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A joint submission on behalf of Individual Investors from ShareSoc and UKSA

5 January 2021

To HM Treasury

Via email to ListingsReview@hmtreasury.gov.uk

Call for Evidence re Review of UK Listing Rules

Our key recommendations are: .

1. **Remove €8m limit in placings.**
2. **Open up placings to all.**
3. **Keep up standards in the UK, to stop even more frauds, scams and scandals.**
4. **Make regulation cost effective. We don't want regulation where it is not needed, or where it will not be effectively enforced. We don't want a nanny state.**
5. **The FCA should regulate AIM, not the LSE.**

We draw your attention to the following factors that we believe impact on the effectiveness of the UK markets:

1. Low valuations of UK market. Some UK companies choose to list in US where the valuations are higher. The Treasury should identify the reasons for lower valuations in the UK market and design appropriate countermeasures to make the UK stock markets more attractive to companies and their investors.
2. Lack of tech companies in UK stock market. In particular there is a lack of large companies. We do not have any FANGS. We have lots of small start-ups. There appears to be a problem of keeping hold of them when they get bigger or start to compete with incumbents. We think the short termism of brokers, some fund managers in the UK and the low valuations that the UK market gives companies are contributory factors.
3. Low liquidity and large spreads. We do however note that these can be good warning signs against investing, in specific cases.
4. Short termism of a lot of (but not all) fund managers.
5. Over-emphasis on dividends.
6. The LSE has a poor track record on enforcement and is not the appropriate body to specify the AIM market rules. There is an inherent conflict between the commercial interests of the LSE to quote as many companies on AIM as possible, with the need for effective regulation. This conflict would be removed if the FCA were responsible for determining and enforcing AIM market rules (as well as the main market listing rules). In addition, the FCA has powers to prosecute criminal offences, unlike the LSE, and could more strongly enforce breaches and provide stronger sanctions against responsible individuals. If the regulator of AIM is changed, or even if not, the regulator should align the AIM free float requirements with that of the main market of a minimum of 25%.

7. The tax treatment of debt and equity should be harmonised. The present system encourages high leverage which can often lead to much higher risks for individual investors due to corporate bankruptcy. This may also indicate that leverage in companies should be limited by regulation.

Our answers to your questions are below. We would be pleased to meet with you to give further background and answer any questions you have on our Evidence.

Answers to Questions

1) Free Float

- **Question 1.1 - Is the UK's 25% free float requirement calibrated at the right level, and should it be changed? If so, how?**

In most cases, the 25% minimum requirement works well. We do not see a pressing need to change.

We are concerned about the rights of minority shareholders and in particular where there is an inability for shareholders to exercise their shareholder rights. Often such niceties get ignored in the hullabaloo and hype that surrounds the flotation process. The need for shareholder rights sometimes does not appear necessary until years later, when problems arise when it is too late to put such rights in place – they have to be there at IPO. If the 25% limit were to be reduced then management would be able to get a special resolution passed even if all public shareholders voted against the resolution.

We note that the FCA does have the ability to accept a lower level of free float on a discretionary basis, if it considers the market will still operate properly.

Saudi Aramco is a case in point. This is a company that operates mostly in a country which does not have a strong record for high corporate governance standards or respect for the rule of law. LSE would welcome the additional fees and income that it would receive if it was allowed to list in the UK, though it is hard to see how this would be in the interests of shareholders, or the reputation of the City.

Accordingly we would prefer the FCA's discretion to accept a free float of less than 25% at the time of IPO to be removed.

As an aside, the desperation to list an oil company which is almost certainly destined to cause huge losses (noting that in the last decade Exxon has moved from being the largest company in the world to the 32nd in terms of market cap) is symptomatic of the short-sighted approach that has dogged the LSE over the last 20 years.

It is important to remember at all times that the LSE is a public, commercial company. While the role of the LSE is central to many of the issues discussed in this paper, it is important to remember at all times that the LSE's primary aim is not to improve the UK market, but to preserve the near monopoly it has. It could even be argued that many of the failures that this paper seeks to address are the direct results of decisions made by the LSE in terms of the pricing model they have adopted and the investment decisions they have made.

Consideration should be given to more actively encouraging alternative exchanges that can compete with the LSE, and hopefully raise standards in the UK market generally.

