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Primary Markets Policy Team
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Sent via email: cp23-10@fca.org.uk

Dear team,

Railpen response | FCA Consultation Paper 23/10 – Primary Markets Effectiveness Review: Feedback to DP22/2 and proposed equity listing rule reforms

About Railpen

Railpen is the trading name of Railway Pension Investments Limited, which is authorised and regulated by the Financial Conduct Authority (FCA). Railpen acts as the investment manager for the railways pension schemes and is responsible for c. £35 billion of assets on behalf of over 350,000 members.

Sustainable Ownership is Railpen's approach to incorporating sustainability considerations into the investments it manages on behalf of members. Railpen's work is enabled by the Trustee's related investment belief: "Incorporating and acting upon climate risk and other environmental, social and governance factors is a significant driver of investment outcomes and part of our fiduciary duty."

As a UK asset owner, with an extensive history of investing at an early stage in high-growth, innovative and UK-based companies like Oxford Nanopore Technologies (ONT), Starling Bank and Gousto, we want to see the UK continue to thrive as a global financial powerhouse. We recognise that there are concerns about the health of the UK equity market and that this is an important policy discussion to have. However, any such discussion – as with all policy debates – must be i) rooted in facts, ii) consider perspectives from the full breadth of those affected (in this case, asset owners and scheme members) and iii) consider the broader context so that coherent, consistent policy decisions that tackle the root causes of an issue can be made.

We provide here our thoughts on those specific questions where we think our experience is of most relevance, but also offer broader views on some of the more fundamental issues, as well as potential solutions, which we think could be more fruitfully explored. Our response draws upon our extensive history of conversations with pre-Initial Public Offering (IPO) (technology and other sector) firms and IPO advisers as well as our own experience as an active, long-term and growth-oriented investor in high-growth companies in the UK. It also builds upon our previous responses to the UK Listings Review – as well as the FCA implementation paper *CP21/21: Primary Markets Effectiveness Review* – and the response we helped produce as chair of the Investor Coalition for Equal Votes (ICEV)[1] to *DP22/2: Primary Markets Effectiveness Review*.

We would like to thank the FCA for its openness in engaging with us and others in the asset owner community. We believe that asset owners have a uniquely valuable perspective, given our role at the top of the investment chain and close alignment of interests with those of our beneficiaries.

We hope that a way forward will be found which will help create the healthy, thriving capital markets the UK needs while also minimising risks and costs to the end consumer/saver through supporting long-term investors like Railpen to be effective stewards of their assets.

Summary

- We agree that there has been a decline in IPOs in the UK – not just across the premium segment, but across other segments too. As capital markets are complex, we would be supportive of an evidence-based, cross-governmental investigation into the root causes of this decline, which could then provide the appropriate basis for solutions which genuinely make a difference. Given the reduction in IPOs across both the Main Market and the AIM, we do not believe that it is, specifically, the governance standards and investor protections required by a premium listing that are the root cause of this reduction in IPOs.

- We do not believe the FCA has provided the necessary evidence to support further changes to the UK listings regime, particularly given that the most recent changes in the wake of the Hill Review – which came into force only 18 months ago – have not yet had time to bed in. Our own conversations with pre-IPO companies and IPO advisers – as well as academic evidence provided by others – would indicate that the issues affecting UK IPO activity are primarily to do with companies wanting a good valuation (which in turn requires deep, liquid pools of high-quality institutional and retail capital) and disliking political and policy uncertainty. *Please see our appendix, which outlines our more detailed reflections upon some of the evidence and arguments presented by the FCA in its paper*.

- Moreover, we believe the evidence indicates that the changes proposed by the FCA – particularly those regarding a more permissive approach to dual-class share structures (DCSS, or unequal voting rights) and shareholder rights in the event of a significant or Related Party Transaction – could actually reduce the pool of institutional and retail investors willing to invest in UK-listed companies.

  This is because rolling back these fundamental investor protections means that investors would find it more challenging to act as effective stewards of their assets which in turn would make them less certain that investing in a UK-listed company was going to lead to the sustainable financial returns scheme members and other savers need. We note that the FCA's proposals, which would make it harder for schemes to be good stewards of their assets, run counter to other proposals from the FCA (such as the work of the Vote Reporting Group) and the government (including the Taskforce

[1] ICEV is a coalition of US and UK asset owners with around $2 trillion in assets under management who are concerned about the long-term effects on outcomes for scheme members of misalignment between invested capital and shareholder voting rights.

for Pension Scheme Voting Implementation) which are aimed at supporting schemes and managers to effectively utilise their voting rights.

In fact, we believe that implementing these proposals would run counter to the FCA's statutory operational objectives to "secure an appropriate degree of protection for consumers" and "protect and enhance the integrity of the UK financial system".

- Although we recognise that others will also be well-placed to offer alternative solutions, we suggest that the UK government and FCA should instead: i) pause any further changes to shareholder rights until a fuller assessment can be undertaken; ii) consider what broader regulatory changes <u>within the framework of UK schemes' fiduciary duty to act in members' best interests</u> could be taken to support a more long-term approach to risk by UK pension schemes; iii) create an outreach programme which effectively communicates the benefits of the UK's high corporate governance standards and robust investor protections for investors and companies; iv) encourage better financial education for school-age children to help grow the pool of retail investor capital; and v) provide long-term sector-level certainty through an industrial strategy and support for UK early stage companies after the incubator stage to avoid a cliff-edge in funding which then means they seek capital from the kinds of short-term investors who might encourage them to list elsewhere.

<u>Our response</u>

Capital markets are complex. A nation's capital market consists of interactions between a wide variety of participants – including companies, investors, advisers – all of which are operating within not just a specific set of financial market regulations and ecosystem, but also a much broader policy and political framework. It is affected by regulatory and legal changes, but also by sentiment and perception.

We agree with the UK Finance/EY 2023 analysis[2] that there are three distinct parts which constitute healthy capital markets: i) companies, ii) investors and iii) an ecosystem that "facilitates and enables a broad and deep market". From this it follows that a healthy capital market is one that is in large part attractive to companies and investors.

