The unlisted securities market

This article traces the development of the unlisted securities market which opened in November 1980, and assesses initial experience of this market. Since it started, the number of companies seeking to market their shares for the first time has picked up, although improvements in the general climate for small businesses were probably partly responsible.

During the 1970s there was a marked fall in the number of companies seeking a Stock Exchange listing. Whereas in the late 1960s and early 1970s some fifty companies on average achieved listed status each year, new admissions between 1974 and 1979 were running at considerably less than half this rate. This fall in demand for listed status was a source of some concern.

Achieving marketability for its securities is usually an important stage in a company's growth.[1] It makes the investment of those who own the company much more liquid, and the existence of a capital market to which small companies can realistically aspire should thus make it easier to obtain start-up equity finance from venture capitalists and other sources. Furthermore, once a quote has been obtained, raising additional capital becomes both easier and cheaper. In the absence of an adequate securities market, companies will tend to rely more on loan finance and therefore to operate at higher gearing levels. From the viewpoint of both existing and potential investors, listing helps to ensure that a full range of information on companies is readily available, and thus to reduce the dangers of a false market. Any decline in companies' demand for listed status may thus have implications both for company finance and for the protection of investors.

There were two main reasons for the downward trend in listings in the second half of the 1970s. First, the general economic climate was seen as unhelpful to small businesses, and especially to the proprietor who sought to dispose of a part of his holding by floating his company on The Stock Exchange. Low real profitability, and uncertainty as to future income, often meant prices for such securities were not high enough to make this attractive, and tax considerations could also discourage a sale. Bank lending often seemed a more attractive way to raise finance for expansion; it was cheaper to arrange and service, and entailed fewer non-financial obligations to the providers of funds.

Second, it was frequently suggested that the conditions imposed by The Stock Exchange for access to the listed market represented a disincentive to listing. For an initial sale of securities by way of a listing, The Stock Exchange has requirements as to the content of a prospectus, and expects a company to be able to show at least a five-year trading record. It also requires the full prospectus to be widely advertised. The consequent professional fees and advertising costs add to the expense of a flotation which, including commissions (and capital duty at 1%), may easily amount to between 5% and 10% of the proceeds.

Continuing disclosure requirements on listed companies are also greater than on unquoted companies which need observe only the legal minimum in the Companies Acts. Additionally, The Stock Exchange usually requires 25% of the shares of a listed company to be in public hands before dealings commence, a level of outside ownership which not all companies may be willing to accept (though the requirement was reduced from 35% during the 1970s in an attempt to increase the market's attractiveness). For all of these reasons, some companies may have viewed the costs and other requirements of entry to the listed market, and the continuing burden of regulation, as not justifying the benefits obtained.

Concerns of this nature were raised by many of those who gave evidence to the Wilson Committee[2] in 1977–78. A number of witnesses drew the Committee's attention to the absence of a market in the securities of companies which, while not ready for a full listing, might still benefit from a degree of marketability. An example often quoted in this context was the over-the-counter (OTC) market in the United States, where a company, often initially sponsored by a single securities firm, can quickly and easily achieve a degree of marketability, and may subsequently progress to other markets which impose stricter requirements but afford greater liquidity. In the United Kingdom one firm of licensed dealers in securities had launched a facility analogous to the American OTC market, but its operations had been on a relatively small scale.

Rule 163(2)

The Stock Exchange has, for many years, allowed member firms to effect occasional transactions in unlisted securities under Rule 163(2). This has provided a limited degree of marketability for companies which do not qualify for a listing. Any company security, provided it is transferable, can in principle be dealt in by members of The Stock

(1) See, for example, the article 'Venture capital' in the December 1982 *Bulletin*, page 511.
(2) *Committee to Review the Functioning of Financial Institutions: progress report on the Financing of Industry & Trade*, HM Stationery Office, 1977; final report, HM Stationery Office, Cmnd 7937, 1980.