- **Question 1.2 – Is there evidence that you can provide to assess potential risks to liquidity from alternative levels?**

No comment.

- **Question 1.3 – Are there other changes or alternative measures to the free float requirements that the review should consider?**

Individual shareholders are very interested in liquidity and spreads. The higher the proportion of a company that is represented by the free float, then all other things being equal, it is likely that the liquidity will be higher, more volume will be traded, and lower spreads obtained.

The AIM rules should also consider increasing their minimum free float requirement from 10% to at least 25%.

It should be noted that illiquidity and wider spreads will sometimes be good warnings to investors or potential investors to not invest or to try and sell.

2) Dual Class Share Structures or other owner-control mechanisms

- **Question 2.1 - Should dual class share structures be permitted in the Premium listing Segment of the London Stock Exchange? If so, what limitations should apply?**

No, the Premium Listing should remain as the Gold standard. Companies that fail to achieve the excellence required to achieve the Premium listing should have a Standard listing or list on AIM.

AIM has specifically been set up to have lower (but still good) standards of corporate governance. Investors on AIM accept this and the risks that this brings with it. However we are not sure we agree with this dual class share structure proposal even for AIM companies: different classes of share are inherently confusing and we are not at all sure that even on AIM there should be classes of share that disenfranchise shareholders, and if so, how that would be communicated to potential investors. Our preference is for all equity shares to have one share one vote on all general meeting matters as there should not be any provision of equity capital without representation.

- **Question 2.2 - What demand is there for DCSS among issuers and what are the benefits and risks for investors? Do you have any evidence to support this?**

We see much (misconceived) demand from issuers, who should not be listened to about this, as the interests of issuers here diametrically conflict with the interests of investors. Time and time again we see bad companies, whose Boards prefer not to engage with their shareholders. Far too often, we see Boards who refuse to listen to the legitimate concerns of shareholders and override them. They bully and bluster their way. A DCSS would be attractive to such Boards. The Premium listing should not permit DCSS.

As noted in Q1.1, we are concerned about the rights of minority shareholders and in particular where there is an inability for shareholders to exercise their shareholder rights. DCSS also impacts on minority shareholders and for this reason a DCSS should not be permitted for Premium listed companies.

- **Question 2.3 – Are there other ways of ensuring London’s high standards of corporate governance are maintained while allowing DCSS in the Premium segment?**

We do not think so.

3) Track Record Requirements

- **Question 3.1 - Do track record requirements prove a barrier to certain types of company? If so, should the UK consider allowing further flexibility in track record requirements?**

The requirement is right for Premium listed companies.

AIM provides a good alternative for companies which cannot provide 3 years of accounts. However, considering how companies grow and receive required funding in sequential tranches, most of which will happen privately over a number of years before companies come to the public stock markets, there are arguments for requiring five years for premium listed companies and three years for AIM companies.

- **Question 3.2 - What kind of extra flexibility could be offered regarding track record requirements?**

We do not believe extra flexibility should be provided. See also our answer to Q3.1

4) Prospectuses

Question 4.1 - Are the prospectus requirements and situations in which prospectuses are required appropriate? Are the thresholds for a prospectus to be produced calibrated appropriately to the size and depth of UK markets, or for types of issuer already held to high disclosure standards?

The €8m rule should be abolished entirely for companies which are already listed. Individual investors should be allowed to participate in placings by existing listed companies without any need for a prospectus.

Once a company is listed, it makes no sense that any investor can buy any quantity of shares in the secondary market, but that an overall limit (€8m) should apply to primary issuance to a particular class of investors. Rather than requiring an additional prospectus, existing rules on disclosure and making misleading statements should be strictly enforced, with strong penalties for directors who breach those rules. Consideration should be given to stronger penalties and criminal sanctions for more egregious cases.

In our recent responses to the FCA Call for Input on the Consumer Investments Market, we made the above 2 points. Our responses to the FCA's Q21 and Q22 is relevant here and are repeated below. ShareSoc's responses are first and then UKSA's:

Q21: Would more investments benefit from 'prospectus-like' disclosure, and/or the disciplines involved in this? If so, in what circumstances?

Chapter 4 section 4.7 discusses Making Risks Clearer.

