

Asset Management - November 9, 2007

Investment entities - new London Listing Rules and introduction of London Specialist Fund Market

Mindful of the need to promote the competitiveness of the London listings market, the UK Financial Services Authority and the London Stock Exchange have conducted a wide-ranging review of the options available for listing an investment fund in London.

The review has comprised:

- modernisation of the rules for listing investment entities on the London Stock Exchange's Main Market, with a view to attracting private equity, hedge, structured credit and infrastructure funds to list on the Main Market under a simplified regime; and
- the introduction by the LSE of a new market dedicated to investment funds which do not require the liquidity and exposure offered by the Main Market, named the Specialist Fund Market.

The LSE's Alternative Investment Market (AIM) will also continue to attract investment funds which may not command a Main Market listing, or for which the Main Market's gold plated requirements for investment entities are unattractive.

The table at the end of this briefing summarises the three London listing options, together with Euronext and the Irish Stock Exchange.

Listing an investment fund

Managers of hedge, infrastructure, private equity and structured credit funds have been spending increasing amounts of time finding ways to access a broader range of investors. Listed closed-end funds have been a growing part of the available arsenal. A diversified pool of investors can be critical to a fund's long term success and listed closed-end funds bring access to investors (such as life insurance companies) which are restricted by solvency requirements in the amount that they can commit to unlisted vehicles. Listed funds also offer access to private clients and smaller institutions and provide daily liquidity, mark to market valuation and the credibility and reporting transparency offered by a regulated and listed company. Lastly, listed closed-end funds do not face the mismatch that traditional open ended funds face between the desire to hold assets for the long term and the typical requirement for 1-monthly or 3-monthly liquidity.

It is worth clarifying the use of the term "listing". Strictly speaking, a listed security in the UK is a security admitted to a market whose rules regarding admission criteria are derived from the EU Consolidated Admission and Reporting Directive. These UK markets are the Main Market and Professional Securities Market. Securities "listed" on AIM or the new Specialist Fund Market do not need to be approved under EU Admission Rules to be listed, so are better referred to as unlisted securities, albeit they trade on a liquid market.

The LSE's Main Market

In October 2006, the FSA concluded that overseas companies (including investment companies incorporated in, for instance, Guernsey) could apply for a secondary listing on the Main Market under Chapter 14 of the Listing Rules without requiring a primary listing elsewhere. The advantage of a secondary listing route for foreign investment entities is that such entities can list without regard to either the disclosure rules, track record rules (under Chapter 6), or the rules applicable to investment entities (under Chapter 15). Brevan Howard listed a Guernsey company under this regime earlier this year.

Changes to the Listing Rules

Following lobbying by the UK investment management industry, the FSA no longer allowed secondary listings and has now concluded that all investment entities will be subject to a single regime to be introduced in spring 2008. Changes to the listing rules are being effected in two stages. The FSA introduced interim changes to Chapter 15 (and 16, for open ended funds) on 28 September 2007. In spring 2008, at the same time as implementing changes designed to prohibit secondary listings of investment entities under Chapter 14 (see note below), the FSA will introduce further changes to Chapter 15, which are currently out for consultation. We summarise here the main requirements for listing on the Main Market, and the changes to the rules which will be implemented.

Admission criteria

To access the Main Market, funds (i) need to publish a prospectus which complies with the FSA's Prospectus Rules and is approved by the FSA and (ii) comply with the FSA's Listing Rules. Issuers incorporated outside the UK but within the EU and seeking admission to a London market will normally draw up a prospectus in accordance with their equivalent local rules which have implemented the EU Prospectus Directive and "passport" into the London market by using that prospectus with evidence of approval of the local regulator. It is generally possible for an issuer based outside the UK but within the EU to publish the prospectus only in English.