We focus here on:

A. The bigger picture – what is required for a healthy capital market
B. Why the FCA's current proposals won't help (and may well hinder) the creation of a healthy capital market
C. What we think should be done instead

We think that it is important to go back to first principles to understand the problem we are trying to tackle, as well as consider broader trends and developments, and seek to do so here. We would encourage the government – with the involvement of all relevant departments and regulators – to do likewise, to support a set of proposed solutions which will be most impactful.

A. The bigger picture – what is required for a healthy capital market

Here we explore what the evidence says around what companies and investors find attractive in a capital market. We note that although we examine each constituency in turn, in reality this

[2] *UK capital markets: Building on strong foundations* (2023).

is a virtuous (or vicious) cycle – companies want capital markets where they can access high-quality investor capital, and investors want capital markets where they can access exciting, innovative companies that generate sustainable financial returns over the long-term.

What makes a market attractive to companies?

Lord Hill, in his 2021 *Call for Evidence – UK Listings Review*, noted that "there is a range of factors that can make a jurisdiction an attractive place to list and do business. These might include (but are not limited to): the strengths of the wider business ecosystem; the visibility of public companies and IPOs; the presence of a pro-investment culture; the prestige associated with a market".

UK Finance[3] noted that the top five factors considered by companies when they come to list are the following (in order):

- Access to a strong investor base
- Valuation and research coverage[4]
- Liquidity
- Comparable companies
- Ease and cost of being publicly traded

It also noted that "governance matters[5]" was the top issue for "large internationally focused UK companies" but not a top five priority for *any other kind* of company (including "small/high-growth US/US/European companies" i.e. exactly the kind that the government and FCA appear to be keen to encourage to list and grow in the UK).

These findings align with what we hear from our own extensive conversations with high-growth, pre-IPO firms (both those in the UK and elsewhere) when discussions about listing jurisdiction arise. Companies tell us that they want:

- A fair valuation
- Deep pools of capital to tap into at every stage of a company's lifecycle (including good aftermarket liquidity)
- Appropriate sell-side coverage
- A stable policy and regulatory environment (for companies)

This in turn requires the following:

- An investor base that understands and values the business correctly
- A critical number of peers listed on the same exchange or the same region
- A significant pool of international and domestic investors attracted to investing in a jurisdiction

We also think it is worth noting, in line with some of the broader evidence base mentioned previously, that one IPO adviser said that governance or listing requirements (and dual-class

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[3] Ibid.
[4] This was echoed by Brian Cheffins and Bobby Reddy in their 2023 Harvard Law School Forum Corporate Governance blog, where they noted "a dearth of investment research on existing and potential UK public firms could be one of the market-oriented factors responsible for the London Stock Exchange's strucggles. Analyst coverage levels can plausibly affect share trading and pricing."
[5] Defined by UK Finance/EY as "practices regarding the executive remuneration and a company's corporate/board structure".

share structures in particular) were “a marginal consideration, if at all” for companies when considering where to list. This view was echoed by other conversations with advisers and pre-IPO companies, who additionally noted that the UK had historically been the “quality” market, with a premium listing seen as an imprimatur of a high-quality, well-run company. It also seems to align with the FCA’s own appraisal of regulation as “not necessarily a key driver in listing choices by issuers” in its consultation.

Conclusion: high-growth firms and their executives care much more about access to a high-quality pool of investor capital than they do about “marginal” rules on governance and listings requirements.

<u>What makes a market attractive to investors?</u>

With companies above all hoping to access the high-quality, liquid pool of investor capital from listing in a particular jurisdiction, that jurisdiction also needs to attract investors. Based on the evidence and our own experience, we would argue that investors are looking for the following:

- Robust investor protections
- Exciting, good-quality national IPO candidates[6]

Railpen is an investor in both passive and active strategies, with a significant (and growing) internal management function and an allocation to high-growth, innovative UK and international companies. The Trustee of the railways pension schemes has a fiduciary duty to invest in members’ best interests and Railpen’s investment team operates within these parameters with a mission to “secure our members’ futures”. At a portfolio-wide level, this means that we allocate across different jurisdictions and sectors to diversify, while at a bottom-up (or stock-specific level) we consider carefully the fundamentals of a company, and its specific risk and return profile.

Railpen works hard to influence portfolio companies to improve their behaviour across material business risks including those pertaining to governance and sustainability. We believe – and evidence shows – that meaningful stewardship activities can boost financial performance over the long-term[7]. To do this, we need to be able to effectively exercise the full suite of stewardship tools and we are therefore keen to invest in companies that provide robust investor protections and **strong shareholder (including voting) rights[8] [9].** Whether or not a company provides these protections will rely in large part upon the regulatory requirements of the jurisdiction in which it lists. *Please also see the appendix for our reflections as to the extent to which companies are incentivised to provide these protections without the necessary regulatory or court-based framework and incentives.*

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[6] Please see our comments above on what companies are looking for.
[7] The FCA’s previous paper *DP19/1 Building a regulatory framework for effective stewardship* cites a number of these papers making the link between meaningful stewardship and financial performance (pp.11-12).
[8] Please see our 2022 Stewardship Report for details of our governance-focused exclusions process and the role which unequal rights at a company plays in contributing to a decision as to whether we invest.
[9] We are not the only investor that prefers to invest in companies with equal voting rights. There have been several recent examples of companies which listed with dual-class share structures at IPO and traded at a discount as a result (inferred from investor comments around their dissatisfaction with the approach at the time), such as Deliveroo and The Hut Group.

