

Changes to the LSE Listing Rules - Enhancing the Effectiveness of the Listing Regime: Feedback and Further Consultation

I. INTRODUCTION

The pressure on the UK Financial Conduct Authority (the "FCA") (formerly the Financial Services Authority, the "FSA") to "enhance" the Listing Regime, amid the continued influx of foreign companies to the UK markets, has been intense and prolonged. Initially, the focus of some vocal constituents of the market was on the foreignness of companies, accompanied by the suggestion that such companies were unsuitable for the high standards of corporate governance expected of London-listed companies. Perhaps in response, FTSE, as long ago as 2006, began rethinking its rules on nationality, and ultimately made it harder for overseas companies to be eligible for inclusion in its coveted UK indices, requiring them to have a free float of at least 50%. The continued focus on the mere nationality of companies listing in London has been somewhat challenging from a political perspective. More recently, the spotlight has shifted from nationality *per se* to companies with controlling shareholders (many of which happen to be companies with business activities primarily outside the United Kingdom), particularly since much of the recent scrutiny over corporate governance has involved companies with controlling shareholders, and indeed the controlling shareholders themselves.

In 2008, the FCA introduced fairly limited reforms, changing the labels for the types of London listings available, delineating between "Premium" (for companies subject to the highest standards of corporate governance) and "Standard" (for all other companies, which are subject to minimum regulation under applicable EU directives for the most part, which were themselves overhauled in 2005). Amid the continued scrutiny over the corporate governance of some premium-listed companies, and further to its consultation document published in October last year¹, the FCA has decided to implement a number of significant changes to the UK Listing Rules. The FCA is also consulting on new proposals that will form part of the same package of changes to be adopted in mid-2014.²

The aim of many of the prospective changes is to ensure the independence of a premium-listed company from its controlling shareholder³ (if it has one), by introducing the regulation of relationship agreements between them, and shifting some power into the hands of "independent shareholders" (those other than the controlling shareholder). While most of the other changes are directed at companies with premium listings in London, some will impact standard-listed companies as well (including issuers of bonds and GDRs), such as the expansion of the Listing Principles to address a standard-listed company's systems and controls

¹ CP 12/25, October 2, 2012. <http://www.fsa.gov.uk/static/pubs/cp/cp12-25.pdf>; CGSH Alert Memo on CP12/25, October 4, 2012. http://www.cgsh.com/fsa_consults_on_changes_to_the_listing_rules.

² CP 13/15, November 2013. <http://www.fca.org.uk/news/cp13-15-enhancing-the-effectiveness-of-the-listing-regime>.

³ Essentially, a controlling shareholder is a person who alone, or together with concert parties and their respective associates, controls 30% or more of the votes to be cast on all or substantially all matters at a general meeting. While there is no specific definition of "acting in concert", companies should consider if the relevant parties are acting together in exercising the control of 30% or more of the votes in all or substantially all matters at the general meetings. The FCA points out that the meaning of that term as used in the Takeover Code should not be taken to be the meaning for the purposes of the Listing Rules (and vice versa).

and dealings with the FCA. Many of the changes will require action to be taken by current and future listed companies.

II. EXECUTIVE SUMMARY

The prospective changes applicable to premium-listed companies with a 30% shareholder include:

- a requirement to enter into a relationship agreement with the controlling shareholder aimed at ensuring the independence of the listed company from that shareholder;
- a requirement for the directors to make a declaration of compliance with the relationship agreement;
- a proposal for enhanced oversight measures requiring that all related party transactions be subject to shareholder approval if the relationship agreement is not complied with or if an independent director believes the relationship agreement not to have been complied with;
- an eligibility requirement, applicable on an ongoing basis, that the company be able to carry on an independent business as its main activity, and in particular, independently of any controlling shareholder;
- a dual voting structure for the election of independent directors that gives independent shareholders greater control (but not a veto) over their election; and
- a proposal requiring any cancellation of a premium listing to be sanctioned by the majority of independent shareholders.