Some funds may find the greater flexibility for the format of prospectuses drawn up under the Prospectus Directive attractive – in particular, issuers can publish a separate registration document, containing disclosure on the fund which sits on the shelf until needed, and a separate securities note, containing details of the securities to be issued and any updates to the registration document. Staggered placings of shares as and when needed is the most efficient means of reducing cash drag in a fund, and a separate registration document and securities note may well be of interest to investment funds as a means of facilitating follow-on issues. In respect of further issues, follow-ons of up to 10% of the equity are exempt from the need to produce an FSA approved prospectus (although

such issues will also need to be institutional only offerings, given that any public offering triggers the prospectus requirement).

Pathfinder route

Issuers making institutional offerings still have the option of producing an unapproved pathfinder prospectus to conduct their pre-launch marketing, although an FSA approved prospectus will be required as a condition to admitting securities to listing on the Main Market. In order to avoid the requirement for an FSA approved prospectus to be published at the marketing (as opposed to listing) stage, the issuer will need to limit distribution of any pathfinder to "qualified investors" only (broadly institutional investors) or require a minimum subscription of €50,000. The key advantage of using a pathfinder prospectus is that it reduces the risk that the issuer, having published an approved prospectus, must publish a further supplementary prospectus disclosing any significant new matters or inaccuracies prior to the closing of the offer. A fund considering a listing will need to consider carefully the pathfinder route with its advisers, given its impact on the timing of bookbuilding and settlement. An approved preliminary prospectus need not include a definite statement as to the number of securities to be offered, provided that it discloses the criteria under which the number will be determined and the issuer publishes a subsequent pricing supplement.

Public disclosure regime

The FSA's Disclosure and Transparency Rules require funds to disseminate material market information affecting the fund via the a regulatory information service and a website, and require annual and semi-annual reporting, and quarterly management statements (which are effectively trading updates). Managers contemplating a listing will need to consider carefully prior to listing what information needs to be disclosed to the market during the fund's life (for instance in a listed fund of hedge funds, this could include disclosure of a change of an underlying manager).

Main list rule changes

Management control over assets

As with other exchanges, the FSA considered that taking legal or management control over assets was a badge of a trading, rather than of an investment, entity. This was because a diversified conglomerate could theoretically list as an investment entity under chapter 15, therefore bypassing the track record requirements. The FSA has accepted that, so long the fund has sufficient risk spreading, there should be no restriction on taking control over assets, thereby allowing private equity funds (and property funds which invest through corporate vehicles) to list. Mindful of the risk of one badly performing asset contaminating the rest of the portfolio, the FSA has stipulated that such funds may not put in place cross-financing arrangements between businesses (e.g., cross collateral undertakings) or put in place common treasury functions (e.g., cash sweeping arrangements).

Listed feeder funds

Funds seeking a listing will often technically be feeder funds, such as vehicles listed to invest into an existing master fund. The regulator's concern with feeder funds is that the listed feeder, by virtue of being invested in the master fund, has given up control over the assets to the master fund – this was previously addressed in the Listing Rules by requiring that the feeder controls the policy of the master in accordance with the Listing Rules' requirements and by requiring the same directors at both levels. Recent changes to the Listing Rules have removed the requirement for the same directors at both levels, but still require the feeder to control the investment policy of the master – which may not be practicable for a new listed feeder fund being formed to invest into an existing master hedge fund. To address this, the FSA proposes a new provision which will rely on the fiduciary role of the board in supervising the fund's investment objective, by obliging the board of the feeder to be satisfied that the investment objectives and diversification requirements of the master conforms to the feeder's. Fund managers will need to ensure that the redemption terms agreed between

the listed feeder and the master fund are also consistent with the feeder's investment policy.

Concentration and investment limits

In 2005 Eurocastle moved its listing from the LSE to Euronext when it changed its investment objectives to allow higher concentrations in direct property portfolios, which would otherwise not have been permitted because of the FSA's rule which limits the amount that may be lent or invested in any company to 20% of the total assets of the issuer. The FSA has now removed this limit in favour of relying on a listed fund to have an investment policy dealing with asset allocation, risk diversification, gearing and maximum exposures. The investment limits previously prescribed for venture capital trusts and property investment companies have been scrapped.