The academic literature – as well as the experiences of other investors – also supports at a macro level our more micro perspectives on this i.e. that strong shareholder rights encourage flourishing, healthy capital markets. For instance, Guillen and Capron (2015)[10] found that "when you have strong protections for the interests of minority shareholders, then more people are willing to invest money in the stock market. As a result, what you get a larger stock market with more turnover and higher capitalization – or more dynamism." The OECD noted that "suppliers of capital are more willing to make loans or provide investment when their rights are clearly stated and effective remedies are available in the event of violations…fair and equal treatment of all holders of common shares is one of the key principles of effective corporate governance."[11]

Finally, both domestic and international investors want the opportunity to invest **in high-quality, well-run companies** – both those which are well-established and those which have only just listed – as these are more likely to achieve sustainable, long-term financial performance. This means companies: that can recruit and retain the best people; are subject to robust scrutiny and oversight; are supported by effective internal controls and risk frameworks; and can access the right kind of external advice and support where necessary. Companies can be supported in pursuing the appropriate approach by not only investor influence but also the relevant regulatory and policy framework.

Conclusion: both domestic and international investors care about the company-specific investor protections and rights available to them, and high corporate governance standards.

<u>What supports a thriving ecosystem</u>

For both broader asset allocation and stock-specific investments, Railpen – like other peer investors – considers the policy and regulatory framework of relevant jurisdictions. At a portfolio-wide level, we want to access a breadth of markets, ideally where returns from one market are un-correlated with those from another. We also have a preference for markets where there is a strong **Rule of Law** i.e. which has "societal conditions that enable fairness and prosperity for all members of society…in an environment which is predictable and fair, where people and organisations are treated equitably, in good faith and with reliability, where access to efficient and timely justice is available at a reasonable cost, and where human rights and international rules are observed."[12]

This in part explains why our portfolio allocation was heavily weighted to the US and UK (this is across all asset classes, not just listed equity) with 50.2% allocated to the UK and 24.8% allocated to the US as at 31 December 2022[13].

At a stock-specific level, we also consider many specific factors and variables in our due diligence and monitoring of a portfolio company, one of which is the policy environment in which the company operates i.e. access to tax breaks, other incentives, a stable and coherent plan for the company's specific sector which will support long-term growth and the financial performance our members need, and recourse to justice and fair courts should issues arise.

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[10] The Value of Protecting Minority Shareholders in the Market - Knowledge at Wharton (upenn.edu)
[11] 1930044.pdf (oecd.org)
[12] For a broader discussion of the role the Rule of Law plays in investor decision-making, please see *The Rule of Law and investor approaches to ESG: Discussion paper* (Bingham Centre for the Rule of Law, 2022).
[13] Please see our 2022 Stewardship Report for further details of our portfolio-wide allocation.

Our conversations with companies indicate that they also take into account Rule of Law considerations, as well as the stability of the national and sector-level policy framework into their listing jurisdiction decisions.

An additional aspect of a healthy ecosystem is also, as highlighted by UK Finance and EY, the support structure and "cluster of talent across financial services and supporting industries". This includes professional advisers such as lawyers and investment banks, as well as well-informed research analysts. A smooth IPO experience which achieves a fair valuation and the right long-term support from investors relies on expert, experienced advisers who are familiar with the local market and the investor community.

Conclusion: both investors and companies require a healthy ecosystem to support them. This includes strong Rule of Law and a stable, certain policy and political environment.

B. Why the FCA's current proposals won't help (and may well hinder) the creation of healthy capital markets

We do not think that the FCA's proposals address any of the issues we have identified above. We also think that they will discourage investors from investing and therefore companies from listing in the UK, exacerbating the decline.

Furthermore, we do not believe that the FCA has sufficiently demonstrated that the current listings regime – and specifically, the robust shareholder rights regime – has played a fundamental role in the decline in the number of companies listing in the UK, and therefore needs to be reformed (again). If it were the fact that robust shareholder rights were an issue for companies, then that does not explain why the AIM – which has looser governance requirements – has also seen a decline in listed companies over the same period[14]. We would also refer back to the evidence we provide here which finds that governance standards are not a key determinant for high-growth companies when it comes to deciding where to list. In the absence of more robust reasoning for the renewed focus on listing rules, these proposals risk seeming unreasonable. *Please also see appendix for a fuller exploration of the evidence base on this issue.*

We do, however, agree that other factors may be at play including the decline in domestic and international flows into UK equities – which in turn deters companies from listing owing to issues with analyst coverage and liquidity. As well as the much-discussed decline in UK pension fund ownership of UK equities, we would also suggest that recent high-profile events such as the UK's decision to leave the EU and the rapid turnover in senior UK political leaders since 2016 (and the consequences of this turnover for long-term strategy formulation as regards key sectors such as technology and green finance) have played their role in shaping investors' (and UK companies') perceptions of the UK as a leading, secure and prestigious market as well as leading to heightened uncertainty. These events have also fundamentally impacted the size and scale of the financial services ecosystem that plays a role in supporting healthy capital markets[15].

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[14] See, for instance, this piece which emphasises that 2021 was "the first time the market experienced a net growth since before the 2008 financial crisis": AIM grows by largest number of companies since 2007 as the junior market experiences IPO boom | Insights | UHY Hacker Young (uhy-uk.com)

[15] For instance, a 2021 New Financial Report found that since Brexit, the UK had lost more than 440 financial services firms (which they considered to be an "under-estimate") Brexit & The City: The Impact So Far - New Financial.

We also agree that more could be done to improve retail investor participation in UK equity markets, an improvement in which could fundamentally improve capital markets through improving liquidity. We outline some high-level proposals for doing so later.

Changing the listings regime in the way currently proposed would do nothing to tackle these fundamental issues and could, in fact, discourage the creation of the healthy capital markets that the government and FCA are rightly looking to support. We believe the proposals:

- **Do not tackle the root causes of a decline in IPOs in the UK market.** We think the evidence shows that the heightened recent uncertainty around UK policy and politics, reduced access to EU markets and investors, well-documented decline in domestic institutional investment in UK companies and relatively low UK retail investor flows into UK companies are the primary reasons for the decline in IPOs. The FCA has not proved that changing the listings rules will fundamentally impact these root causes, nor has it allowed time for the previous changes to the listings rules (in 2021) to bed in to understand whether these have had an impact[16]. We would argue that market participants might have had legitimate expectations that no further changes would take place for at least the next few years.

