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# Enhancing the effectiveness of the Listing Regime

## A summary of the proposals set out in FSA Consultation Paper 12/25

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**Further information**

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# FSA CONSULTATION PAPER CP 12/25 – ENHANCING THE EFFECTIVENESS OF THE LISTING REGIME

On 2 October 2012, the FSA published consultation paper CP 12/25 which, amongst other things, sets out proposals for:

- amendments to the Listing Rules aimed at 'enhancing the effectiveness of the Listing Regime'; and
- other supplementary changes to implement the Alternative Investment Fund Managers Directive.

The deadline for responding to the consultation is 2 January 2013.

Click here to see the proposals at Chapter 7 of CP 12/25. A summary and review of the proposals are set out in this note.

## INITIAL DISCUSSION - FSA CONSULTATION PAPER CP 12/2 (CP 12/2)

Earlier this year, CP12/2 initiated a conceptual discussion of the general issues relating to 'free float', minority shareholder protection, effective governance and the quality of the premium segment of the Listing Regime.

When considering these issues, the FSA and various stakeholders were concerned about the Official List's ability to remain a competitive listing destination, whilst ensuring that it maintains its clear and high quality standards of investment which are key features of its attractiveness to both domestic and international issuers and investors.

As part of the discussion, the FSA considered revising the free float requirements for the specific purpose of protecting the interests of minority shareholders who may suffer at the hands of 'controlling shareholders' of listed issuers. In particular, certain stakeholders are concerned that there has been a corporate governance failure in situations where there is a controlling shareholder and a low level of shares held by independent shareholders. It is noted, however, that such failures have not been common, which suggests that there is no systemic failure relating to the free float requirements which needs to be addressed. Other stakeholders are also concerned that any changes to the free float requirements would be disproportionate and would effectively give minority shareholders 'control' over the market and that consequently, any changes would have an adverse effect on the competitiveness of the market.

## KEY PROPOSALS

In light of the responses arising from CP 12/2 and following its discussions with the Financial Reporting Council and FTSE, the FSA has concluded that adjusting the free float requirements will not adequately address the market's primary concerns relating to the protection of independent shareholders and wider governance issues.

It has therefore proposed a package of measures, some of which are new and some of which have been used previously, which are individually designed to address specific issues to ensure that a solid framework of corporate governance is embodied in the Listing Rules, whilst ensuring that the Listing Regime retains its high quality standards and remains competitive.

### 1. CONTROL AND INDEPENDENCE REQUIREMENTS

#### New eligibility requirements

The FSA has proposed two new separate rules to replace the current control and independence requirements in LR 6.1.4R(2) and (3) which apply to new applicants for a premium listing. Under the new rules, a new applicant for a premium listing must demonstrate that:

- it controls the majority of its business; and
- it will be carrying on an independent business as its main activity.

The FSA proposes that the new independent business and control requirements will apply both to applicants for, and companies with, a premium listing at all times on a continuing basis.

The new eligibility requirements will be supplemented by guidance setting out the factors that may be relevant when determining whether a new applicant meets the control and independence criteria.

#### Guidance

Factors that may indicate that an applicant is unable to carry on an independent business include situations where:

- the applicant does not have a lack of strategic control over the commercialisation of its product or its ability to earn revenue;
- the applicant cannot demonstrate that it has access to independent financing; or
- the majority of the revenue generated by the applicant in business is attributable to business with a controlling shareholder.

Factors that may indicate that an applicant does not control its business include situations where:

- the company is able to exercise only negative control or only has veto rights over significant decisions

affecting the management of the business made by third parties;

- the company has 'precarious control of the business' that relies on contractual arrangements that may be altered without its agreement; or
- the company has in place contractual arrangements which result, or could result, in a temporary or permanent loss of control of its business.