→ A premium-listed company that might have a controlling shareholder should therefore:

- analyse whether the company in fact has a controlling shareholder for FCA purposes (this should include an analysis of whether there are any concert parties or associates which would trip the 30% aggregate threshold);
- consider whether such controlling shareholder would be willing to enter into the prescribed relationship agreement with the company and then comply with it, and if not:
 - consider whether the company will be able to tolerate the enhanced oversight measures for related party transactions; and
 - consider the cancellation of its premium listing before the tougher thresholds are introduced for shareholder approval of cancellations;
- consider, with special regard to the new guidance, whether the company will be able to satisfy the new eligibility and ongoing requirement that it carry on an independent business as its main activity, in particular independently of its controlling shareholder; and
- review any relationships between the independent directors and any controlling shareholder, and in any event, prepare for the dual voting structure.

The prospective changes applicable to all premium-listed companies include:

- an eligibility requirement, applicable on an ongoing basis, that the company be able to carry on an independent business as its main activity;
- proposed changes to the guidance on when the FCA will consider reducing the 25% free float requirement;
- changes to the free float requirements in relation to locked-up shares and new guidance on the withdrawal of a modification to the free float when the prevailing liquidity is insufficient for the FCA;
- requirements that voting rights related to premium Listing Rules be controlled evenly by holders of premium-listed shares, and where there is more than a single class of premium-listed shares, voting rights be shared on a proportionate basis

→ A premium-listed company should therefore:

- consider, with special regard to the new guidance, whether the company will be able to satisfy the new eligibility and ongoing requirement to carry on an independent business as its main activity;
- check whether the company was permitted a free float of less than 25% and consider whether the prevailing liquidity levels are such that it might become ineligible for a premium listing;
- examine the company's existing public float levels (having regard also to the proposed new guidance) with particular emphasis on identifying whether lock-ups of more than 180 days by particular shareholders would have an adverse effect on its free float to such an extent that it might become ineligible for a premium listing;

- across classes; and
- proposals for small related party transactions to be disclosed on a more timely basis than in the next annual report.

- review the company's share capital to assess whether the rights deriving from the Listing Rules are controlled evenly by holders of premium-listed shares, and where it has more than a single class of premium-listed shares, whether voting rights are shared on a proportionate basis across classes; and
- put in place systems and controls that will allow the company to make the required announcements of small related party transactions as soon as they are entered into.

The prospective changes applicable to all standard-listed companies, including companies listing GDRs or bonds, include:

- a requirement that the company take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations as a London-listed company;
- a requirement to deal with the FCA in an open and cooperative manner; and
- proposed changes to the free float requirements in relation to locked-up shares and new guidance on the withdrawal of a modification to the free float when the prevailing liquidity is insufficient for the FCA.



A standard-listed company, including a company listing GDRs or bonds, should therefore:

- review its systems and controls to ensure that it has formal mechanisms in place to enable substantive compliance with all its obligations as a listed company. This should include, for example, ensuring that the existing directors are aware of their obligations as the directors of a listed company and reviewing the systems which analyse whether information held throughout the corporate group is inside information requiring disclosure to the market;
- check whether it was permitted a free float of less than 25% and consider whether the prevailing liquidity levels are such that it might become ineligible for a standard listing; and
- examine its existing public float levels (having regard also to the proposed new guidance) with particular emphasis on identifying whether lock-ups of more than 180 days by particular shareholders would have an adverse effect on its free float to such an extent that it might become ineligible for a standard listing.

III. IMPLICATIONS FOR PREMIUM-LISTED COMPANIES WITH A CONTROLLING SHAREHOLDER

1. Relationship Agreement

The requirement to have a relationship agreement

A relationship agreement must be put in place to govern the relationship between the premium-listed company and any controlling shareholder. The FCA is proposing a transitional period of six months to ensure that either a new agreement is put in place or that any existing agreements cover the mandatory provisions.