Investment policy changes

One typical area of uncertainty for investment funds has been the extent to which the fund continues to be bound by an out of date investment policy published in its prospectus. The Listing Rules now require a fund to publish an annual statement as to how the fund has invested its assets in accordance with its investment policy, and to obtain prior shareholder approval to any material change to its investment policy - bearing in mind that small cumulative changes to an investment policy made over a period may reach a point where shareholder approval is required.

Board independence

The requirement for board independence, which is that a majority of the fund's directors (and the chairman) must be able to demonstrate that they will act independently of the investment manager, has always been a feature of the UK listed investment entity regime and will be retained under the new regime. A listed private equity fund will generally need a number of independent directors to approve those matters which (in a limited partnership structure) have usually been approved by the limited partners themselves (e.g., variation or termination of the management agreement). The FSA requires that, for board members to be independent, they may not be directors or employees of the investment manager, of any

master fund or of any other fund managed by the same investment manager or its affiliates. Therefore, directors already serving on other portfolios of the manager, whom the manager may regard as independent in character, may not also serve on the board of the listed fund.

Interestingly, in line with the greater responsibility that the FSA is now requiring from independent boards, the FSA is proposing to abolish the existing rules which require the investment manager and the directors to have sufficient and appropriate experience and to rely instead on a requirement that the board considers whether the directors and the investment manager together have sufficient and appropriate experience.

Notification and reporting requirements

In addition to the requirement to publish six-monthly interim management statements and half-yearly and annual financial reports, listed investment companies are obliged to make quarterly public disclosures of their top ten investments and all positions over 5% of the portfolio, and disclosures of cross-holdings in other listed closed-end funds. Hedge fund portfolios may well be too diverse for portfolio information presented in this way to be meaningful and there is sensitivity in the hedge fund industry to making a stock by stock disclosure of positions. This requirement remains unchanged in the interim regime. In the meantime, the FSA has proposed reforming the disclosure rules to oblige issuers only to report on the details of any position over 10% of the portfolio.

Related party transactions

Related party transactions are transactions between the issuer and its shareholders, directors and various associated parties. Under the Listing Rules, such transactions can give rise to shareholder approval and an independent fairness opinion, subject to exemptions covering small transactions and transactions in the ordinary course of business. The related party rules have tended to regard investment managers in the same category as directors, and therefore potentially cover transactions between the issuer and the investment manager, in particular, sales and purchases of assets between funds managed by the same investment manager and co-investment arrangements.

Arguably, the presence of the fund's independent board and appropriate contractual arrangements will ensure that arrangements between the fund and the manager are at arm's length. The FSA has proposed the following, currently under consultation:

- co-investment arrangements made at the same time and on the same terms or in accordance with a pre-existing agreement between the fund and the manager should not be treated as related party transactions;
- other clients (for instance, funds) of the investment manager should not be treated as related parties, so purchases and sales between funds will not be subject to shareholder approval;
- transactions between the fund and other clients of the investment manager which benefit the investment manager will not be treated as related party transactions, provided that they are contemplated under the terms of the investment management agreement.

Dividend policy

The Listing Rules have previously prohibited funds from paying dividends unless they are covered by investment income – thereby limiting the payment of dividends from capital realisations. This rule has now been removed. In view of the liberal protection of capital regimes in some popular offshore jurisdictions, it will in future be possible for funds to make generous returns of capital to investors by distributions.

Foreign issuers and limited partnership interests

To be admitted on the main London SETS trading service (which is the prime London trading system) securities must be settled through the CREST dematerialised trading system. Currently, only securities constituted under the laws of the UK, Ireland, the Isle of Man, Jersey or Guernsey can be admitted to CREST. Issuers incorporated elsewhere will need to arrange depositary interests to be admitted to CREST – these are broadly receipts issued by a depositary representing ownership of the company's shares, which can be listed and traded in London independently of the underlying shares.