## 2. CONTROLLING SHAREHOLDERS

In 2004, the FSA amended the Listing Rules to remove the express requirement for an issuer to be independent of a controlling shareholder as it was believed that the relationship should be a matter for disclosure and subject to investor scrutiny and judgment. However, in light of the recent concerns over the protection of independent shareholders, particularly where there is a controlling shareholder, the FSA has reinstated the express provision that a premium listed issuer must be capable of acting independently of a controlling shareholder and its associates.

The proposed definitions of 'controlling shareholder' and 'associate' will be based largely on the previous definitions of those terms.

A 'controlling person' will be a person who holds:

- 30% or more of the shares or voting power in a new applicant for, or a company with, a premium listing, or its parent undertaking; or
- shares or voting power that enable it to exert a significant influence over the management of a new applicant for, or a company with, a premium listing.

The proposed definition will also include the ability to aggregate the interests of those acting in concert.

## 3. ADDITIONAL REQUIREMENTS FOR CONTROLLING SHAREHOLDERS

The FSA proposes to introduce the following additional requirements for companies with a premium listing who have a controlling shareholder:

**Relationship agreement**

The FSA proposes to reinstate the express requirement for a relationship agreement to be in place to govern the relationship between the company and its controlling shareholder. In spite of its previous removal from the Listing Rules, the entry into relationship agreements has remained relatively common. The FSA has noted that market participants consider relationship agreements to be a valuable tool in regulating the relationship between a controlling shareholder and the new applicant, provided that it is complied with on an on-going basis.

*Content requirements*

The FSA has mandated specific content requirements for the agreement which include ensuring that:

- transactions and relationships with a controlling shareholder are conducted at arm's length and on normal commercial terms;
- a controlling shareholder abstains from doing anything that would have the effect of preventing a new applicant from complying with its obligations under the Listing Rules; and
- a controlling shareholder must not influence the day to day operations of the new applicant.

*Continuing obligations*

The FSA believes that it is important that the agreement provides appropriate protection on an on-going basis and gives the FSA enforcement powers where a company has breached its obligations. Consequently, the new proposals require the relationship agreement to remain in effect for so long as the shares are listed on the Official List and the listed company has a controlling shareholder.

*Material amendments*

Any material change to the relationship agreement will require independent shareholder approval. For this purpose, the independent shareholders will be all shareholders other than the controlling shareholder and its associates. In determining what constitutes a material change, the listed company should have regard to the cumulative effect of all changes since the shareholders last had the opportunity to vote on the relationship agreement or, if they have not yet voted, since the company's admission to trading.

*Disclosure*

In order to promote transparency on the correct operation of the new rules, the proposals provide that a copy of the relationship agreement (or details of where it may be obtained free of charge) must be included in the company's annual report. The annual report must also include a statement by the directors that the company has complied with the relationship agreement throughout the financial year, or where there has been any non-compliance, a description of the non-compliance and confirmation that the UKLA has been informed.

**Independence of directors**

*Board composition*

The FSA is proposing to introduce a new eligibility requirement to govern the composition of the board where a new applicant for a premium listing has a controlling shareholder. The applicant's board must have either:

- a majority of independent directors; or
- an independent chairman and independent directors making up at least half the board.

The requirement will apply to all UK and overseas companies.

The FSA believes that this proposal is an important part of a proportionate response to the concerns of stakeholders but it appreciates that there is wide support of the 'comply or explain' principle under the UK Corporate Governance Code (Code) and is therefore consulting on whether stakeholders would prefer to proceed with the new proposals or keep the 'comply or explain' approach and retain flexibility for board composition in all circumstances. Given the flexibility of the 'comply or explain' approach, it will be interesting to see whether stakeholders will favour a shift towards a more prescribed route which may involve a shake-up of certain boards to favour minority shareholders.

The FSA does not propose to introduce new rules defining independence for this purpose. The current practice will continue whereby issuers will themselves determine independence of directors by reference to the Code. The FSA notes that whilst the Code does not see the Chairman as independent post appointment, it proposes that a Chairman who was judged as being independent on first appointment would continue to be so for the purposes of these new provisions.