- **Will make UK listed companies less attractive to investors.** Both the academic evidence and our own experience shows that strong shareholder rights and defences are fundamental to a company's attractiveness. Long-term institutional investors like Railpen seriously consider the available shareholder rights, like the right to vote on Related Party Transactions (RPTs) or a one-share, one-vote arrangement, as part of their decision-making. This is because our ability to influence a company's management – and the extent to which a company is incentivised to listen to the owners of capital – is shown to be an important ingredient in the long-term financial performance we need to obtain good outcomes for beneficiaries. The FCA's proposals to diminish these rights will seriously impact the attractiveness of UK-listed companies[17] and fundamentally alter the calculations made about whether or not to invest in UK listed companies. This further diminishing of international and domestic investors could in turn further discourage companies from listing in the UK, as the liquid capital pools they are after do not exist.

- **Will damage what has made the UK unique and allowed it to compete internationally with other jurisdictions for so long.** Our international peer investors tell us that part of what has made the UK so attractive and allowed it to hold its own against other financial markets has been its role as a beacon for high corporate governance standards and robust investor protections. Similarly, companies tell us that gaining a UK listing is considered a powerful signal that a company is well-run and well-placed to thrive over the long-term. The US market has some fundamental advantages over the UK, in large part owing to its scale which leads to very deep, very liquid pools of capital. The UK faces natural restrictions in this respect but has overcome this through building a reputation as the world's 'quality market' – an approach which other markets, such as Japan, have sought to implement (through

[16] We would argue that market participants might have had legitimate expectations that no further changes would take place for at least the next few years.
[17] We explore this later, but to be clear: while we advocate for one-share, one-vote arrangements (and many other corporate governance improvements) at US companies, the investment calculus for a US company is different as they have a counter-balancing line of defence in the system of shareholder litigation i.e. the courts.

raising corporate governance standards) in the hope that they will become more attractive to institutional investors. We believe that rather than damaging the UK's reputation through the current proposals, the government and FCA should instead double down on its reputation for high standards and proactively make the case both to domestic and international capital market participants.

We would also urge policymakers to recall that several of these investor protections were brought in to prevent a re-occurrence of value-destroying corporate behaviour by executives[18]. Davies (2019) explores the history of RPTs and notes that initial, 19th Century rules on self-dealing were often modified by companies to give themselves greater freedom – getting around the notion of fiduciary duty to shareholders – and that subsequent RPT rules "responded to corporate scandals with the requirement of shareholder approval of substantial property transactions"[19].

C. What we suggest should be done instead

We are not convinced that the government and the FCA has comprehensively assessed the nature and causes of the decline in UK IPOs in recent years. Owing to the complex nature of capital markets, such an assessment should not be left to just one government department or regulator, nor should it happen in an ad hoc and piecemeal fashion. Moreover, where any changes *are* agreed and implemented, these changes should be given time to bed in before introducing further changes in the same space.

Our first suggestion, therefore, is that the FCA should pause any further changes to the listings regime until a fuller assessment can be made i) of the specific impact of these changes and ii) of the fundamental and 'big picture' causes of the decline in IPO activity in the UK. We would suggest that such an exploration is undertaken by a cross-governmental, or perhaps even cross-party, commission. Such a discussion should include all investor voices and parts of the ecosystem, particularly the asset owner voice, given our alignment with the needs of our members.

We're confident that others will also offer some alternative ways forward, should a proper cross-departmental and/or process be developed to seek such solutions. At this stage, we offer the following suggestions:

- **Steps to support domestic institutional investment in the UK (which recognise and do not seek to cut across UK scheme trustees' fiduciary duty to invest in members' best interests).** We have mentioned previously that Railpen has an extensive history of investing in UK success stories at an early stage, as well as an extensive allocation to assets in the UK more broadly (beyond listed equity, including government debt, property and infrastructure). As well as an organisational culture that supports innovation and 'not running with the herd[20]', we believe that we are supported in doing this via the following attributes:

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[18] Academic evidence shows that, for instance, RPTs can be highly detrimental to financial performance e.g. Liu and Lu (2004) in *Earnings Management to Tunnel: Evidence from China's Listed Companies* show that the more frequently a company engaged in connected transactions, the lower its firm value dropped.

[19] *Related Party Transactions: UK Model* (Davies, P., 2019)

[20] This culture and approach derives from, and aligns with, the Investment Beliefs of the Trustee of the railways pension schemes, which can be found in our 2021 Stewardship Report.

- Significant scale. With £35bn of assets under management on behalf of 350,000 members, our scale allowed us to undertake our Investment Transformation Programme (ITP) from 2013 and begin to bring more of the investment management in-house. The majority of our assets are now managed in-house and this proportion is likely to grow in the coming years. This has not only brought efficiencies in terms of cost, but has also given us greater control and influence over our assets, as well as the ability to develop and deepen our expertise in innovative asset classes and emerging sectors like fintech and biotech. This in turn has allowed us to move nimbly in response to market movements and has supported a risk-taking mindset.

- The open nature of many of our DB sections. As many of our DB sections remain open, we invest with a truly long-term time horizon, which means that we have an extensive allocation to growth assets including listed equity and private markets. This makes us unusual amongst DB schemes, many of which have been closed to new members and accrual for some time and so invest in a more defensive range of assets which are geared towards providing a stable income stream. In turn, this shapes our attitude to risk as we recognise that a certain level of risk needs to be taken to support the returns we need for good member outcomes.

We do not go as far here as to draw definitive conclusions as to how other pension scheme investors should operate (and in turn what regulatory and policy activities should be undertaken). However, we hope it is instructive to provide evidence from our own experience at this stage.

Otherwise, we are supportive of many of the PLSA's policy proposals in their recent paper *Supporting Pension Investment in UK Growth*, particularly the suggestions on the DB Funding Code. We agree that, where supported by a strong employer covenant, open DB pension schemes should be able to carry long-term risks as part of their investment strategy, even as they approach maturity. At present, this kind of flexibility for open DB funds does not appear to be part of The Pensions Regulator (TPR)'s regulatory vision and future activities.