Although the new Listing Rules (together with the rules of the Specialist Fund Market, see below) indicate that limited partnerships will now be accepted for listing, unithised limited partnership interests are not admitted to CREST. CREST admission is not a condition of admission to the Specialist Fund Market and admission of the securities to other central securities depositaries (for instance, Euroclear) can be accommodated. Limited partnership interests can be admitted to Euroclear.

The Specialist Fund Market

The Specialist Fund Market has been launched as the market for closed-end funds which require the liquidity and status of a London market but not the investor reach or standing of a Main Market listing. The LSE is hopeful that issuers (such as offshore hedge funds) which have so listed on Euronext will consider the Specialist Fund Market. What type of funds is the SFM aiming to attract?

- funds which are approaching a small institutional investor base and which want the ability to craft and change their investment policy and management arrangements according to investor appetite, both at launch stage and in the early years;
- funds which are offering a more exotic or specialist strategy only suitable for institutional investors;
- funds which are interested in a minimal public disclosure regime; and
- funds which may want to offer occasional liquidity or dealing to investors.

It is worth mentioning that the Irish Stock Exchange (together with newer exchanges in the Channel Islands and the Cayman Islands) have attracted thousands of open-ended funds for whom a technical listing offers advantages in terms of investor base but which do not require liquidity.

Listing criteria

The criteria for admitting a fund to the Specialist Fund Market are simply:

- as for all the LSE's markets, the securities must be transferable securities which are freely negotiable

(in other words, fungible and transferable without restriction);

- the fund must be closed-end; and
- as for the Main Market, a prospectus must be produced in compliance with the FSA's Prospectus Rules and approved by the FSA.

Funds admitted to the SFM will need to comply with the disclosure and transparency rules applicable to Main Market issuers, but will not be subject to any equivalent rules (for instance, to maintain an independent board) for investment entities.

The LSE has discretion to refuse admission to trading on the SFM in certain circumstances, and has indicated that it intends to impose the following criteria:

- as for the Main Market, the fund must demonstrate that it intends to invest its assets in a way which is consistent with the object of spreading investment risk; and
- the investment entity should be highly specialised and only target institutional, professional and highly knowledgeable investors.

The LSE has indicated that investment products targeted at retail investors will not be admitted and should consider AIM, the Main Market or the FSA authorised fund route. But are there regulations which prohibit the marketing of funds listed on the SFM to a retail base? Given that funds admitted to the SFM must be marketed with an EU Prospectus Directive compliant prospectus, an EU-wide retail offering is theoretically possible. If the fund is marketed by means of adviser-to-client recommendations (for instance, through the IFA network) or private client portfolio managers, firms need to comply with the private client suitability rules – and firms may be unwilling to sell more specialist funds listed on the SFM to private clients. However, it remains to be seen whether authorised firms (and financial advisers) will wish to give exposure to the SFM to any segment of the retail market. Securities listed on the SFM will not be eligible for inclusion in UK tax-free investment plans (as opposed to Main Market or authorised fund securities), but this may not be a significant factor in their adoption by UK individuals. As is the case for the Main Market or AIM, marketing of SFM-listed securities in the US will be restricted to institutional investors under the US Investment Company and Securities Exchange Acts.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

For more information on the topics covered in this issue, please contact:

Peter King
London
+44 20 7655 5108
peter.king@shearman.com

Bill Murdie
London
+44 20 7655 5149
bill.murdie@shearman.com

John Young
London
+44 20 7655 5961
john.young@shearman.com

	LSE Main List	Specialist Fund Market	AIM	Euronext	Irish Stock Exchange
Typical type of entity	Closed-end offshore company or open ended onshore 'investment trust'.	Closed-end offshore company, possibly limited partnerships and other onshore structures.	Closed-end offshore company.	Closed-end offshore company or limited partnership.	Open ended offshore company. Limited partnerships or unit trusts possible.
Significant restrictions on investment	None, other than invests consistently with risk spreading requirement.	None, other than invests consistently with risk spreading requirement.	None, other than invests consistently with risk spreading requirement.	None.	For professional investor funds, no significant investment restrictions. Legal or management control of investments prohibited, although this rule is often waived.
Prohibition on significant trading activity	Issuer must not conduct significant trading in investments.	No restriction.	No restriction.	No restriction.	No restriction.
Track record/experience requirements	3 years relevant experience or authorisation for the investment manager required.	No specific requirement.	No specific requirements, although nominated adviser is responsible for suitability of entity for listing and is likely to require relevant experience.	No specific requirements, although Euronext may impose requirements in the interest of investor protection.	Appropriate experience for investment manager required, although professional investor only funds not subject to formal requirement.
Free float requirement	At least 25% of shares must be in public hands (i.e. 25% of shares must be held by <5% shareholders or shareholders unconnected to the board).	LSE will require fair, orderly and transparent market, so will expect sufficient free float.	No specific requirement, although AIM generally requires at least 10% of shares in public hands.	Generally, 25% free float requirement but may allow lower percentage if market can function at lower level.	No. Funds structured for a single investor are common.
Type of financial adviser required	Issuer must retain a UK sponsor.	No requirement.	Issuer must retain a UK nominated adviser.	Issuer must retain a listing agent.	Issuer must retain an Irish sponsor.
Governance	Board must have a chairman and a majority of directors who are independent of the manager.	No requirements, although investors likely to expect a majority of independent directors.	No requirements, although investors and nomad likely to expect a majority of independent directors and compliance with UK Code of Corporate Governance for Main List entities.	No requirements, although investors likely to expect a majority of independent directors.	Issuer must have at least two independent directors.
Target/permitted investors	Any.	Institutional only.	Any. Often institutional only at admission stage.	Any. Often institutional only at admission stage.	Retail funds only eligible if listed or domiciled in EU or some offshore jurisdictions;

	LSE Main List	Specialist Fund Market	AIM	Euronext	Irish Stock Exchange
					otherwise they may only be marketed to professional investors.
Main documentation	FSA approved prospectus in compliance with EU Prospectus Directive required at admission stage.	FSA approved prospectus in compliance with EU Prospectus Directive required at admission stage.	Non-prospectus directive AIM admission document required (not approved by any regulatory authority and not needing to comply with EU Prospectus Directive), unless making a public offer.	Prospectus directive in compliance with EU Prospectus Directive required at admission stage.	If open ended, exchange approved listing particulars required. If closed-end, prospectus directive in compliance with EU Prospectus Directive required.
Follow-on offering	Pre-emptive offer round must be made if shares are being offered at less than NAV. Prospectus required to list new shares unless (i) less than 10% offering <u>and</u> (ii) no offer to the public.	No pre-emption rules. Prospectus required to list new shares, subject to same exemptions as Main List.	No pre-emption rules. Prospectus directive prospectus not required to list new shares, but required if offer to the public (e.g. under a rights issue).	Prospectus required to list new shares.	No pre-emption rules. Prospectus not required for open-ended funds.
Feeder funds	Currently, issuer must control investment policy of feeder.	No restriction.	No restriction.	No restriction.	No restriction.
Restrictions on investment in other listed entities	Cap of 10% of total assets on investment in other listed closed-end funds.	None.	None.	None.	None.
Distribution flexibility	No restrictions imposed by exchange.	No restrictions imposed by exchange.	No restrictions imposed by exchange.	No restrictions imposed by exchange.	Dividends may only be paid out of accumulated realised and unrealised capital gains net of accumulated realised and unrealised capital losses.
"Recognised stock exchange" for UK Revenue purposes?	Yes	No.	No.	Yes.	Yes.
"Regulated market" for UCITS and bank/insurer prudential rules?	Yes.	Yes.	No.	Yes.	Yes.