Under these proposals, the eligibility criteria governing the composition of the applicant's board will also apply as a continuing obligation. A period of six months will be allowed to rectify any non-compliance with the continuing obligation (for example, where an independent director resigns).

*Election of independent directors*

Currently, a director may be elected or dismissed by approval of the majority of all shareholders who vote. In a company with a controlling shareholder, independent shareholders may not hold enough shares to influence the outcome of the vote. The FSA believes that it is important for independent shareholders to have more say in the election of the independent directors who are representing their interests but recognises that undue control should not inadvertently be given to such shareholders. It has therefore proposed a dual voting structure for the appointment of independent directors of a premium listed company with a controlling shareholder. Such appointments must be approved both by the shareholders as a whole and also by the independent shareholders. Under the proposals, if the result of these two votes conflict, a further vote may take place not less than 90 days later on a simple majority basis.

## 4. Application of Proposals to Mineral and Scientific Research Based Companies

The revised independence requirements, including the rules on controlling shareholders, majority independent board and procedures for the election of independent directors are proposed to be applicable to all mineral companies and scientific research based companies.

It is also proposed that the eligibility requirement to control the majority of the business should apply to scientific research based companies but the FSA proposes that this requirement (and its equivalent continuing obligation) should not apply to mineral companies, the rationale being that co-venturing investment structures through which mineral companies commonly partner are well established and accepted by investors in this sector.

## 5. Continuing Obligations

The FSA is also proposing a number of additional amendments to the continuing obligations of companies with a premium listing, including the following:

**Voting by premium listed shares**

The FSA has previously encountered proposals for share structures where matters which are subject to a shareholder vote imposed by virtue of the premium listing requirements could have been decided by holders of unlisted shares. The FSA is seeking to tighten the rules so that the investor rights and protections arising from the premium listing segment only attach to premium listed shares and not to any other securities.

In order to preserve the high standard of the premium listing segment, the proposed rule provides that all shareholder votes that are required to be undertaken by a premium listed company should be decided by the holders of premium listed shares. The proposals also include guidance on the modification of the proposed new rule in exceptional circumstances (such as voting rights attaching to unlisted preference shares which are in arrears or dual listed company structures).

**Non-compliance with continuing obligations**

It is proposed that issuers should be subject to an obligation to notify the FSA of non-compliance with any of the continuing obligations set out in LR 9.2 (and not just the free-float requirements as currently provided). It is also proposed that, where a company is not complying with any of such obligations, it should consider applying for a cancellation of its listing or a transfer of its listing category so that it sits in a

regime in which it is able to comply with its appropriate listing obligations.

**Disclosure in annual report**

An amendment to LR 9.8.4R is proposed which requires all disclosure items that must be included in the annual report and accounts to be presented in a single identifiable section.

**Warrants and options to subscribe**

The eligibility requirements for applicants currently limit the total number of issued warrants or options to 20% of the issued share capital but this limit does not apply as a continuing obligation. In order to create consistency, the FSA proposes either requiring companies with a premium listing to comply with LR 6.1.22R on a continuing basis or deleting the existing eligibility requirement in LR 6.1.22R altogether.

## 6. LISTING PRINCIPLES

At present, the Listing Principles apply only to premium listed issuers. The FSA believes, however, that this has resulted in a misinterpretation in the market that the principles that should apply to all listed companies are only applicable to premium listed companies.

Consequently, the FSA proposes the following changes to Listing Principles in LR 7.2.1R:

**Application to standard listings**

Principle 2 (systems and controls) and Principle 6 (open and co-operative dealings with FSA) of the existing Listing Principles will be applicable to all listed companies.

**Premium Listing Principles**

The remainder of the existing Listing Principles (principles 1 and 3 - 5 (inclusive)) will be re-categorised as Premium Listing Principles that apply to companies with a premium listing only.