- **Creating a positive story around the UK's 'quality' USP**. As Lord Hill notes, and as our own pre-IPO companies have told us, prestige is an important determinant in a listing decision. At present, the mood music in the media[21] and amongst policymakers is tending to the negative on the impact of the UK's investor protections and corporate governance standards, even though these things are proven to support long-term financial performance.

  We think that the UK government should proactively go out to domestic and international market participants (particularly investors) and highlight the importance of high corporate governance standards and a robust investor protection regime. In an era of heightened geopolitical instability and with the long-term impact of climate change and Covid leading to much greater uncertainty for companies and investors, a compelling and positive story about the UK's shareholder rights regime could mean the UK becomes an increasingly popular choice for any 'flight to safety' for investors.

[21] CP23/10 referred to a few of these media sources.

- **Better financial education for a healthier retail investor market.** We note the FCA's evidence that households in the US, France, China and elsewhere are much more likely to have investments in (domestic and international) equity markets than in the UK. Although the causes for this are many and complex, we think that better and earlier financial education about the importance of taking a measured approach to risk-seeking and the long-term benefits of investing could help boost the UK retail investment market and boost liquidity. This would be particularly helpful for UK-listed firms as many retail investors have a home market bias.

- **A more stable policy environment, with long-term, sector-level strategies.** This should include specific government help for scaling up companies once they are out of the incubator stage and to provide alternative to venture capital[22]. This kind of long-term, dedicated political and policy support (e.g. dedicated tax breaks for companies and investors, or the government committing to underwriting certain investments in certain sectors) could mean that fewer companies face a cliff-edge around funding at a critical stage in their journey and therefore need to access capital sources which are more inclined to influence on e.g. decisions on listing jurisdiction for short-term reasons.

Our answers to the consultation questions

We answer here only those questions where we feel we are best able to provide an informed answer.

Q4. Do you agree with our proposed approach to dual-class share structures for the single ESCC category and the proposed parameters? If you disagree, please explain why and provide any alternative proposals.

We do not agree with the FCA's proposed approach to dual-class share structures (DCSS). We believe that the proposals are unnecessary, will make it harder for scheme investors to act as effective stewards of their assets and ultimately not only reduce the pool of capital that pre-IPO companies tell us they want, but will detrimentally impact the long-term returns we need to achieve good outcomes for scheme members. Instead, we think the FCA should stick with the current approach i.e. a five-year mandatory sunset clause, with a 20:1 weighting cap (which is already more permissive than the 10:1 limit in Singapore and Hong Kong), and where voting rights can only be exercised in a very limited set of circumstances.

There is extensive evidence that demonstrates the negative impact on financial performance of DCSS that last beyond the first few years after listing[23]. This owes to the fact that managers are less incentivised to listen to their shareholders and dilutes the impact of market discipline: as highly engaged investors, we see this for ourselves with companies like Alphabet known for their lack of willingness to engage with their investor base[24]. We would also note that much of the academic evidence we cite likely overstates

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[22] UK Finance notes that venture capitalists are more likely to suggest non-UK jurisdictions for listing as they are keen to obtain the highest possible valuations at exit, instead of considering what might be in the best long-term interests of the company's stakeholders.
[23] We summarise several of the most pertinent sources in our 2021 response to the Hill Review: [railpen-response_uk-listings-review_05-01-2021.pdf (azureedge.net)]
[24] Railpen recently pre-declared its intention to vote against Alphabet across a number of resolutions, including against individual directors, for exactly this reason: [PRE-declaration: ALPHABET – SHAREHOLDER ENGAGEMENT (azureedge.net)]

the length of the time period during which DCSS can have benefits for companies, as companies now tend to IPO when they are at a more mature stage in their lifecycle[25].

We note that the FCA suggests that investors should negotiate and moderate 'excessive' approaches to DCSS. However, this not only assumes a high level of interaction between pre-IPO companies and the long-term investor base – and our conversations with IPO advisers indicate that long-term institutional investors are rarely invited to such discussions – but also, after IPO, disregards the disempowerment and lack of influencing levers through enabling DCSS.

We, as part of the Investor Coalition for Equal Votes (ICEV) that replied to DP22/2, were supportive of the five-year mandatory sunset clauses and other investor protection measures outlined in DP22/2. We think that five years gives the increasingly mature newly-IPO-ed company sufficient time to execute on its strategy and avoid takeover bids. Given that this change was only implemented 18 months ago and in DP22/2 the FCA noted that its "intention..would be to continue to maintain the high levels of transparency, corporate governance and shareholder protections that characterise the UK listing regime" and "it may not be appropriate to move to a more permissive form of DCSS", we are surprised that the FCA has both altered its position and is consulting again on further changes so soon, without allowing time for the full impact of these changes to be evidenced. We think that both investors and companies could have legitimately expected that no further changes would have been proposed for the next few years.

We also find it surprising that steps to further allow unequal voting rights have been proposed, in light of other recent – and very welcome – steps taken by the government and the FCA to support investors (including asset owners) to wield their voting rights more effectively[26]. We agree with the government and FCA in their work elsewhere that thoughtful exercise of voting rights, and meaningful stewardship practices overall, can help enhance and protect long-term financial performance at firms in a way that benefits scheme members and other individual investors.

We hope we have adequately explained earlier in our response the likely negative impact on what the FCA is trying to achieve, by way of healthy capital markets, from its current proposals as they will likely reduce the pool of high-quality and liquid capital that companies tell us they are looking for when deciding whether to list in a particular jurisdiction.

Q7. Do you agree with the proposed approach to significant transactions for a single ESCC category? If not, please explain why and any alternative proposals.

We do not agree with the proposed approach to significant transactions for a single ESCC category. This is because as currently drafted, it is only "reverse takeover" transactions which would qualify for prior shareholder approval and this does not provide sufficient protections for shareholders as regards significant transactions, which may well negatively impact value for shareholders and – ultimately – the returns we are able to achieve for scheme members.

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[25] See, for instance, Ritter (2023) which notes that the median number of years between founding and the calendar year of the IPO was either years (1980-1989) and 11 years (2001-2022) [Microsoft Word - IPOs-Age (ufl.edu)](#).

