

Going Paperless

AIM Streamlines Reg S Settlement to Lure New U.S. Business

There's one big drawback for the growing number of U.S. companies going to London to raise capital. That is the oddity of manual settlement for U.S. Regulation S equities. As bizarre as it may seem, for fear of violating U.S. Securities and Exchange Commission compliance requirements, Reg S equities settle on the Alternative Investment Market much as they would have on the London market in the time of Queen Victoria—using pieces of paper and share certificates. Well, you can kiss that problem goodbye.

AIM is acting to streamline its Reg S procedures with an eye toward attracting more U.S. business to the market. The practitioners who make their living on AIM every day say the new business likely to migrate from the U.S. to London as a result of the changes is “huge.” The universally applauded changes come as AIM's money-raising accelerates to break all previous records.

Brokers and money managers absolutely hate the antiquated manual system AIM uses to settle trades of U.S. Reg S equities. The problem is that AIM's sole authorized electronic settlement system, called CREST, has no way to cope with the restrictions that accompany reliance upon Reg S. As a result, Reg S shares are settled manually, slowly, and expensively.

All that is about to end. AIM is just months away from implementing electronic settlement of Reg S equities. Reg S grants an exemption from U.S. securities registration for certain companies making offerings outside the U.S. It is one of the most popular approaches used by U.S. companies to raise money in London.

(In theory, Reg S equities can also trade on the main market of the London Stock Exchange. As a practical matter, companies big enough to trade equities on the LSE's main market typically have already registered their equities or rely upon a different exemption to trade offshore. In London, Reg S is really only relevant to equities on AIM.)

As a bonus, the intensifying competition among European companies offering securities settlement services is on the verge of handing AIM another powerful tool for attracting U.S. business to London: electronic settlement of Rule 144A securities. Rule 144A provides an exemption from U.S. securities registration for private resales of securities to institutions. Since AIM is primarily an institutional market, bringing electronic settlement of Rule 144A to AIM is a match made in heaven.

The crucial restriction that has kept Reg S equities from settling electronically on AIM is what the SEC calls the “distribution compliance period” following an offshore offer-

ing. During this period—one year for equities—the offshore securities are barred from being sold into the U.S. market. The inadvertent sale of a single share in the U.S. or to a “U.S. person” who is temporarily outside the U.S. could cause the U.S. issuer to unknowingly violate Reg S.

“We have recently announced a joint service with SIS SegalInterSettle AG that will for the first time give an immediate electronic settlement option for U.S. AIM companies that will enable compliance with ‘Reg S,’” said Anne Moulier, a U.S. business development executive with the LSE. “We are now in consultation with market participants about detailed implementation of this service.”

Moulier conceded that even saddled with the manual system, AIM has been remarkably successful in attracting U.S. companies to its market. But she said the difficulties created by paper settlement “can restrict the secondary market liquidity of those companies' shares when they first come to the market.”

“Our new service should make it much cheaper and easier for investors to trade Reg S stocks, significantly enhance the liquidity of U.S. companies coming to AIM, and increase AIM's attractiveness to U.S. corporate issuers,” she said.

The problem of paper trading goes deeper than mere inconvenience and expense for entities trading in the secondary market. It can permanently depress share prices. The international law firm Osborne Clarke, whose global offices include London, Cologne, Munich, Paris, Brussels, Rotterdam, and Palo Alto, Calif., revealed this more troublesome issue in a recent white paper entitled, “Is AIM the New Nasdaq?”

The paper points out a variety of matters a company should consider before going to AIM for capital. However, the only serious drawback it could find was the unintended consequence of paper settlement of Reg S issues. Osborne Clark found that restricted Reg S equities trading in the form of share certificates generally trade at a discount to AIM's non-restricted shares.

The existence of the “Reg S discount” is confirmed by others with everyday experience on AIM.

The one person in London who may well have the broadest perspective on how AIM really works is Adam Hart, deputy head of corporate finance and head of business development for London brokerage and advisory firm KBC Peel Hunt. He serves as chairman of the AIM Advisory Group, which presents the views of the practitioners on AIM to the market's management.

Hart said moving Reg S transactions onto an electronic

system is an extremely positive development. However, he wasn't sure that SIS SegalInterSettle AG, more commonly referred to as SIS, would end up settling many of the trades. Hart believes it is just as likely that the SIS proposal will force CRESTCo to make changes to its own system that will pave the way for electronic Reg S settlement on CREST.

"Market participants have been encouraging CREST to do this for three or four years," he said. "We think it is a good idea. The fact that SIS has come forward with this may spur some activity on the part of CREST. CREST has suggested they may have this sort of system in place by autumn."

Hart said most brokers and fund managers in the U.K. have accounts with CREST. Very few are with SIS. Switching from one settlement system to another requires a considerable investment of administrative time and money, he said.