**New Premium Listing Principles**

Two new Premium Listing Principles will be introduced requiring that:

- the voting power of each share within a premium listed class should carry an equal number of votes (new Premium Principle 3); and
- where a company has more than one class of equity shares admitted to premium listing, the aggregate voting rights of the shares in each class should be broadly proportionate to the relative interests of those classes in the equity of the company (new Premium Principle 4).

Premium Listing Principle 3 is introduced to ensure that classes of shares with varied voting power ought to be listed on the standard segment as admission of such share structures would devalue the perception of high quality that is currently associated with a premium listing.

Premium Listing Principle 4 is intended to address circumstances where share structures involving multiple classes are being created with the express intention of retention of control by a small group of individuals through the use of enhanced voting power for a particular class. Similarly, such arrangements undermine the equitable principles upon which the premium listing is based. The FSA also proposes guidance as to the factors it will have regard to (on a non-exhaustive basis) in assessing whether the votes attached to a class of shares is proportionate. These factors include the extent of any other differences in the rights of the various classes of shares, the extent of dispersion of the relative liquidity of the classes of shares and the commercial rationale for the different rights.

## 7. FREE FLOAT

As mentioned above, the FSA recognises the potential role that the amount of shares in public hands plays in giving shareholders sufficient power to counterbalance a controlling shareholder but it does not believe that increasing the current level of the free float requirements would be sufficient to ensure effective governance in a listed company, particularly in relation to the premium listing segment.

**Premium listing segment**

The FSA has however announced proposals to clarify the operation of the free float provisions to companies with a premium listing. These proposals include:

- excluding shares subject to a lengthy lock up period (longer than 30 calendar days) from the calculation of shares in public hands on the basis that such shares do not provide any liquidity; and
- specifying the criteria that the FSA will apply in determining whether to modify the 25% requirement for shares in public hands. The proposed criteria include companies where the number of public shareholders exceeds 100 and the expected market value of the shares in public hands at admission exceeds £250 million.

Guidance is also proposed to be inserted into the Listing Rules that, even where these two criteria are met, other than in exceptional circumstances, it is unlikely to agree to a request where the number of shares in public hands will be below 20%.

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**Standard listing segment**

The FSA notes that whilst it does not believe it is justifiable to make significant changes to the free float requirements for premium issuers, there may be room for increasing flexibility in the standard listing segment.

Consequently, no rule change is being proposed but the FSA is seeking views on admitting securities which have very low free floats in percentage terms provided that there is sufficient liquidity. Furthermore, the FSA is seeking views as to whether it should modify the free float requirement based on its assessment of the proposed number, nature and diversity of holders post admission.

In light of the suite of new measures relating to free float and corporate governance, the FSA is also re-opening consultation on the following proposals which were included in CP 12/2:

The FSA is proposing new guidance to:

- reflect the FSA's existing approach of allowing individual fund managers in an organisation to be treated separately, provided investment decisions with regard to the acquisition of shares are made independently, for the purposes of the free float requirement thresholds; and

- explain that the FSA considers that financial instruments that give a long economic exposure to shares but do not control the buy/sell decision in respect of the shares should not normally be treated as an interest for the purpose of the public hands threshold.

**PROPOSED AMENDMENTS RELATING TO THE IMPLEMENTATION OF THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)**

Chapter 8 of CP 12/25 sets out the FSA's proposals for further changes to the Listing Rules relating to the implementation of AIFMD.

In its published DP 12/1, the FSA expressed concern that conflicts may arise where responsibilities overlap between the board of an investment trust and the Alternative Investment Fund Manager (AIFM). To address this concern, the FSA proposed that the potential conflict could be managed by prescribing that, to be eligible for a premium listing, a fund would itself hold the AIFM permission. The FSA notes that responses to DP 12/1 did not support this proposal overall.

In place of a prescriptive solution, the FSA has made a revised proposal to incorporate a new eligibility requirement at LR 15.2.19R which states that the board of a listed issuer must be in a position to monitor and manage the performance of its key service providers, including any investment manager effectively. This requirement would also be a continuing obligation on the listed issuer.

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