Exchange, even though no application may have been made for it to be listed and the company might not fulfil the conditions for listing. In such cases there is no formal relationship between The Stock Exchange and the unlisted company. In response to questions raised by the Wilson Committee, The Stock Exchange, in December 1977, gave wider publicity than it had previously to the Rule 163(2) facilities, pointing out that this market already offered companies many of the benefits afforded by OTC trading in the United States.(1) While brokers had to seek The Stock Exchange's permission for each transaction under this rule, in practice the approvals mechanism was rapid and represented no real hindrance to dealing. The Exchange reserved the right, however, to object to the development of continuous trading in any security, which it saw as more properly taking place on the listed market.(2)

As a result of this publicity, interest in Rule 163(2) facilities increased and a number of companies issued securities specifically with a view to their being traded on that market. The extent of this interest, however, raised difficult regulatory problems. It was clearly desirable that The Stock Exchange should aim to satisfy the demands of small and growing companies, and of investors who were prepared to buy their securities: but there was a danger that in the largely unregulated Rule 163(2) environment, and with no disclosure requirements, speculative interest could get out of hand and trading become unsoundly based. Moreover it soon became difficult to describe trading volumes in some Rule 163(2) securities as 'occasional'.

Formation of the unlisted securities market

With a view to placing this trading on a sounder footing, in December 1979 The Stock Exchange circulated proposals for a more formal unlisted securities market (USM). After some amendment, these proposals formed the basis for the present USM, which started in November 1980. It was made clear that any company whose shares were likely to be traded frequently should seek admission to the USM, and that deals on the Rule 163(2) market would in future be permitted only for genuinely occasional transactions. The USM is much closer in form to the listed market than to the Rule 163(2) market, though admission requirements in several key areas are significantly less onerous than in the listed market:

- Only 10% of a company's issued ordinary capital need be in the hands of the public before dealings start, as against 25% on the listed market.
- Normally a three-year prior trading record is adequate as against five on the listed market, and in some circumstances The Stock Exchange will accept a company with no trading record but with a fully developed product or project which requires financing.
- Much less advertising is required than for a listing, making possible a useful reduction in costs.

A company entering the USM must sign a 'general undertaking' similar to the listing agreement for listed companies, which governs continuing disclosure to avoid a false market developing in the companies' shares. Where shares are already sufficiently widely held, companies may enter the USM by way of an introduction; alternatively, entry may follow a placing or an offer for sale. A placing—where shares are sold to clients of a broker rather than made the subject of a general offer to the public—is the normal method of distribution, though where the amount offered exceeds £3 million or the market capitalisation of the company exceeds £15 million The Stock Exchange requires a public offer to be made. Where the distribution takes the form of a placing, 25% of the issue must be offered to the jobbers to ensure a reasonable availability of shares to the investing public.

Developments in the USM 1980–83

Despite close similarities with the listed market, the USM has had considerable success in attracting companies that were not formerly prepared to apply for a listing. In the first $2\frac{1}{2}$ years of trading, 171 companies were admitted: 62 joined the market by way of an introduction, and the remainder by way of a placing (95 companies) or an offer for sale (14). Of these companies, 8 subsequently joined the listed market, and a further 7 were suspended or acquired, so at the end of April this year 156 companies, with a total market capitalisation of £1.3 billion, were being traded on the USM. The daily average value of bargains in the early part of 1983 was some £5 million. On the listed market, by contrast, UK companies' shares with a value of some £130 billion are listed and transactions in equities have recently been worth some £250 million per day. These figures suggest that turnover of USM shares is nearly twice as rapid as turnover in the listed market.

The USM is often associated with high-technology products and processes, and a number of the companies traded there are involved in computers and electronics or in other advanced fields such as bio-technology. But USM companies in fact cover a wide range of products and services, including oil, property, building and brewing (Table A). The manufacturing companies traded on the USM—the largest single group identified in Table A accounting for almost half the number of companies—include foundries and agricultural equipment as well as advanced machine tools and aerospace equipment. A common feature is a new product or approach, though there are many examples of companies engaged in wholly conventional businesses. A number of USM companies are involved in finance, including licensed deposit-takers and insurance companies.

(1) Comparisons with US practice may, however, be misleading, in that the regulatory environment there is different, and The London Stock Exchange covers a much wider range of companies than do the main US exchanges. Many companies which have a full listing in London might, in the United States, be regarded as candidates for the OTC market.

(2) A further and similar market exists under Rule 163(3) in the securities of certain mineral exploration (mainly North Sea) companies, many of which cannot show the trading record necessary for a full listing. In this market, however, there is a relationship between The Stock Exchange and the companies, who undertake to apply for a listing when they are able to do so, and in the meantime to meet standards of disclosure similar to those for a listed company. No special permission is required for individual transactions in these companies' securities.

