (although the problems of the AIM market have been long-standing). The main points are:

- The AIM market has been criticised by many for the quality of companies listed on the market and for the way it operates. ShareSoc, UKSA and our Members think that some reform is necessary.
- It is possible to invest in successful AIM companies but as any experienced AIM investor knows, doing so consistently is another matter altogether. The AIM index has underperformed main market indices over the last 20 years. AIM is a minefield for inexperienced investors.
- Historic problem cases include as Globo and Silverdell, and companies such as Izodia, Versailles and Langbar, and the numerous oil/gas or mineral exploration companies, some of which were of course simply fraudulent businesses. These suggest failures of the due diligence and quality control processes at AIM.
- Recent failures include Telit, Fusionex, Real Good Food, Redcentric, BNN, ITQ and Quindell.
- Investors accept the risks involved in small and early stage business models, but do not accept that these risks should be exacerbated by poor corporate governance and maverick management.
- The reputation of AIM is such that it actually puts off good quality companies from listing on it. Therefore, SMEs that wish to raise equity for expansion are often discouraged from listing on AIM and this is damaging for the health of the UK economy.
- But there are some simple ways to improve the AIM market without imposing large costs on the market participants. ShareSoc has published a document which spells out exactly what should be done. It is present on our web site here: **Improving-the-AIM-Market**

The following is a summary of a few of the key recommendations in that proposal:

– The enforcement of AIM regulations needs to be improved.
– The roles of Nomad and Corporate Broker should be separated, and Nomads should have clearer responsibilities.
– The QCA corporate governance code or a de novo AIM code should be recommended for AIM quoted companies.
– Directors remuneration should be reported and approved at AGMs.
– AIM company directors should have knowledge of UK Company Law
– Share placings should be constrained.
– New listings should be vetted by an independent panel.
– There should be a minimum number of independent non-executive directors.
– General Meetings should be held at convenient dates and times and should be accessible by UK investors

These recommendations are spelled out in more detail with explanations for their need in the document.

On the 27th September 2016, the BBC broadcast an analysis of AIM and asked whether enough is being done to protect investors. ShareSoc was involved in supplying some of the evidence for the programme and David Stredder spoke on it. See our blog for a report on it here: **BBC-File-On-Four**.

The signatories to this petition requested that action should be taken to reform the AIM market along the lines suggested by ShareSoc directors.

***Responses to specific questions***

We have responded below in more detail to the specific amendments from the point of view of our members.

**I. The role of London Stock Exchange**

**Q1 Do you agree that the proposed extension and codification of the existing early notification process would be beneficial?**

Yes, we agree that the proposed extension and codification of the existing early notification process would be beneficial. As the conditions for entry to AIM are designed to be limited, formalising an early discussion on the appropriateness of a prospective applicant will avoid situations where obstacles to admission are not identified until after a prospective applicant has incurred costs relating to the proposed admission, which prove material to a smaller company.

However, we question whether the process is necessary for some re-admissions – particularly in the case of reverse takeovers in Rule 14 – and would encourage London Stock Exchange to consider exempting these from the new process. These would include where:

- a transaction is a reverse takeover resulting from a 100% class test and not due to a fundamental change in the business, the company's board or voting control.

**Q2 At what point should this early notification be required in order to make it feasible for the nominated adviser to have identified the information required but also early enough in the process to enable the discussion to have a benefit to the parties in their preparation for admission?**

There is a challenge in getting the balance right between minimising potential costs by having an early dialogue and delaying notification until sufficient work has been carried out in order to verify the relevant information and have sufficient time to analyse its import and potential impact.

If the focus of the early notification is made more explicitly about appropriateness issues, the scope of the initial due diligence can be better focused on this area. This will both expedite the notification and minimise cost where a possible obstacle may emerge.

