Don't write off the SFM

Two years after the establishment of the Specialist Fund Market, there have been few listings but the range of funds is diverse

Two years ago the London Stock Exchange (LSE) launched the Specialist Fund Market (SFM), its first new market since Aim back in 1995. The SFM was set up and touted as the first public capital market specifically designed for specialist investment vehicles, in the belief that there was a gap in the market for a trading platform that properly accommodated the needs of the investment fund industry.

Unfortunately, this coincided with a severe recession that saw capital markets grind to a virtual halt. Like all other markets, the SFM has suffered, with only five funds being admitted to trading by September 30 2009. The question is whether its failure to attract more is down to market conditions, strong competition from other markets or a fundamental flaw in its structure.

Recent flurry

Although there was little activity on the SFM in its first two years, there has been a flurry of admissions this year with NB Private Equity becoming dual-traded, seeking greater liquidity by adding the SFM to its existing Euronext listing. And a new fund, Altus Resource Capital, was also admitted to the SFM in June. Altus raised £26 million, which indicates that even though the wider economic climate is poor, investors are still responsive to certain investment opportunities.

In 2008 and 2009 only five funds were admitted to trading (with one fund managing also to de-list in that time) compared to nine funds on Aim and 32 on the Main Market. However, in comparison to Euronext, its real and established competitor, the SFM has been relatively successful. In the same two years only six funds listed on the main Euronext market.

Euronext, Aim, Main Market or SFM?

When Apollo, KKR and Marshall Wace all decided to list funds on Amsterdam's NYSE Euronext in 2006/2007 it was clear that there was a need for a public market that had the flexibility to admit investment funds with alternative structures. The SFM was therefore launched to be the market for funds that wished to target institutional, professional and sophisticated investors and to gain access to permanent capital. The LSE decided neither of its existing markets, Aim and the Main Market, served this purpose. Aim had had some success at attracting property and country-specific funds, but its principal focus was, and still is, on high-growth companies, and the Main Market's admission rules restricted access to all but the most well established and risk averse managers.

While there is plenty of choice for funds seeking a technical listing in Europe (Dublin, CISX, Luxembourg) the LSE's three main markets and Euronext all offer greater liquidity and permanent capital.

The SFM requirements

Admission

As an EU-regulated market, the European Commission's Prospectus Directive applies to the SFM, as it does to Euronext and the Main Market but not to Aim. The two-stage application process includes the approval of a Prospectus Directive compliant prospectus by the UK Listing Authority, part of the Financial Services Authority (FSA), (alternatively, the prospectus can be passported in to the UK if it has been approved by a relevant authority in another EU state).

The disclosure requirements for the SFM are minimal compared to the Main Market, and are restricted primarily to compliance with Annex 15 including, amongst other things, a detailed description of the investment objective and policy, details of any investment restrictions, information on the investment manager and other advisers, valuation principles and the frequency and the method by which the net asset value of the investment entity will be determined and relevant financial information.

For a new fund, the SFM clearly has an advantage over the Main Market because there are no Listing Rules to comply with so its prospectus will be less extensive. However, as with the Main Market, funds that have existing individual investments of over 20% of their gross assets, typical for feeder funds, have to disclose those investments by way of mini-prospectuses within the larger fund's prospectus. This, however, should not necessarily deter funds from seeking admission – see Marwyn Value Investors Limited's 500-page prospectus.

SFM securities are not eligible for admission to the Official List. One disadvantage of this is that securities may not be bought by index tracker funds. However, on the plus side they are not subject to the onerous restrictions contained in Chapter 15 of the Listing Rules, which pre-suppose retail investor participation. They therefore do not have to satisfy the listing requirements that may put off certain managers. For example, there are no requirements to have a diversification of investments, no minimum trading record is required, there is no requirement for board independence from the investment manager and shareholder consent is not required to approve a fund's investment strategy or significant related party transactions. There is also no requirement to have a minimum number of shares held in public hands or to have a minimum market capitalisation. These more relaxed admission standards finally permit certain alternative funds including feeder funds and new fund managers to come to a regulated market in London.

Flexibility

Given the targeted investors, the SFM's rules are able to be more flexible, allowing for a wide scope of fund structures and investment strategies, including partnerships. The SFM is also open to issuers of both UK and non-UK domiciled investment funds. Managers are able to locate their investment entities in jurisdictions they feel best serve their particular strategy. Euronext is similar although slightly more restrictive, having a fast-track regime for funds based in certain approved countries.

As mentioned above, the SFM has few

Many of their fundamentals are the same but there are some big differences. In particular, the admission procedures, corporate governance standards, ongoing obligations and regulatory framework. (See box for details.)

> "The SFM has attracted the smaller and maybe less internationally recognised fund managers"

Who chooses the SFM?

Although admittedly it is a small sample, those funds that have chosen the SFM do suggest some trends are developing.

So far the SFM has attracted the smaller and maybe less internationally recognised fund managers. In fact when compared to the Main Market there is a sharp contrast. On the SFM, the two funds to have raised capital, Da Vinci CIS Private Sector Growth Fund and Altus Resources Capital, raised approximately $110 million and £26 million respectively. Whereas on the Main Market, higher profile names such as BH Global Limited and Blackrock Absolute Return Strategies Limited have raised £533.8 million and £143.5 million.

In addition, the LSE has marketed the SFM as a platform for funds looking to invest in any sector or industry and the existing funds on the SFM do indeed have a diverse range of investment mandates. For example, NB Private Equity has an investment portfolio that consists of 39 private equity fund investments that are broadly diversified across asset class, geography and industry; IRF European Finance Investments is engaged in banking, financial and insurance services. Altus Resource Capital's investment focus is on gold producers in the Junior Resources Sector; and Da Vinci, which has since de-listed, invested in securities of pre-IPO companies in Russia and other members of the former CIS. Marwyn Value Investors, the feeder fund to the Marwyn Neptune Fund, is the only feeder fund on the market, but this does show that the London regulated market is finally open to feeder funds. Yet, once again, the underlying Marwyn Neptune Fund has a diverse portfolio with investments in drug and alcohol testing, entertainment, construction materials, and specialty confectionery.

