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UK PROSPECTUS REGIME REVIEW – RESPONSE TO CONSULTATION

Question 9 in consultation: Do you agree with our proposed change to the prospectus liability regime for forward looking information?

Lord Hill's UK Listing Review contained a proposal to reduce the prospectus liability for issuers and directors to facilitate the provision of forward-looking information ("FLI") by introducing a new defence to liability if they could demonstrate that they had exercised due care, skill and diligence in putting the FLI together and that they honestly believed it to be true at the time at which it was published. This would apply to IPOs and follow-on equity raises requiring a prospectus, makes perfect sense and is long overdue.

So, in terms of the consultation, a resounding yes to Question 9, providing the defence is available against all potential plaintiffs.

Question 10 in consultation: Do you think that our proposed changes strike the right balance between ensuring that investors have the best possible information, and investor protection?

The introduction to the consultation document states that the proposed measures have *'the overarching aim of enhancing the functioning of UK capital markets.'* In response to Question 10, we suggest that the proposed initiatives represent a step in the right direction. But they need to go much further to address the dysfunctional rules on wider FLI for companies already UK listed.

It would be bizarre if directors end up with wider protection for FLI in a prospectus than they enjoy in subsequent communication with investors post listing.

Current status

Currently, directors of companies listed in the UK are obliged under s417 of the 2006 Companies Act to publish a business review within their annual report which includes, inter alia, the main trends and factors likely to affect the company's future.

To encourage this greater transparency, directors enjoy protection (known as safe harbour protection) under the Act: a director can only be liable for statements that are untrue or misleading

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and are made in bad faith or recklessly or when there is deliberate and dishonest concealment of material facts.

Provisions are inadequate

The current levels of protection are too narrow. They only apply only to the narrative content in a company's annual report and only cover liability to the company, not third party plaintiffs. Wider communication is not covered.

Contrast this with the SEC safe harbour protection in the US which extends protection against any third party plaintiff to the content of any document filed with the SEC providing forward looking statements are accompanied by suitable cautionary language.

Consequences

Because of this incomplete protection, directors avoid making forecasts, instead giving aspirational targets and KPIs in annual reports, with imprecise numbers attached such as "mid-teens" or "a range of 5-10%". Management is creating places to hide by avoiding precise measurable milestones.

Communication of more specific forecasts to investors takes place via sell-side analysts, steered towards a number by the company's CFO. In practice, each analyst will be guided towards a number close to the company's internal expectations. A range of similar numbers with a consensus mean exists and it is now best practice for companies to publish this sell-side consensus on their websites. Whilst many do, most do not.

This a circuitous two-sides-of-a-triangle transmission mechanism for companies to communicate forecasts to investors indirectly, not directly.

Investors tolerate this because the Listing Rules oblige directors not to create a false market in their shares and if they recognise that sell-side consensus becomes materially different from their own internal expectations, they must update the market immediately through a public regulatory announcement.

Companies like this indirect transmission arrangement because if an investor loses money relying on a forecast that turns out to be wrong, any legal redress lies with the analyst's employer, not the company. In practice it is well-nigh impossible to sue analysts' employers for inaccurate forecasting, so investors effectively have no redress.

Our suggestion

Directors should be given safe harbour protection against any third party to publish the company's own internal expectations for the financial year that has already begun, providing this is published as part of a public regulatory announcement and with appropriate accompanying cautious language. As these internal expectations already exist, there will be minimal extra work involved.

A dysfunctional and shrinking UK stock market

Directors of companies with shares listed solely in the UK are too muzzled. Because they run the risk of being sued by investors for giving FLI that might subsequently turn out to be inaccurate, disclosure is kept deliberately and frustratingly vague, general rather than specific.

Some companies are much more open than others and the more unforthcoming companies can follow their example.

Institutional investors in UK listed companies with large percentage holdings feel relatively deprived on FLI compared to their counterparts in US listed companies and both have much less FLI than major investors in private equity who routinely see investee company management accounts and internal expectations and will be aware of what issues directors are discussing including plans for major acquisitions or disposals. Management in private equity has nowhere to hide from its investors.

The current rate of take-overs of UK listed companies is running at record levels with astonishingly high premia being paid for changes of control. The media rightly questions why UK investors previously valued companies being acquired at so much less than the acquirers. Part of the answer is investors in UK listed companies struggle to put high valuations on companies where useful FLI is scarce and where management creates places to hide.

FLI is crucial: without it, investors are flying blind.

Greater statutory legal protection comparable to the US for directors discussing the sustainability of a company's profitability, material issues and future prospects in a more transparent way with investors, certainly those deemed to be market professionals, is long overdue.

For directors, it would make London a more attractive place to list and remain listed.

For investors, armed with greater visibility of companies' near-term futures and prospects, higher valuations might ensue.

Kind regards

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