However, the principal objective should be to have a dialogue sooner, rather than later, in the due diligence process. In promoting this idea, we recognise the risk that AIM Regulation may not have sufficient resources to accommodate a potential increase in such dialogues, but would contend that it would be beneficial if London Stock Exchange were able to ensure that AIM regulation had sufficient "bandwidth" to engage in what we believe would be an advantageous outcome for future market participants.

There must be a transparent and accountable decision-making process to which London Stock Exchange adheres. It should commit to a maximum time period for responding following the submission of all material data. We would suggest a period of no longer than ten business days; this would align with the Schedule 1 submission procedure.

**Q3 Does the list proposed at section 4 cover the key information that should be set out in the early notification process and, if not, what additional information would be beneficial?**

The list given is based on the existing Schedule 1 notification. One of the functions of the Schedule 1 is to serve as a "gazetting" document of record, which is also used to assist London Stock Exchange in considerations of appropriateness.

We believe that the existing Schedule 1 process should remain as a "gazetting" process with its existing content requirement. However, we consider that the earlier discussion process should focus on the appropriateness criteria discussed and illustrated in the sections headed "The role of the nominated adviser" (p6) and "Guidance on when the Exchange may exercise its AIM Rule 9 powers" (p8).

**Q4 Do you agree that it would be helpful to publish a list of non-exhaustive examples of factors to be taken into account by nominated advisers when assessing appropriateness for AIM?**

Yes, we strongly agree that it would be helpful to publish a list of non-exhaustive examples of factors to be taken into account by nominated advisers when assessing appropriateness for AIM. What you have suggested is a good start. Although nominated advisers have a great deal of knowledge on appropriateness considerations obtained from regular contact with AIM Regulation, as well as the AIM Rules and the Inside AIM guidance, collating this knowledge into a unified guidance note – whether incorporated into the AIM Rulebook or as a free-standing document – could be beneficial to the market. It would facilitate the education of potential applicants by nominated advisers and may also serve as a filter to reduce the possibility of early meetings resulting in an adverse outcome.

**Q5 Do you agree with or have any comments on the proposed examples at section 4?**

The proposed lists are helpful.

Additionally, we recommend including details of remuneration of directors, share ownership, restrictions on sale of shares by directors, current and potential dilution of shareholders vis-a-vis share schemes, the current run rate and projected run rate of such dilution and any other special forms of remuneration such as carry or growth shares.

The "risks" category is somewhat unlimited in scope and may not be as helpful as simply classifying this category as the risk of investor detriment. Furthermore, London Stock Exchange could consider adding a reference based, or operating in, high-risk jurisdictions, or free float, or articles which give founders too much power.

We also note that we discuss the inclusion, or otherwise, of free float further in the answer to Q6 below.

**II. The development of AIM and eligibility criteria**

**Q6 Do you agree that the current approach to free float strikes the right balance or do you consider that London Stock Exchange should consider the introduction of a minimum "shares in public hands" requirement?**

**No.** The core issue here is the shareholder rights implications for minority shareholders. Company articles, plus promises made by the Board and directors and the way the LSE and others enforce the regulations and applicable laws are crucial to creating an environment that protects minority shareholders.

The current approach of having no restriction on free float leads to new entrants sometimes having very few shares held outside of concentrated illiquid holdings. This lack of liquidity impedes efficient price discovery and prejudices the rights of minorities.

The QCA Small and Mid-Cap Investors Survey[1], jointly published with RSM in March 2017, found that the majority of "institutional investors" think that there should not be any kind of enforced minimum free float, either by value of company or size of shareholding floated, as it is unnecessary and burdensome. When they said "institutional investors" they meant fund managers or the agents of the savers who provided them the capital to manage. Too many people in that industry fail to recognise this distinction and you should not slip into lax use of the English language in this regard. Many advisers sit on both sides of the fence and receive generous fees for flotations regardless of the ultimate benefits to beneficial owners and individual investors. This may conflict their view and you appear not to have taken account of this when you quoted this survey.