[26] These include the FCA's *Vote Reporting Group*, the government's *Taskforce on Pension Scheme Voting Implementation (TPSVI)* and the Financial Reporting Council's *UK Stewardship Code 2020*.

The vote on significant party transactions is an important investor protection. Simply requiring disclosures, without any accompanying mechanisms for investors to do anything about a transaction they are unhappy with, fails to provide an appropriate level of protection.

We are aware of instances where a company has gone out informally to its shareholders with a proposed significant party transaction and where it was unable to get the support necessary to pass a shareholder vote. Had such a shareholder vote requirement not been in place, it is likely that the company would have felt empowered to go ahead with a transaction that clearly caused its investor base significant concerns and could have resulted in a significant loss of value. More broadly, were these proposals to go ahead, we have concerns about the wider quality of transactions that would be more regularly taking place as companies feel less concerned about the ability of investors to scrutinise such transactions and make any dissatisfaction felt.

As with the proposals around DCSS, these proposals would again undermine investors' ability to be good stewards of their assets and to influence corporate behaviour in a way that helps protect shareholder value and, ultimately, value for beneficiaries.

Q12. Do you agree with the proposed approach to RPTs for a single ESCC category, which is based on a mandatory announcement at and above the 5% threshold, supported by the 'fair and reasonable' assurance model which includes the sponsor's confirmation as described above? If not, please explain why and any alternative proposals in the context of a single ESCC category.

We do not support the proposed approach. The requirement for a compulsory shareholder vote on related party transactions is a vital protection, allowing investors the opportunity to make their views known and felt on transactions that are i) fundamental to shareholder value and ii) ripe for potential abuse[27].

We do not believe that the FCA has made the case for relaxing the current RPT rules. Firstly, RPTs that are "in the ordinary course of business" are exempt from the rules around shareholder votes. This exemption already allows straightforward RPTs to go ahead. Secondly, part of the FCA's rationale for relaxing RPT protections appears to be that "such shareholder votes are relatively infrequent and usually result in approval". It is likely that the impact of a robust RPT regime means only those that are most likely to be approved come to shareholders for a vote in the first place.

We are also concerned by how such a relaxation interacts with other FCA proposals here, and its broader policy objectives. For instance, the FCA notes on RPTs – and elsewhere – that investors would need to consider "the composition and performance of the company's board, its governance practices and conflicts management processes" in gaining comfort around an RPT. However, at the same time the FCA wants to make it more difficult for investors to influence to improve board oversight through the proposed dilution of voting rights.

The FCA also notes that "our rules cannot prevent every risk to shareholder value or be a substitute for investors carrying out their own analysis". However, it fails to properly

[27] The Organisation for Economic Co-operation and Development (OECD), in its 2012 paper *Related Party Transactions and Minority Shareholder Rights,* explores several examples of RPTs (such as WorldCom) which went badly wrong and notes that "[transparency] is not alone sufficient" for protecting shareholders.

acknowledge that additional due diligence imposes greater costs on investors which ultimately get passed on by managers to owners and negatively affect the outcomes achieved for members. This runs counter to the very welcome FCA and TPR joint focus on improving value for money for scheme members.

We have significant concerns about the implications of relaxing investor protections on RPTs. Although currently relatively few in number, we believe that this would rapidly change and mean a greater number of companies of dubious quality listing in the UK – further discouraging investors from investing in UK-listed companies and damaging the UK's reputation.

Q21. Do you agree with our proposed approach to reporting against the UK Corporate Governance Code for companies listed in the single ESCC category, and are there any other mechanisms the FCA could consider to promote corporate governance standards?

We believe that the UK Corporate Governance Code has played an important role in supporting the high corporate governance standards at UK companies for which our country is renowned. We are supportive of extending the mandatory reporting scope to a wider pool of companies and, given that the proposed ESCC category would newly cover standard listed companies that do not currently report against the Code, we welcome this proposal.

Please note that we do not consider this welcome development to sufficiently counter-balance the reduction in investor protections and investors' ability to act as good stewards (given that corporate governance and stewardship are "two sides of the same coin" as a senior FRC official noted recently – we would agree). The positive impact of companies being required to disclose how they comply (or explain why not) with the Code's requirements is diminished when the ability of shareholders to act upon this information where they have concerns is much reduced.

Q45. Have we identified the areas where our proposals may impose additional costs on investors? If not, please explain the additional costs that we should consider in our CBA.

We believe that the FCA has significantly underestimated the additional costs to investors that – importantly – will lead to additional costs for beneficiaries. These missing costs include:

- More costly stewardship work (to try to achieve a similar level of outcome). Where there are unequal voting rights, our experience and academic evidence shows that company managers are not incentivised to respond meaningfully to investors and there are therefore likely to be additional costs in achieving stewardship objectives. More effort will have to be expended upon not only trying to obtain a meeting with company decision-makers, but also on additional tactics, such as AGM attendance or co-filing resolutions. These costs will likely be passed on to the end saver. It is already the case that investors have challenges in achieving sufficient stewardship resource[28] and this will simply exacerbate the problem.

[28] This is why the UN-backed *Principles for Responsible Investment* (PRI) has recently commenced a project exploring stewardship resourcing issues.

- Loss of value for the end client (scheme members and retail investors). We have previously referred to the extensive academic evidence that shows that long-term financial performance suffers at companies with unequal voting rights, as well as some of the issues around RPTs and significant transactions. Removing important shareholder protections in these areas will be detrimental to good outcomes for individuals.

- Transaction costs for passive investors. Should the FCA continue with proposals around DCSS, significant transactions and RPTs, then unless index providers exclude e.g. companies with DCSS from their mainstream indices[29], investors wishing to avoid the risk inherent in such companies will have additional costs imposed upon them either through the requirement for a bespoke index or through having to shift out of UK index trackers to trackers following other countries' indices given that a UK listing will be less likely to be an indicator of high-quality, well-run firms.