If a company wishes to IPO on London Stock Exchange or AIM then it is required to create a prospectus, and it **should publish that prospectus on its website, and file that prospectus with a central governmental registry where it remains permanently available**. Knowingly making untrue statements in such a prospectus should be a criminal offence.

The UK needs to learn from the reforms introduced in the USA, e.g. in 1934 when the Securities and Exchange Commission was set up; and Sarbanes Oxley, which makes officers accountable for disclosures.

The FRC appears to be planning to introduce a Sarbanes Oxley type requirement in respect of annual reports and we presume this should extend to prospectus like disclosures too. **The FCA should support this.**¹

CA2006 contains provisions to protect the rights of minority shareholders. These are very important and great care should be taken to preserve these rights.

Currently, Pre-emption rights are being ignored. Pre-emption rights exist for a reason – to prevent existing minority shareholders from being exploited by a majority of shareholders. **The FCA needs to review this.**

There is another problem that is immediately apparent to us:

Mates rates. Shares are placed with a small group of loosely connected (n.b. not "connected" in the legal sense) or associates or business acquaintances at a discount to the prevailing market price. On announcement of a placing (and sometimes in the run up to the placing) shares prices decline and a select group of investors are able to buy shares in the placing at a lower price than other investors have had to pay in the preceding weeks. Often, it is speculated that some of the select group may have sold shares at a higher price in the preceding weeks, when they perhaps suspected but did not know a placing was likely. We can provide examples if you want them.

We are pleased that the temporary relaxation of the Pre-emption rights rules which allowed up to 20% placings, has now been removed and the 5% rule is now again operational.

The EU €8m limit on placings that can be reserved for retail shareholders should be removed. Placings do not require a full prospectus. This arbitrary limit has the effect of treating retail investors unfairly. This limit is in conflict with the CA2006 s172 requirement for Companies to act fairly between shareholders.

¹ So should The Treasury.

We understand that some of the less sophisticated members of the EU proposed the €8m limit. It is not for the UK to change EU limits. However, as the UK has left the EU and the transitional departure arrangements ended on 31 December 2020, we recommend that in January 2021 the FCA should seek to implement the best regime for the UK markets.

Whilst believing that **appropriate disclosure is essential**, we would also be concerned if the cost of providing this disclosure were so great that it had unintended consequences. For example, to protect investors we strongly support the principle of pre-emption rights. But if a company needing to raise capital regards the regulatory costs of a rights issue to be too high, this means that the ability to subscribe can be denied to “ordinary” shareholders, because they do not have access to the alternative placing mechanisms.

The IPO prospectus is a very detailed document and every word has to be signed off by the Directors.

The combination of the IPO documents, annual and interim reports, and trading and RNS updates provides adequate information for investors to decide whether to invest in a placing.

If the directors are aware of market sensitive information they should announce this to the whole market **at the same time**. It should be illegal to only inform those who are consulted about a fund raise². We would argue that it is already illegal for directors not to make market sensitive information available to all shareholders promptly when they become aware of it. S80 and S80A of FSMA should be rigorously applied by the FCA.

If the above proposed regime were followed, it would greatly simplify the administration of fund raises, in many cases, whilst still allowing companies to do the more formal rights issue if they wished.

Many people have said to us they find it entirely unnecessary to have a prospectus of hundreds of pages and would prefer a much shorter version with the key facts. The current regime is a product of the nanny state approach which we feel is inappropriate to sophisticated investors and needs to be streamlined.

We note that the eventual costs of all of this over-zealous over-regulation is eventually paid for by investors and leads to increased cost of capital for UK companies, which makes the UK a less attractive place to invest and reduces the size of the UK economy with negative social consequences.

What about companies near to bankruptcy and the argument that if word gets out of their problems the shorts might make matters worse? E.g. AA is a recent example, also Carillion and Sirius. Directors like to be able to sew up deals behind closed doors. We think this is a false (specious and self-serving) argument as the going concern rules/laws already requires directors to put relevant information out in the market place. Sharp investors (e.g. Muddy

² We note there are exceptions to our generic point. Sometimes the directors are aware of an acquisition, for which a fund raise must be undertaken. They take some investors inside (those whom they think are large/quick enough to 'get the job done'), and disclose the acquisition to them as the reason for the acquisition. If they made the whole market aware, it might ruin the chance of making the acquisition. S172 CA 2006 still requires them to act fairly between shareholders, which needs to be robustly enforced to ensure that individual shareholders are not penalised. The Primary Bid approach has shown it is possible for individual investors to participate on similar terms.