He believes that paper settlement has, in fact, caused Reg S equities to trade at a discount to other equities on AIM. Hart agreed there is a good chance that the move to electronic settlement will enhance Reg S liquidity and make AIM even more attractive to U.S. companies.

Alan Berkeley, a partner in the law firm Kirkpatrick & Lockhart Nicholson Graham, views AIM from both sides of the Atlantic. He practices in New York and London, moving from one city to the other about every three weeks. He said it is almost impossible to overstate the importance of getting the settlement of Reg S equities onto an electronic system.

"This is a huge development," he said. "There is a tremendous amount of interest in the AIM marketplace. A major hurdle to U.S. listings will disappear. This is going to convert interest into action."

Berkeley suspects that cheaper, faster settlement could indirectly stimulate improved liquidity for AIM. "You see, AIM now is mainly an institutional market," he said. "With electronic settlement, I expect retail to pick up, though it may take some time. And when there is more retail, liquidity will improve. When that happens, it will bring even more U.S. companies to London."

Piers Linney, chief executive officer of Towergate Capital, said he hopes AIM will follow up Reg S electronic settlement with electronic settlement for qualified institutional buyers (QIBs). Several companies made the same point about QIBs at a recent AIM workshop in London to explain the new Reg S settlement system. The SIS proposal makes no provision for

tracking Rule 144A securities.

(QIBs and Rule 144A are essentially two sides of the same coin. Rule 144A is one of the regulatory provisions that authorizes private resales between QIBs.)

"We do have experience of U.K.-listed companies issuing restricted shares to U.S. QIBs," he said. "They can only trade in certificated form as they can only transfer to other QIBs. CREST in the U.K. can't track restricted shares and trades.... Anything that reduces the need for shares to be held in cer-

tificated form to simplify U.K.-U.S. transactions is a good thing."

Daniel Hartmann, head of product management for SIS SegalInterSettle AG in Olten, Switzerland, said the SIS system for settling Reg S transactions is ready to run now. "The

only reason we don't have an active system is that we don't have any active clients," he said. "We are calling on banks and other financial institutions that might be interested."

As a practical matter, most Reg S equity trades in the U.K. take place on AIM. The market is putting the final touches on revisions to its rules and procedures that must be adopted before its members are allowed to settle on SIS. The new rules must, in turn, be approved by the U.K. Financial Services Authority (FSA). However, the FSA takes pride in responding promptly to the market. Reg S equities on AIM could, in fact, be clearing electronically on SIS by September.

This puts CREST, with its unpopular, manual Reg S settlement system, in a vulnerable position. As Nick Bayley, head of trading services for the LSE and AIM points out, "One of the consequences of implementing the proposed changes is that SIS may become the default place of settlement for Reg S traded securities."

"If that is the case, [LSE and AIM] member firms trading Reg S traded securities, particularly registered market makers, will need to consider arrangements to enable settlement in SIS either via direct participation in SIS as a member or by using a settlement agent that is a SIS participant," Bayley said.

However, CREST has recognized the danger in forcing its customers to go down the street and do business with its principal rival, SIS. It is preparing to top SIS with a system that can settle both Reg S and Rule 144A securities electronically.

"Following recent requests by CREST clients, CRESTCo is investigating a solution with the market to provide a more comprehensive electronic settlement solution for Regulation S and Rule 144A securities," said Denis Peters, a CRESTCo

The problem of paper trading goes deeper than mere inconvenience and expense for entities trading in the secondary market. It can permanently depress share prices.

spokesman at the company's office in Brussels. "There is no target date yet for the launch of a more comprehensive solution. We will advise clients of developments in this area in due course."

Will CREST's new settlement system create head-to-head competition for Reg S electronic settlement and, as icing on the cake, move Rule 144A securities onto an electronic system for settling transactions with QIBs? And when might this happen? There's no way to know, until CRESTCo releases the full details of its system and LSE, AIM, and the FSA have a chance to review them.

One thing is clear: AIM is growing at an accelerating rate—even before harvesting the benefits of streamlined Reg S and Rule 144A procedures. The latest figures show that AIM broke the £30 billion (\$55.27 billion) fundraising mark

before the first half of this year ended.

An analysis by Grant Thornton Corporate Finance in London shows that a quarter of all new money ever raised on AIM since its 1995 launch was brought in the doors during the first six months of 2006. From the beginning of this January to June 21, AIM-listed companies raised £4.9 billion (\$9.03 billion). That is more than double the £2.1 billion (\$3.87 billion) raised during the first six months of 2005.

"Not only does AIM offer a flexible and liquid environment but also the opportunity of a quicker fundraising process as compared to the creation of a private fund," said Philip Secrett, partner at Grant Thornton. "In terms of funds raised, the market has entered fifth gear, with momentum coming from specialty and property funds raising significant amounts of new money." —RC

RMR