Table A
USM companies by industrial sector: April 1983

	Percentage of companies	
	By number	By market capitalisation
Oil exploration and services	12	30
Property	10	8
Manufacturing:		
Food and drink, including brewers	7	6
Computers/electronics	17	12
Other	25	24
Services:		
Builders/civil engineers	3	1
Finance	7	7
Leisure	8	5
Other	11	7
	100	100

Up to March 1983, companies had raised some £162 million at the time of admission to the market, £101 million for retention by the company and £61 million on disposal by the existing shareholders. A further £55 million was raised by way of rights issues, so that the total amount raised so far for retention by companies is £156 million. The amount raised through the USM last year was equal to about 7% of that raised through the listed market (Table B).

Table B
Money raised by issues on the USM and the listed market
£ millions

		Unlisted securities market				Listed market
		Raised on entry		Rights issues	**Total amount raised for company**	Net amount raised
		For share-holders	For company			
1980	Q4	2.4	6.9	1.5	**8.4**	449
1981	Q1	0.2	1.4	—	**1.4**	267
	Q2	12.4	13.1	—	**13.1**	430
	Q3	5.8	5.8	8.2	**14.0**	548
	Q4	6.9	21.4	0.9	**22.3**	587
1982	Q1	2.4	4.8	31.6	**36.4**	189
	Q2	8.6	5.6	—	**5.6**	584
	Q3	10.2	15.2	—	**15.2**	90
	Q4	11.3	19.1	3.8	**22.9**	304
1983	Q1	1.1	7.3	9.4	**16.7**	628

A notable feature of the USM has been the generally high prices paid for shares quoted there. This contrasts with the generally poor rating of small companies' shares, which was seen as a major disincentive to new issues in the mid-1970s. Only 13% of companies coming to the USM have been capitalised by the market at less than the balance sheet value of their net tangible assets (Table C): more than half have been accorded values at least twice as high as net assets, and often considerably more—the pattern is in fact not dissimilar to that in 1973, the last year in which significant new issue business was done on the listed market. Price earnings ratios, which may be a better measure of the market's rating of small companies, have also been high.

To an extent, the availability of prices high enough to induce the proprietors of small and growing companies to market their shares reflects the strength over the past few years of the share market as a whole. However, USM prices have tended to be particularly strong, despite the decline of the oil shares which represented a large weighting in the index in the early stages of the market's life; between the commencement of trading and April 1983 the USM index[1] rose 72%, while the FT-Actuaries all share index rose 47% (see chart on page 230). Many shares have risen to a substantial premium over the issue price in the first day of trading, partly because of the small amounts available to satisfy demand; one possible reason may be the prevalence of placing as a means of distribution, though in such cases 25% of the issue must be made available to the market. Subsequent to issue, as might be expected, the prices of some securities in which there has been heavy speculative interest have been volatile.

Issue costs

The cost of a new issue on the USM is generally less than on the listed market, mainly because The Stock Exchange does not require the prospectus to be advertised so widely; professional fees may also be lower. There is no initial listing fee, though The Stock Exchange makes a small annual charge. Even so, the cost of an issue is by no means negligible. Issue costs reported in the prospectuses of a sample of companies coming to the market indicate that actual placing expenses have been between £25,000 and £150,000, and the cost of offers for sale in the range £250,000 to £500,000. The major expenses are likely to be accountancy and legal fees, commissions to the issuing house and broker, and the Government's 1% capital duty, which is levied on all issues of securities by companies. Issues have seldom cost much less than 5% of the proceeds, and the high element of fixed costs can bear heavily upon companies raising small amounts, or which are offering only a small proportion of their share capital. However, when compared with the market capitalisation of companies coming to the USM—which may be a better measure of the benefits of membership than net issue proceeds—issue costs are substantially lower.

Other trading in unlisted securities

As noted earlier, before the establishment of the USM, a firm of licensed dealers in securities had sponsored a market in unlisted securities. The dealer would arrange an offering

Table C
Premiums on issue: ratio of market capitalisation to net assets
Percentages

	1973 (Listed market)	1980–82 (USM)
Premium of market capitalisation over net assets		
Less than 0(a)	3	13
0 –100	47	34
101–500	44	39
More than 500	6	14
	100	100

(a) Ie issue made at discount to net assets.