- Costs from a narrow approach to company decision-making (negative impacts on diversity of thought). The FCA has been laudably keen to encourage diversity of thought at companies that fall within its regulatory perimeter. However, diluting the shareholder voice in companies' decision-making (through unequal voting rights) means that the views of a less diverse group of individuals is considered which evidence shows is likely to lead to cognitive bias and ineffective decision-making[30].

More generally, we believe that there has been insufficiently explicit consideration of the potential impact of these proposed changes upon individual savers throughout the entire paper. It should be recognised that it is scheme members (and retail savers) who are the ultimate owners of assets and who will suffer from additional direct and indirect costs and ultimately negative consequences.

Q51. What do you consider to be the most important factors in deciding where to list (for example, regulation, valuations, depth of capital markets, comparable peers, investor/analyst expertise, taxation, director remuneration requirements, indexation, location of main operations). Please rank your factors in order of importance.

Please see our earlier comments around what evidence shows is driving companies' decision as to where to list.

We would additionally note that our conversations with companies do not indicate that executive remuneration practices in the UK are a particularly important factor. We agree with those companies who tell us that a few million per year for the average FTSE CEO is sufficient to retain and attract talent. We also note evidence that shows that fair pay practices are important for ensuring the fulfilled, motivated and engagement workforce that is fundamental to sustainable company performance[31]. More specifically, we note the significant level of workforce dissent and dissatisfaction witnessed in recent years at US

[29] Until recently, there was precedent for this happening, with S&P DJI excluding new companies with dual-class share structures from their S&P Composite 1500 index. Sadly, this decision was reversed in early 2023.
[30] See, for instance, *Research Report on the Effectiveness of Oversight Committees: Decision-making, Governance, Costs and Charges* (Tilba, Baddeley and Liao, 2016).
[31] Please see some of the evidence cited in our 2022 work with the PLSA, CIPD and High Pay Centre *How do companies report on their 'most important asset'*.

firms[32], which have historically much higher executive remuneration quantum and greater gaps between CEO and average worker pay. This in turn affects a company's reputation and brand and can have serious, financially material long-term consequences in terms of its 'social license'.

Q52. Do you have any suggestions as to how we might quantify the benefits of our proposals? And can you provide any evidence of the cost savings to issuers that might arise from our proposals to no longer obtain shareholder approval for certain significant transactions and RPTs?

We do not believe that these proposals – beyond the expansion of the UK Corporate Governance Code requirements to those firms that currently have a standard listing – carry benefits in terms of the healthy capital markets that the FCA and the UK government are currently seeking to promote.

We hope the comments contained here and in the appendix are helpful, and would welcome the opportunity to discuss further or provide any additional clarity.

Yours sincerely,

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[32] Examples include Amazon, Starbucks, Chipotle Mexican Grill, Alphabet and Activision Blizzard.

Appendix – our thoughts on the evidence and arguments presented in CP23/10

In light of the wide-ranging (and occasionally unforeseen and unpredictable) implications of any policy or regulatory change, we believe that the burden of proof i.e. the requirement to provide robust evidence as to why the proposed change is desirable, should fall on those proposing the change.

We note that to support its case for further changes to the UK equity listings regime, the FCA has offered a number of evidence points and made a variety of arguments (we note there appears to be only one reference to an academic study made in the paper). In addition to our discussion in the main body of this response, we here further explore the data and rationales provided in the consultation paper – as well as those made in the broader and ongoing debate in the media – and offer our own reflections and data points in response. We would also welcome further clarity from the FCA on a number of points below.

<u>Areas where we'd appreciate further clarity</u>

- **"Views differed on permitting dual class share structures in the context of a single equity category".** Has the FCA considered providing a further breakdown as to what proportion of respondents supported further enabling of unequal voting rights and what proportion opposed it? Furthermore, we believe it would be helpful to understand how these proportions compared for different types of respondent i.e. investors (and those with a responsibility to the end saver) vs. those with a commercial interest in further loosening such as company advisers and others. We note from the list of non-confidential respondents published in the consultation paper that the majority could be considered to have a commercial interest.

- **"…those asset managers we spoke to expressed limited awareness of, or reliance upon, our listing rules when making decisions on their investment strategy or in engaging with companies…instead portfolio managers focused on fundamental analysis and more direct, ongoing engagement."** This does not align with our own experience as both an active and passive (and highly engaged) investor. Please see our views as expressed earlier in our response around the importance both of the Rule of Law at a portfolio-wide level and the shareholder rights that come with owning a particular company in our investment decisions. We would be interested to further understand how many investors the FCA engaged with as part of its post-DP22/2 discussions, including whether they were active or passive, and whether any asset owners were included.

<u>The FCA's evidence base</u>

- **"...we have also considered further the data on UK listed markets. This does show a persistent decline over recent years in the number of listed companies… it suggests our markets could work better".** We note that the figures presented are not disaggregated by companies on the premium segment, the standard segment or indeed the AIM market. While we agree that the chart does show an overall decline in the number of listed UK companies, has the FCA considered in depth the implications that data elsewhere demonstrates a decline in AIM listed companies over the same period? Given the more relaxed approach to governance standards at AIM (with a number of issues with companies as a result), this does not appear to us to indicate that it is the high governance standards and robust shareholder rights at premium listed companies which are the problem.

However, this is not a UK-only phenomenon. In fact, we note that the US has also seen a decline in listed companies since 2000[33]. We would argue that the era of cheap financing has made remaining private, including the scope for greater leverage that such an approach offers, a more attractive option. We agree with the FCA that greater transparency from companies is a good thing. However, we would suggest that, instead of lowering governance standards and shareholder protections in the listed space to ensure they do so, a sensible alternative approach might be to seek to raise standards of transparency and behaviour from private companies[34].