On the other hand, the hope that this would be a market for funds with complex, alternative structures from any jurisdiction does not seem to have been realised. Four out of the five funds to have chosen the SFM (Da Vinci, NB Private Equity, Marwyn Value Investors Limited and Altus Resource Capital) are limited liability companies incorporated in Guernsey and the fifth, IRF European Finance Investments, is a Bermudian incorporated company. No great variety so far.

What can we tell from this? First, it would appear the big players have kept away from the SFM. It is too early to tell why that is; maybe they need to see a larger number of funds on the market, or see whether it can deliver liquidity, or are simply waiting until the markets pick up. One thing is certain, so far managers are not taking advantage of all the flexibility the SFM has to offer. Most of them have kept to a simple and straightforward

corporate governance requirements. The lower standards can of course mean investors' interests could be prejudiced. However, the majority of the funds currently admitted have adopted corporate governance standards that are substantially over the minimum required and have even voluntarily adhered, to the extent possible and practical, to the Combined Code on Corporate Governance. This clearly indicates that market practice is robust enough to impose a higher standard of corporate governance and funds believe that their ability to raise capital will be affected if they fall short of this higher standard.

Disclosure

The Transparency Directive applies to funds on both the London and Amsterdam regulated markets, in the UK as implemented by the FSA's Transparency Rules and in the Netherlands by the Act on Financial Supervision. So, all funds are required to: (i) disseminate regulated information in a fast, non-discriminatory manner on a pan-European basis; (ii) supply consolidated annual reports, half-yearly reports and interim management statements; and (iii) release announcements and certain documents (such as shareholder details) via an RIS and make them available on a website. Registers showing directors' interests and major shareholder movement will also need to be kept. The rules for Aim-listed funds are not as onerous, but release of details of major shareholders, restrictions on share transfers and circulation of copies of the annual report and half-yearly reports are still required. The Market Abuse Directive also applies to the regulated markets requiring issuers to maintain insider information lists and have these ready for inspection by the FSA.

Many fund managers may find some of the above sensitive. They will be unused to being required to disclose information on possibly confidential or sensitive investments. Equally, there are investors that will not want the extent of their holdings made public. The question for the future of the SFM and indeed all funds trading on regulated markets is "will fund managers and investors be prepared to sacrifice their traditional privacy for the hoped for liquidity?"

Professional advisers

The process of listing on Aim and the Main Market is well established, but admission to the SFM, while streamlined, is still a relatively new experience and it is worth noting one of the bigger differences – there is no requirement to have a Nominated Advisor (Nomad) or sponsor overseeing the process. Euronext has a similar regime to the SFM whereby, although a fund has a listing agent, its role is merely to "guide and counsel". This benefits the fund's bottom line as it reduces costs even if other advisers, including the lawyers and accountants, will need to take on more prominent roles. A fund is, of course, still able to appoint a sponsor/Nomad equivalent if it feels it needs guidance from a financial adviser experienced in public capital markets, particularly if it is looking to raise new funds and needs assistance with maintaining liquidity post-admission. Market practice so far is limited, but NB Private Equity Partners Limited (admitted June 2009) retained a sole sponsor and broker when it was admitted on the SFM.

"The funds on the SFM do have a diverse range of investment mandates"

structure, which would work equally well on other markets, limiting the ability if the SFM to find a niche for itself.

Not as bad as it looks

The SFM has become a credible alternative to Euronext and does provide an option for funds that do not or cannot comply with the Listing Rules applicable to the Main Market and also find Aim unsuitable. However, although the SFM is young and untested, and launched just as the credit crunch began, the first two years have been undeniably quiet. It still does have a number of hurdles to overcome.

The perception is that its liquidity levels are relatively low. In addition only two funds have so far raised equity on the market. The recent fall in trading prices experienced by most of the listed funds is not only a result of the poor economic climate but also because of a lack of liquidity in the SFM, leading many funds to trade at a marked discount to net asset value. Nevertheless, it is not so long ago that Aim was branded a failure following an unsuccessful first few years, and much of the above is true of funds on all markets, so these are not reasons enough alone to dismiss the SFM.

The future is uncertain. The LSE may see more funds moving to the SFM from Aim rather than from Euronext. Unless the SFM can establish greater liquidity, Euronext's similarity removes much of the benefit of a move to the SFM. Alternatively, due to the newly relaxed regime for the Main Market, issuers may choose to move straight to the Main Market and not to the SFM – as with MW Tops. Of course, the LSE clearly hopes the future of the SFM will consist not only of transfers but also new funds raising new capital.

Tracey Pierce, Head of Equity Primary Markets at the LSE is positive about the future and believes that "the SFM is unique in offering alternative investment vehicles access to a dedicated public market, enabling them to target a very specific professional investor audience" and she expects to see the number of admissions to the SFM rise.

The choice between the various public capital markets or whether to stay private is a highly subjective and individual one. If the lure of permanent capital is too much for fund managers then the SFM can be an appropriate route for funds targeting institutional investors but also requiring a more flexible approach than either the Main Market or Aim offer. In addition, it will hope to take advantage of the larger pool of capital in London compared to Amsterdam. However, the SFM's reputation has not yet been established and doubts about its future have not yet been addressed fully. It will be interesting to see how successful the SFM and permanent capital vehicles will be when markets recover.

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