(1) There is only one index of USM prices. Its construction is, however, not comparable with the FT-Actuaries indices which measure the performance of the listed market; the latter weight their constituent shares by reference to relative market capitalisations, thus providing a measure of the value of all the shares in the market. The USM index, on the other hand, in effect gives each share an equal weight. Had the USM index been constructed in the same way as the FT-Actuaries index it would have shown a different pattern because the USM oil shares, which have not performed strongly, would have been more heavily weighted.

of his clients' securities to investors and would then stand ready to facilitate a secondary market, either by matching buyers and sellers or by taking positions himself. These operations, although small, played an important part in stimulating awareness of the need for a market in smaller companies' securities. Since the establishment of the USM a number of other dealers have sought to promote OTC dealings in sponsored unlisted securities, publishing prices on a regular basis. There is no clear organisation or form to this trading and it is difficult to establish how many dealers are active or how many securities involved; but prices appear to be regularly advertised in the securities of some fifty companies.

The direct costs of an issue sponsored by a firm of licensed dealers may be less than an issue on the USM, though a fair comparison of the costs would need to take account of any premium investors were willing to pay for a quotation on the USM: if the USM were thought to have better depth or liquidity than the OTC facility, issues which were to be traded on the USM might be expected to obtain higher prices. Such a comparison is not easy to make in the UK market, which is not well developed. In the United States, studies suggest that there may be some difference in price levels between the OTC market and the exchange markets, and quite a marked difference between the single-sponsor OTC market and the more active NASDAQ[(1)] OTC market.[(2)] Companies whose share prices are advertised by licensed dealers are not subject to Stock Exchange regulation concerning disclosure of information; the sponsoring dealer may, however, impose standards of his own.

In addition to the market sponsored by licensed dealers, Stock Exchange members may still effect transactions in unlisted securities under Rule 163(2) and Rule 163(3). In the twelve months to April 1983 some 330 securities were traded on an occasional basis under Rule 163(2), and a further twenty companies have securities which may be traded on a continuous basis under Rule 163(3).

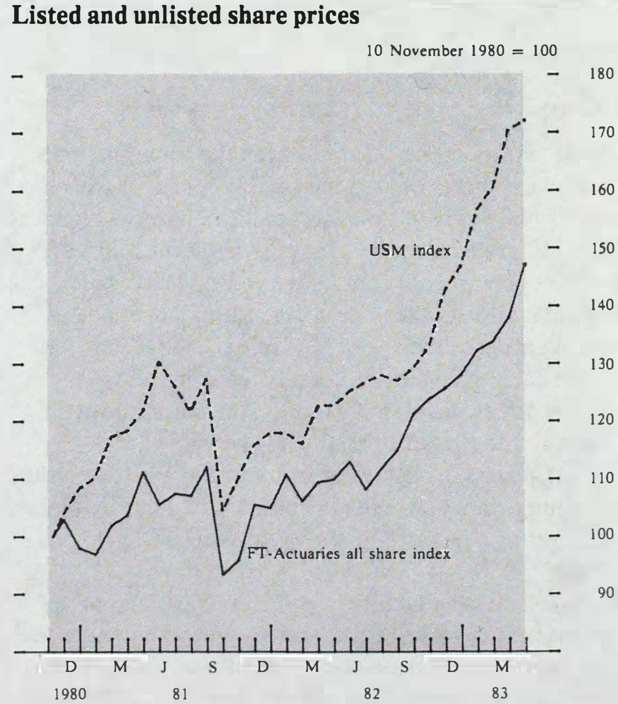
Assessment: the impact of the USM

For a growing company, achieving marketability of its shares will be an important step. It will then find it easier to raise capital for development, and it will often be possible for those who financed the company in the early stages to realise a part of their investment. In other ways, too, marketability increases the range of opportunities open to the company; for example, acquisitions are easier when shares are acceptable as consideration. The USM has brought these benefits to many companies. And while the amounts raised are small by comparison with the listed market and in the context of corporate finance in general, issues on the USM nonetheless represent a useful contribution to the funding of smaller firms. Shareholders have also benefited from the liquidity afforded by an active secondary market. The decline, noted in the 1970s, in the number of companies coming to The Stock Exchange, has been reversed.

For investors, the USM offers the advantage of a market within The Stock Exchange, with access to its settlement systems and compensation fund arrangements. Unlisted securities are, moreover, traded under the same single capacity system—ie separation of broking and jobbing functions—as applies in the listed market, though, if no jobber can be found to make a market in an unlisted security, The Stock Exchange will allow brokers to act either in a matching capacity or as both agent and principal. So far no stock has failed to obtain the support of a jobber.