This notwithstanding, we acknowledge that a minimum free float could be useful in terms of reducing uncertainty in the admission process, and providing liquidity. We note that although the current unwritten rules on free float are generally understood by advisers and regulators, they also often confuse prospective companies, who are often less familiar with the AIM admission process.

***Furthermore, London Stock Exchange should review the reference to "the participation of recognised institutional shareholders" as an admission suitability factor. This indirectly, and perhaps inadvertently, suggests that London Stock Exchange sees the market as having two classes of investor, with retail investors classed as subordinate to institutional investors. We believe that this reference risks deterring growth companies below an institutional investment size criterion, and subsequently damaging the market.***

***If the London Stock Exchange believes that retail investors are an important part of the market, then steps should be put in place to encourage the participation of retail investors in fund raisings. Primary Bid is an example of a market based solution.***

**Q7 If you believe London Stock Exchange should consider introducing specific free float requirement, what would you consider to be an appropriate minimum and the reasons why? What types of shareholders should be considered as "shares in public hands"?**

We would prefer 50%. The ITQ issue highlighted in Roger Lawson's blog post on 8 Sep 2016[2] illustrates the need for this perfectly, where concentrated ownership has allowed minorities to be ripped off.

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[1] Small and Mid-Cap Investors Survey 2017:
http://www.theqca.com/article_assets/articledir_256/128121/QCA_RSM_Small_and_Mid-Cap_Investors_Survey_2017_Report.pdf

[2] https://www.sharesoc.org/blog/regulations-and-law/sophos-interquest-government-policy/

If for commercial reasons, the LSE does not accept this recommendation and chooses a lower percentage, then the definition of free float should exclude large institutional shareholdings as the size of these holdings for many AIM companies makes these holdings illiquid.

We note that it is often founders and/or management who tend to cause problems of control rather than institutions.

**Q8 Do you believe that it would be beneficial to extend minimum fundraising criteria at admission, or should it continue to only apply to AIM investing companies?**

**No.**

We do not believe that extending minimum fundraising criteria to all AIM companies is necessary. The benefits seem uncertain, potentially minor and would make introductions to AIM where no funds are raised on AIM more challenging. Such AIM introductions are not necessarily of more immature, more risky or of less well financed companies. We would like clarity with respect to whether any minimum fundraising rule applies to primary capital or whether it could include placings of secondary shares at the point of admission.

By way of a current example of potential impact of minimum fundraising criteria, GetBusy is potentially coming to AIM after being spun out of Reckon, an Australian quoted company. Funds are being raised via the exercise of rights prior to AIM admission. In this case would the rights exercise prior to admission count for the purposes of the minimum fund raising rule? The answer may well be that GetBusy may meet the minimum fundraising criteria, although a legal opinion would potentially have to be sought, which would add to both costs and complexity.

We consider that adding "not raising sufficient funds at AIM admission" to the list of factors that may give rise to concerns, could help in indicating that using AIM to raise funds at the point of admission is preferable but not mandatory.

**Q9 Do you agree that such a proposal should only apply only to non-revenue generating companies? If yes or no, please explain why.**

No. Very few companies generate no revenue; we consider devising a rule which is so infrequently applied unnecessary.

**Q10 If a threshold is introduced, what level of minimum fundraising would be most appropriate on or immediately before admission and why?**

a) **£2m**
b) **£3m**
c) **£6m**
d) **Other**

We do not believe that there should be any kind of enforced minimum.

NEX is a viable alternative, so AIM needs to be clear on its desired role and place in the market.

Another alternative for companies is simply to have an internal market with a private company valuation done every six months and shareholders investors are asked to submit bids/offers

which are then matched up and/or scaled down. This process works quite well for many companies who do not require large amounts of capital, e.g. Archant.