- **"If certain protections no longer offered by our rules are viewed as important to certain groups of investors, then there are mechanisms by which markets can set such conditions…index providers could review inclusion criteria."** Has the FCA discussed with index providers their propensity to step in – without additional charges – and protect investors from poorly governed companies through changes to index inclusion criteria? By withdrawing fundamental shareholder protections and leaving asset owners and managers to rely on index providers, it is likely that this would lead to additional costs to investors that will then be passed onto scheme members. We have discussed dual-class share structures with a number of index providers, including as part of our work with the Investor Coalition for Equal Votes (ICEV) and although they would be happy to develop an additional index product for investors, it is likely this would come at a cost. As emphasised by the recent, disappointing decision by the S&P Dow Jones Index to enable more companies with unequal voting rights to list on the S&P Composite 1500 index, our experience is that index providers appear unwilling to proactively protect passive investors from the long-term negative impact of dual-class share structures.

- "**...without meaningfully moving away from the premium listing approach, a single segment is unlikely to prove sufficiently flexible to allow the full range of company models to list in the UK."** Instead of rolling back what is essentially one of the few positive differentiators for UK capital markets, if it is too difficult to provide sufficient flexibility with a single segment regime, it may instead be more productive to retain the multiple segment approach. Has the FCA considered – also in light of the lack of investor demand for a single segment regime as highlighted in its discussion in DP22/2 – that the issues and implications for stewardship and shareholder rights of a move to a single segment regime as currently proposed may be too costly, and that its objectives are better served by retaining the segmented approach?

- "**We have considered evidence from US markets that show a higher prevalence of DCSS particularly among companies in the technology sector…the same data also suggest average 3-year buy-and-hold returns are better for companies with dual-class share structures across 1980 – 2022, particularly for technology companies, although this does not prove causation."** We agree that this does not prove causation and is not a powerful piece of evidence, for the following reasons. It is

[33] See, for instance, McKinsey's 2021 paper A closer look at trends in public company listings and IPOs | McKinsey

[34] We recognise that some steps have been taken to do so through the FRC's *Wates Corporate Governance Principles for Large Private Companies* as well as the expansion of the definition of a Public Interest Entity (PIE) as outlined in the (then) Department for Business, Enterprise and Industrial Strategy's (BEIS) proposals on *Restoring trust in audit and corporate governance*. We would encourage further, 'hard law' steps in this direction to encourage greater investor confidence (and therefore investment) in private companies.

well understood that technology companies – both with and without DCSS[35] – have outperformed the broader market over the same time period. We would also suggest that the 3-year buy-and-hold period does not accurately reflect the needs or approach of investors like pension schemes, whose time horizons are often 10-, 20-, or even 50+ years long. Evidence from other markets – whose capital markets are less reliant on (the long-running bull market in) technology companies – with dual-class shares, such as Brazil and France, indicate that actually the impact of DCSS on returns can be negative, even after a few years[36].

- **"More recent market developments and media commentary have also focused attention on the UK's attractiveness as a listing destination and the role listing rules play in this."** We do not think that citing a prevailing media narrative, based on the comments of journalists and media outlets incentivised to provide headlines and interpretations of a small sample of company comments that will attract the most attention, should be considered a robust contribution to the evidence base. We welcome instead the FCA's decision to ask in question 51 of theiraaa paper "What do you consider to be the most important factors in deciding where to list" and hope due consideration will be given to the broader evidence base we outline here, as well as the evidence fed through by asset owners and others who do not have a commercial interest, but rather are closely aligned to the interests of savers.

We would also like to take this opportunity to explore some of the broader points which we have seen in the media and from industry commentators – and which appear to be gaining ground – around the proposed changes to the listings regime rules:

- **'UK investors also invest in other markets where they do not have the same voting and shareholder rights'.** The US is often cited as one example, with China as another. However, the FCA itself notes in the consultation paper that "…US requirements are supplemented by legal fiduciary duties on a company…and court-based processes". It is also more straightforward and less costly to e.g. file shareholder resolutions in the US than it is in the UK. These alternative lines of defence have made it easier for investors to overcome governance-related reservations and participate in the extensive and non-replicable US technology stocks rally. However, we would note that unequal voting rights and other standard US corporate governance practices which fall below what we would deem acceptable are considerations not only in our stock-specific investment decisions at Railpen but also in our governance-based exclusions process[37].

- **'Companies may still choose to list with equal voting rights, or offer shareholders a vote on a significant transaction or RPT, without being required by the listings rules to do so.'** Companies may still do so. However, this is also open to them in the US and a significant minority of companies still choose to list with unequal voting rights[38]. We also note that companies have been slower than the long-

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[35] As an example, we should note that both Amazon and Microsoft have performed extremely well over this time period and are considered highly innovative firms. Neither of these companies have dual-class share structures and this does not seem to have dampened their ability to disrupt and perform effectively.

[36] We outlined some of the evidence from these markets in our response to the Hill Review, which can be found online.

[37] You can find further details of this exclusions process in our 2022 Stewardship Report.

[38] For instance, the CII found that in the US in 2022, 15.2% of companies which went public in 2022 had dual-class share structures with unequal voting rights.

term investor community to respond on issues like climate change, gender diversity and workforce treatment. Although activity on these issues is the right thing to do for shareholders – in terms of having a material beneficial impact on financial performance – evidence indicates that companies' progress lags what investors would like to see. We therefore remain sceptical that companies will listen to the full breadth of their investor base on issues such as shareholder rights.

- '**UK initiatives such as the UK Stewardship and Corporate Governance Codes will ensure that the UK maintains high standards of corporate governance.'** Has the FCA, in its own conversations with the Financial Reporting Council (FRC) and other relevant regulators, gained an insight into the extent to which these organisations view the Codes as close substitutes for the protections currently offered by the listings rules?

  We think that these two Codes have played a powerful and important role in shaping investor and company attitudes towards corporate governance, environmental and social issues, as well as what it means to be a truly active steward of assets. However, such 'soft law' approaches – which rely on disclosure – while going some way to raise standards, are insufficient on their own and particularly in the absence of the voting rights which add weight to an investor's engagement efforts with a company on its behaviour. More and better disclosure is important for an investor's understanding of a company's approach to material issues, but if their ability to have their views on this information heard by the company is limited through a reduction or dilution of shareholder rights, the extent to which progress is encouraged is limited.