It would be wrong to attribute the success of the USM to the small differences in regulatory approach as compared with the listed market. The development of the USM needs to be seen in the context of developments in the economy generally and in the environment for small firms in particular. The recent emphasis in both fiscal and industrial policy on the needs of small firms is reflected in a range of tax incentives, in the government's loan guarantee scheme, and in the variety of special facilities for small and expanding companies which have been developed by the banks and the investing institutions.[(3)] The rapid growth of the venture capital industry represents another aspect of the burgeoning facilities available to small businessmen. Furthermore, the climate for equity investment has been generally favourable in the period since the USM's establishment, as is evidenced by the steady increase in the FT-Actuaries all share index (see chart); the number of companies joining the listed market has also been

Listed and unlisted share prices



(1) National Association of Securities Dealers Automated Quotations System. To be quoted on this service, a company must have at least two market makers, who must undertake to make continuous two-way prices.

(2) See, for example, Dhaliwal, *The effect of exchange listing on a firm's cost of equity capital;* Capital Market Working Paper, US Securities & Exchange Commission; Washington DC, November 1980. A different view, however, is given in Phillips & Zelcher, *Exchange listing and the cost of equity capital,* Securities & Exchange Commission; Washington DC, March 1982.

(3) Many of these facilities are described in the Bank's guide *Money for Business*—see inside back cover.

increasing, with more than 100 companies joining the market between 1980 and 1982.

These conditions have benefitted OTC trading in unquoted securities as well as the USM. Some have suggested that the recent interest in unquoted shares outside the USM indicates that the USM is in some sense failing to provide a sufficiently flexible and informal facility; and there are still many who see the American OTC market as a more appropriate model than the USM for a market in small firms' securities. Some companies seeking marketability for the first time clearly welcome the less formal arrangements in the OTC facility, even though these may entail some loss of efficiency and liquidity and provide less assurance of investor protection than is the case with the USM. However, the OTC market in the United States has developed within a system of statutory regulation, including extensive Securities and Exchange Commission (SEC) requirements on disclosure, which is not duplicated in the United Kingdom. Nor is there any self-regulatory body in this country comparable in formal status and function with the US National Association of Securities Dealers. The USM, by contrast, is subject to the regulatory authority of The Stock Exchange. Thus while licensed dealers in the United Kingdom provide what is clearly a useful facility to companies which may not yet be ready for the USM, any substantial development of this trading would doubtless need to be accompanied by commensurate development of arrangements to protect investors.

The USM itself has not been immune from adverse comment, usually in relation to the volatility and level of prices. Two factors in particular have been identified. First, even though USM companies meet disclosure requirements that are as rigorous as those imposed on listed companies, investors may still have difficulty in valuing companies whose products are in many cases novel and untried, and which may themselves be immature. There is less good research by brokers and financial analysts than tends to be the case for listed companies; and the recent emergence of a number of specialised publications commenting on the USM has added to investor interest without necessarily improving the quality of information. In these circumstances it is not easy to ensure that a false market is avoided.

Second, the extent of interest in USM securities is often out of proportion to the amounts of stock available. USM companies tend to be small and to enter the market with only a small proportion of their shares in the hands of the public (though in fact few companies have taken advantage of the 10% minimum distribution, and most have issued around 25% of their shares, the minimum for listed companies). Pricing an issue can be difficult,[1] and requires a conservative view of prospects; after the start of dealings prices have often risen sharply, reflecting the scarcity of stock, a situation exacerbated by the prevalence of placing as a means of distribution, which makes those who would have applied in an offer for sale bid for their stock in the narrow secondary market.

To a degree, features such as those described above are bound to be more prominent in a market which is deliberately designed to cater for smaller and less mature companies than does The Stock Exchange. It is in the nature of many of the businesses whose shares are quoted on the USM that they involve significant risk while offering the investor substantial possible rewards. The valuation of the securities of such businesses will always be difficult, and their prices may be expected to fluctuate more than those of larger companies. There is clearly a chance that the prices of some highly-rated shares may fall back, and ratings on the USM on average are higher than on The Stock Exchange. The failure of some of the more speculative companies could damage the market as a whole by affecting further demand for unlisted shares. Nevertheless, the market has already attracted a broad cross-section of companies and as it continues to expand its resilience should be increased. The doubts that have been expressed about the USM do, however, argue for a cautious response to any suggestion that the present entry requirements—as regards track record and disclosure, for example—need to be relaxed to enable the market to admit companies not willing or able to meet the USM's present requirements.

(1) Though there has recently been some interest in the use of tenders to establish issue prices.