Waters) can easily see the debt and covenant issues. Many investors shorted Carillion. JP Morgan shorted Sirius Minerals. The current rules act to the detriment of individual investors, because of information asymmetry.³

The focus of our organisations is on investments in Main Market and AIM companies and funds. We do not wish to comment on companies that are not listed in our answer to this question.

Recommendations

Removal of the €8m limit for placings in UK traded companies.

Note: the consequence of this recommendation is the removal of the need for a full prospectus when raising money.

If company wishes to IPO on London Stock Exchange or AIM, it should publish that prospectus on its website, and file that prospectus with a central governmental registry where it remains permanently available. Knowingly making untrue statements in such a prospectus should be a criminal offence.

Q22: Should more investments be subject to continuing disclosure requirements after they are issued, and what liabilities should be attached to these disclosures?

Our answer to this question follows on from our preceding answer.

Once a company has issued such shares or securities, it should be required to publish accounts each year drawn up to the same standards as other public interest entities, which are published on its website and filed with a central government registry, such as Companies House, on a relatively tight timescale similar to the listing requirements of the stock exchange.

When Directors become aware of market sensitive information, they are under an obligation to inform the market promptly. Directors who fail to do so should be subject to personal penalties. Too often penalties are paid by the company's shareholders and not by those who perpetrated the misdemeanours.

UKSA made these comments to Q21

'Prospectus-like' disclosure is desirable in principle but needs to be implemented in a way that avoids the regulatory provisions leading to unwanted outcomes. This can be illustrated by current practices

³ To clarify. It is rare (Patisserie Valerie?) for a company to simply go bang. Usually there is a long time period of deterioration where the market is of course aware of increasing difficulties. The regulator needs to review exactly what should be disclosed to the market? That a company is in merger/rescue talks with another? How much of the negotiation would then have to be in the public domain? It must not make negotiation of a deal almost impossible. There will always be a resource asymmetry between investors (time, expertise, access to databases, experience); we cannot see that this can be levelled out, nor are we convinced that it would be desirable to do so.

regarding raising of additional equity capital by companies which are already listed on the stock exchange.

It has become very common for such companies to raise additional capital by means of placings rather than rights issues, thereby overriding the pre-emption entitlement of existing shareholders. In placings, shares are often issued to third parties who may be “friends” of the management, at issue prices which dilute the existing shareholders. The company’s excuse is that issuing the prospectus required for a rights issue would be too slow and too expensive.

We regard pre-emption rights as an essential ownership right of shareholders, to be overridden only where the share issue is genuinely de-minimis. We regard even standard 5% limit permitted by the Pre-Emption Group⁴ to be too high, let alone the 20% that was allowed during the COVID-19 crisis, and consider that 1% would be a more appropriate limit.

However, to make reducing the limit feasible, the requirements for prospectuses when shares are being issued in the form of a rights issue by companies which are already listed need to be simplified to focus on only the essentials, while protecting investors by imposing sanctions on directors who fail to disclose all information which a prudent shareholder would consider relevant.

Even in cases of financial distress we would prefer to see the company make a large deeply discounted rights issue, without paying for underwriting, rather than spending the shareholders’ money on underwriting fees. Either the deeply discounted shares will be taken up by the existing shareholders, or they can then be placed elsewhere, having given the existing shareholders the chance to subscribe.

UKSA made these comments to Q22

Our answer to this question follows on from our preceding answer. The short answer is yes and liabilities should only attach if the continuing disclosure requirements are deliberately misleading or fraudulent. For example, the recently introduced authorised investment funds value for money annual reports are a good thing; the question is do they provide adequate information in the interests of consumers?

Once a company has issued shares or securities to consumers, it should be required to publish accounts each year drawn up to the same standards as other public interest entities, which are published on its website and filed with a central government registry, such as Companies House, on a relatively tight timescale similar to the listing requirements of the stock exchange.