**Q11 Are there any other circumstance where a company should not have to meet minimum fundraising criteria, beyond those referred to above with respect to companies with a historic track record?**

Establishing a comprehensive list of when companies should not have to meet minimum fundraising criteria is challenging. As the benefits are uncertain, we believe it could be preferable to not have minimum fundraising criteria at all.

**III. Corporate governance requirements for AIM companies**

**Q12 Do you consider the current requirements set out in section 6, including duties of the nominated adviser at admission to consider the efficacy of the board and the adoption of appropriate corporate governance standards and disclosure under AIM Rule 26, to be effective? If not, please explain why?**

NO, because it is not working. There are too many bad cases. This has created a trust problem. This is a cultural problem that is deeply seated in the financial services industry, which seems at times to view the customer as a source of revenue to be exploited. Building trust is best addressed through greater transparency.

The current requirements are inadequate and do not cover many of the problems we see as investors in AIM companies. The lack of adherence to any corporate governance standard is common. The lack of knowledge of AIM company directors about company law and what should be considered good corporate governance are two major deficiencies. There are too many examples of company directors acting in a cavalier fashion, or failing to disclose significant information to investors. The education of directors in ethical principles might also be a good idea.

Any revised corporate governance requirements imposed on an AIM company should continue to allow that company to apply arrangements that are tailored to its individual needs, given its stage of development, and which are developed through considered engagement with its key stakeholders and advisors.

This notwithstanding, we acknowledge that a potential risk is that an AIM company's governance arrangements do not keep pace with changes in the needs of the business, the market or wider stakeholder expectations. We therefore recommend that AIM should be more explicit on the need for a continuing dialogue between an AIM company and its advisors regarding the efficacy of the board and the adoption of appropriate corporate governance standards and disclosure under AIM Rule 26, rather than only at admission on to the AIM market. Rather than the introduction of new rules, this should be done through refreshing the guidance given in Inside Aim.

Regarding AIM company board composition, we believe:

- Every AIM Company should have a minimum of one truly Independent NED. NEX exchange has this as a requirement, and AIM should have a rule at least as strong as NEX in this respect.
- There should be a statement to encourage diversity on AIM Co Boards –research by First Flight earlier this year found that 25% of AIM Companies still have all male Boards.

- The Australian stock exchange does not allow a Director to be on more than 3 Quoted Company Boards – this is eminently sensible and we think there should be a similar statement about the number of roles AIM Non Execs have.
- The number of Chair roles an individual can have should be limited to 2 Quoted companies.

We would not support the imposition of inflexible rules in other of these respects and would favour an approach that allows an AIM company to focus on what is meaningful and appropriate for its particular circumstances. The FRC have a project looking at the quality of smaller quoted company reporting and one of the concerns is that there is insufficient attention paid by such companies to the quality of reports. (Larger) AIM companies should be encouraged to separate the role of finance director and company secretary to ensure that they have sufficient resources to meet their compliance and reporting obligations.

With respect to the adequacy of AIM Rule 26 in terms of corporate governance disclosures, we consider the current corporate governance disclosure requirements to be at too high a level which allows, allowing some AIM companies to adopt a vague boilerplate approach to governance disclosures. Particularly in annual reports, it is often the case that compliance with a specified governance code is claimed "…as far as is practicable for a company of our size…". Clear explanations of which elements of the code have not been adopted and what, if any, alternative measures have been taken are rarely evident. We recommend that, either directly through the AIM Rules for companies or indirectly through reference to underlying corporate governance codes, greater guidance on the level, location and nature of corporate governance disclosures is provided.

We also recommend that a stronger enforcement of the application of AIM Rule 26, both in terms of pure compliance and in terms of quality of disclosure is considered. This may be achieved directly through the AIM Rule compliance process but may, from a financial reporting perspective, also be achieved through a greater collaboration with the FRC's Corporate Reporting Review function.

**Q13 Do you believe that AIM companies should be required to report annually against a governance code?**

1. Larger companies. They should choose between the QCA Code and the Financial Reporting Council's UK Corporate Governance Code (the UK Code) whose imposition on companies at the lower end of the market would be an unnecessary and unwelcome burden.
2. For other companies, the QCA Codes will usually be best.

Overseas based companies who do not choose to follow the QCA Code, should explain which parts they are not following and why.

This point notwithstanding, however, we believe that the structure and guidance provided in formalised corporate governance codes promotes a greater consistency both in the general approach – if not in the detailed practices and policies adopted – adopted by AIM companies and also on the advice provided by advisors. This might be achieved through giving an AIM company a choice between adopting, for example, the UK Code, the QCA's Corporate Governance Code

for Small and Mid-Sized Quoted Companies (the QCA Code)[3] or, for non-UK-incorporated companies, a similar code from their local jurisdiction. The QCA Code, in particular, is a principles-based, outcome-focussed code, which provides guidance on a company's approach to corporate governance within a flexible and scalable framework.

The remuneration disclosures as set out in the ShareSoc Remuneration guidelines should be followed. See http://www.sharesoc.org/ShareSoc-Remuneration-Guidelines.pdf

## IV. Standards of conduct and approach to non-compliance with the AIM Rulebooks

**Q14 Are there further ways London Stock Exchange can helpfully educate market participants, particularly individuals, as to what London Stock Exchange can and can't do in respect of its remit, beyond the information already available on its website?**

There should be

1. better enforcement of the LSE AIM regulations and matters of company law relating to companies listed on AIM.
2. Increased levels of trust in companies listed on AIM and in those who advise in this area.
3. Where problems occur, the individuals involved should be held accountable. Too few people have been prosecuted or sanctioned. The levying of fines on companies is cost on share owners and not on those directors under whose watch the problems have arisen.

LSE also need to enforce its rules more rigorously and promptly. This sends a clear message with respect to how the rules are interpreted and what is and is not acceptable in practice. The same applies in respect of the FRC, SFO and the FCA. We pointed this out in a letter published in the Financial Times[4] about the need to rebuild trust in business:

> *"The SFO, CPS and/or BEIS should be given more resources and told to pursue problem cases much more speedily. Companies should not be allowed to hide behind expensive lawyers. The whole process of settlements, where management admit no blame and shareholders pay the fines/settlement amounts, mean management get off scot-free and also needs a review."*

London Stock Exchange should consider participating in retail conferences to explain AIM Rulebooks. This more interactive approach could be a more effective in educating individual market participants.

London Stock Exchange should assist organisations such as ShareSoc and UKSA (and possibly others) by helping to seek redress and by helping them to prosecute offenders.

We encourage the publication of breach and sanction data by London Stock Exchange. The information provided in this discussion paper is an excellent start.

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[3] Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies (2013): http://www.theqca.com/shop/guides/86557/corporate-governance-code-for-small-and-midsize-quoted-companies-2013-downloadable-pdf.thtml

[4] https://www.ft.com/content/9e7ca6b8-453e-11e7-8519-9f94ee97d996

We discourage the use of private sanctions and warnings. It is very important for investors to have specific, tangible evidence of enforcement actions.

We also advocate better education of NOMADs with respect to their responsibilities on corporate governance a) when assessing the suitability of companies' CG for admission; b) when advising companies on an ongoing basis.

**Q15 Do you agree with automatic fines for explicit breaches of the AIM Rules for Companies? If so, what types of breaches should the fine be applied to?**

Bearing in mind that explicit breaches for the AIM Rules for Companies are varied in nature, we consider the concept of automatic fines to be unsuitable. It can also often be inequitable.

Fines are paid by shareholders. Directors and executives commit breaches.

**Q16 In respect of Q15, what do you believe is the appropriate level of fine?**

The levying of fines on companies is a cost borne by shareholders and not by those directors under whose watch the problems have arisen.