- **Question 4.2 – How might current prospectus requirements be changed to better reflect the UK markets and the types of issuers listed on them?**

See answer to Q4.1

- **Question 4.3 - Should the loss of disclosure or liability attached to a prospectus document be replaced by any alternative measures if the general exemptions to a prospectus are widened?**

⁴ <https://www.ft.com/content/630dcb71-d5cc-4c02-9381-4760eb21cf9c>

See answer to Q4.1

5) Dual and Secondary Listings

- **Question 5.1 - Are the UK requirements around dual and secondary listing a barrier to dual listing in the UK? If so, what could be changed to further encourage dual and secondary listings here?**

We consider that the UK should adopt a more discerning approach when overseas listed shares are listed on the London markets.

Some companies' primary listings will be on exchanges that have very high standards. In such cases, the only requirements that the UK should impose will be those relating to clearing procedures, to ensure that investors receive the shares they are paying for, and receive the sale proceeds for any shares that they sell. The UK should publish a list of those exchanges that it regards as having "very high standards."

For companies whose primary listing is on other foreign exchanges, the UK should not relax its existing requirement. Even with the present rules we have seen, for example, Chinese and Kazakhstan companies mistreat investors, and any relaxation of the UK listing rules for secondary listings would only make this problem worse.

6) Other issues

- **Question 6.1 - Are there any other immediate issues the review should consider?**

Valuations of UK companies are in general much lower than comparable companies in other markets. They are much lower than equivalent companies in the US. We made this point to you in our submission to the Patient Capital Review.

This may be because of an over-emphasis on:

- short term performance for and by some fund managers and analysts;
- on dealing rather than investing for the long term by brokers;
- value versus growth;
- dividends or over distributions of supposedly excess capital.

We believe that another key reason for this **valuation gap** is a lack of participation in the UK market. Increasingly, member feedback suggests that UK investors are investing more and more in overseas companies. Part of this is due to the low quality of companies on the LSE compared to other jurisdictions (there is not one leading global tech company listed in the UK, for example). There may be an argument for the government to identify and provide protection of high quality UK companies and prevent them being acquired/taken over by foreign investors, and such arguments are stronger where there are precisely specified national security considerations (major weapons manufacturers, critical cybersecurity firms, etc.). Any such move would align the UK much more closely with the more interventionist and protectionist approaches adopted by countries like France. This would be likely

to have major ramifications for UK companies, their investors and UK stock markets. While some might welcome such a change, it seems likely that others would strongly resist it.

The valuation gap creates a negative cycle: a lack of quality investment opportunities or low liquidity and large spreads discourage investors, leading to lower valuations. It has been noticeable that all of the UK listed spread betting firms have reported a huge increase in number of clients and turnover during 2020. The most popular shares on these platforms tend to be US companies. This reinforces the point that the LSE is not a captive market for UK investors. Investors are increasingly looking to invest globally, where spreads are often in the region of 0.1%. This also reflects the short termism of brokers/dealers who rely on trading for their income and its conflict with long term investing.

In the UK market, spreads are rarely this low, and liquidity is also a recurrent problem. For many AIM companies, even a shareholding of £10,000 may be difficult to trade. Large spreads and low liquidity immediately suggest that an imbalance between the number of companies quoted on the UK markets and the number of participants in the market. While a small number of shares which are flavour of the month can trade efficiently, for the majority of companies, this imbalance is reflected in high spreads, low liquidity and low valuations.

Although liquidity and spread are also huge concerns, poor liquidity/wide spreads doesn't necessarily mean that it's a poor company, it may mean that its shares aren't traded much (and the wide spreads discourage trading, leading to a vicious circle). Sometimes this is indicative of poor investor engagement, even though underlying business may be sound. E.g. one of our members reports that CLIG (Main Market, Premium Listed) is an excellent business (and engages well with shareholders), but its shares often trade on a wide spread (varies from day-to-day).

There are multiple reasons why the UK's stock markets reflect lower valuations than would other global stock markets. Some of these reasons have been reflected in this response to your call for evidence. Another example is banks where value has been captured by employee stakeholders and their pay so that their savers (depositors) and their shareholders have little to share from any remains of their profits. Sometimes it is difficult to identify these causes, rather than the correlations, of lower valuations. The Treasury should identify the main reasons for or causes of lower valuations in the UK market and design appropriate countermeasures to make the UK stock markets more attractive to companies and their investors.