**Q17 Are there other changes to the Disciplinary Handbook that you think London Stock Exchange should consider?**

The key thing is effective liaison with FRC, SFO, BEIS, etc. This needs to be publicised. There is most definitely a perception that LSE regulation enforcement is poor. A significant factor in this is the current lack of transparency and lack of feedback to complainants. During our recent meeting the LSE executives made a number of good points which indicate progress, but this will not change the perception unless it is publicised in a way that is transparently clear that progress is being made. The Cornhill case was a most positive step forward in this regard.

**V. Further comments**

As part of our response to this review, we have detailed some additional issues that should be addressed by London Stock Exchange as it reviews the AIM Rules.

A. Share-based management incentives

Unlike with fully listed companies which are subject to the listing rules, there is no requirement to put management share-based incentive plans to shareholder vote for AIM companies. On occasion, this has resulted in inappropriate share schemes, where material proportions of a company (in excess of 30% dilution for nil consideration over ten years) have been proposed by company directors.

Share-based compensation schemes are becoming increasingly prevalent and the value being transferred from external shareholders to company management continues to rise. Often led by the remuneration consultants pressurising non-executive directors, there is a particularly alarming trend to use nil-cost share schemes, where on occasion, due to poorly designed

schemes, very material share-based compensation has been paid to company management for poor performance.

We believe that all schemes that involve share-based awards should be put to a shareholder vote. Companies should have to justify diluting shareholders and seek their approval for an agreed level of dilution and flow rate. As a minimum, option schemes which would result in excess of 10% share dilution over ten years and LTIPs (using nil cost or de minimis cost shares) which would result in excess of 5% share dilution over ten years should be put to shareholder vote.

The QCA Remuneration Committee Guide for Small and Mid-Size Quoted Companies[5] encourages companies to facilitate a voluntary vote on share scheme proposals (whether binding or not) as this demonstrates a willingness to engage with shareholders in a meaningful way. This sends an important message about a company's corporate governance and its regard for the providers of capital.

The ShareSoc Remuneration Committee Guide encourages companies to facilitate a voluntary vote on share scheme proposals (whether binding or not) as this demonstrates a willingness to engage with shareholders in a meaningful way. This sends an important message about a company's corporate governance and its regard for the providers of capital.

B. International companies

International companies on AIM are subject to the governance standards of their home jurisdictions. In many instances these may be less stringent than UK corporate governance standards and in particular the QCA Code.

There are challenges and numerous historic problems for AIM in admitting international companies – particularly where corporate governance or culture with regards to minority shareholder rights varies from the standards of UK corporate governance. We believe that London Stock Exchange, in concert with nominated advisors and other corporate advisers, should actively encourage international AIM companies to comply, where possible, with the QCA Code.

If there are significant divergences between the level of corporate governance standards at which an international AIM company is operating and the QCA Code, we believe it legitimately calls into question the appropriateness for such a company to list on AIM.

C. NOMADs

Nomads have two distinct roles:

- project management and quality control of new admissions and fundraisings, and
- compliance by companies with their continuing obligations.

The qualifications to become a Nomad revolve around their involvement in admissions and fundraisings. This limits the number of people who can qualify to be a nomad and influences the

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[5] Remuneration Committee Guide For Small and Mid-Size Quoted Companies (2016): http://www.theqca.com/shop/guides/118376/remuneration-committee-guide-for-small-and-midsize-quoted-companies-2016-downloadable-pdf.thtml

cost of employing qualified personnel. Requiring that this expensive scarce resource performs the role of monitoring companies' compliance with their continuing obligations adds to companies annual cost of remaining on AIM. The London Stock Exchange should identify other groups of people who are qualified to monitor compliance with continuing obligations such as Company Secretaries or Accountants. This would open up the pool of people able to monitor continuing compliance and free up qualified nomads to focus on new admissions and fundraisings.

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

Yours faithfully,

Mark Northway
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ShareSoc

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