It is noticeable that this review has focussed on what can be done to make the UK a more attractive regime for companies to list, where perhaps a more important consideration is what can be done to make the UK a more attractive regime in which to invest. The key point is that the stock market is now global, the marginal costs of investing in UK shares are excessive, and the returns from UK shares have been below average. The idea that somehow the UK market can be improved by relaxing the standards applicable to listings is utterly misguided and little more than a failing business model seeking a race to the bottom.

Any review of the UK listing regime should focus primarily on what can be done to build an exchange fit for the 21st century, and who is best placed to deliver the innovation that can reverse 20 years of decline. An exchange that aimed to facilitate the movement of capital with minimal marginal costs would have no problem attracting leading global companies.

Consideration should also be given to whether the LSE is the appropriate body to specify and enforce the AIM market rules, given a poor track record on enforcement. There is an inherent conflict between the commercial interests of the LSE to quote as many companies on AIM as possible, with the need for effective regulation. This conflict would be removed if the FCA were responsible for determining and enforcing AIM market rules (as well as the main market listing rules). In addition, the FCA has powers to prosecute criminal offences, unlike the LSE. A well regulated AIM market should attract more capital than the current “wild west” or “casino” it has been described as. NB we are not advocating more complex or stringent rules for the AIM market (except for free float and track record requirements), just that the current rules (especially concerning disclosure and misleading statements) should be more strongly enforced and that breaches should be subject to stronger sanctions against responsible individuals.

The tax treatment of debt and equity should be harmonised. The present system encourages high leverage which can often lead to much higher risks for individual investors due to corporate bankruptcy. This may also indicate that leverage in companies should be limited by regulation.

The UK government and FCA should recognise that “home country bias” (the tendency of investors to overweight their home jurisdiction in their portfolios) may obscure the real problems that need identifying within UK stock markets and can be seen as simply an investment mistake in the short term. To the extent that UK based investors have increased the non-UK element of their portfolios, that is simply them being sensible.

Familiarity, ease of access and mutually beneficial legal structures (eg the related tax regime) tend to influence this. There is also a historic bias, but that does not make it right. A market cap balanced global portfolio should be regularly reassessed but we suspect that many UK based do not do this. A lot of investors who have been overweight UK have significantly underperformed over the past 20 years and Government policy should recognise this issue. There are also a lot of arguments which can be used to support “home country bias” in the UK such as good quality investment opportunities, shareholder enfranchisement, pre-emption rights, ease of access to home companies, good corporate governance and improving corporate reporting; and The Treasury needs to consider carefully if these arguments hold water on an objective basis looking at results over the decades.

- **Question 6.2 – Are there any non-regulatory, non-legislative actions that could the UK take to promote the use of public equity markets?**

The treatment of entrepreneurs gains when they transfer to the market and partially sell their companies is important and should be prioritised. As we come out of the economic depression following Covid, we will need many hard working entrepreneurs supported by patient capital to provide new jobs and be engine of growth in the UK.

Capital gains tax similarly needs to be reformed to reward individuals who are successful. The base year should be moved up from 1984 to 2010. This would greatly simplify, what has become a very complex tax to calculate.

The UK should aim to create higher valuations of UK based companies, by making the UK a more attractive location to have your head office, factories, offices and key staff.

These are important issues that need to be considered at the highest levels. Accordingly, we have copied our response with our views to the Minister for Business, the FCA and the FRC.

Yours sincerely

Cliff Weight
Director
ShareSoc

Dean Buckner
Director
UKSA

Copies to

The Rt Hon Alok Sharma MP, The Secretary of State for Business, Energy and Industrial Strategy
Nikhil Rathi, CEO FCA
Sir Jon Thompson, CEO FRC

Appendix

About ShareSoc and UKSA

We write on behalf of ShareSoc and UKSA, both of whom represent the views of individual investors. In addition to our own members, 6 million people own shares or have investment accounts with platforms in the UK. The Office for National Statistics estimates that at the end of 2018 UK-resident individuals held 13.5% of the UK stock market, up by 1.2% from 2016 and moving away from the historical lows of 10.2% in 2008. In 2020, the Financial Times estimated that 15% of the UK stock market is held by individual shareholders. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

See <https://www.sharesoc.org/investor-academy/advanced-topics/uk-stock-market-statistics/>

For more information see:

www.sharesoc.org

<https://www.uksa.org.uk>