Mandatory provisions of the relationship agreement

The relationship agreement must include undertakings that:

- transactions and relationships with the controlling shareholder will be conducted at arm's length and on normal commercial terms;
- the controlling shareholder will not take any action that would have the effect of preventing the company from complying with its obligations under the Listing Rules; and
- the controlling shareholder will not propose, or procure the proposal of, a shareholder resolution which is intended, or appears to be intended, to circumvent the proper application of the Listing Rules.

These prescribed provisions are significantly lighter than might have been the case. The first undertaking is largely a support structure for the existing related party transaction regime which already requires a fairness analysis of related party transactions of any significance. The second and third undertakings are directed at particularly pernicious activities by a controlling shareholder that would prevent the premium-listed company from complying with its obligations under the Listing Rules. Companies' existing systems designed to ensure compliance with the Listing Rules should already protect against such pernicious activities, but the relationship agreement requirements introduce further checks on such behaviour. The FCA opted against introducing a potentially broad provision that purportedly prohibited the controlling shareholder from influencing the day-to-day running of the company. A watered-down provision has instead been introduced as part of the guidance as to whether the company has an independent business – see below under *“Implications for premium-listed companies with a controlling shareholder – Continuing obligation to be operating independently of any controlling shareholder”*.

Annual Report Compliance Certification and Enhanced Oversight Measures

In recognition of the possibility that a controlling shareholder could disregard a relationship agreement or that the company may not have the appetite to insist on strict adherence to the relationship agreement given the influence of the controlling shareholder, the FCA will require transparent disclosure in the annual report regarding compliance. The exact scope of the disclosure is under consultation but the current proposal would require disclosure:

- that the company has entered into a relationship agreement, or if such agreement has not been entered into, confirmation that the FCA has been notified and the reasons for the agreement not having been entered into;
- that the independence provisions in the relationship agreement have been complied with throughout the preceding financial year by both the company and the controlling shareholder, or if there has been non-compliance, that the FCA has been notified and the annual report must then include a description of the background and reasons for the failure to comply; and
- whether an independent director did not support a clean compliance statement and, if this was the case, that the FCA has been informed.

The FCA acknowledges that where the controlling shareholder and not the company might have caused a breach of the relationship agreement, it would be manifestly unfair to the independent shareholders to cancel the company's premium listing as a result. Consequently, it is proposed that a notification to the FCA of non-compliance, or disagreement by an independent director with a clean compliance statement, would trigger an enhanced oversight regime. This would require all related party transactions, regardless of size, between a premium-listed issuer and its controlling shareholder to be subject to shareholder approval until the next annual report in which the board is able to make a clean statement of compliance. Depending on the nature of the relationship between the company and the controlling shareholder, this requirement for shareholder approval could be highly problematic. In recognition of this, the FCA is proposing to retain discretion to waive application of the enhanced oversight measures on a transaction-by-transaction basis where these measures would impede the operation of the business or otherwise in exceptional

circumstances. Such waiver would be subject to discussions with the company about the severity of the breaches and would take into account the view of the directors, including the independent directors.

2. **Continuing obligation to be operating independently of any controlling shareholder**

To underpin the fundamental policy objective that a premium-listed company be able to operate independently of any controlling shareholder, the FCA is bolstering the existing eligibility requirement for a company to carry on an independent business as its main activity by introducing guidance that sets out indications of when the business is not in fact independent. Furthermore, not only must a company satisfy this eligibility requirement at the time of its initial listing, the new rules will require companies to comply with this requirement on an ongoing basis. The company will potentially become ineligible for continued listing if it ceases to be independent of its controlling shareholder, regardless of the existence of a relationship agreement.

The following factors, directly referring to controlling shareholders, are indications that the company is not sufficiently independent:

- a majority of the company's revenue is attributable to business with the controlling shareholder;
- the company cannot demonstrate that it has access to financing other than from the controlling shareholder;
- the company is supporting a controlling shareholder by giving security over its own business; or
- the controlling shareholder appears to be able to influence the operations of the company outside its normal governance structures or through material shareholdings in significant subsidiaries of the listed company.

While the prescribed undertakings in the relationship agreement ought to be fairly easily complied with by companies with controlling shareholders, these indications of dependence may well catch some existing premium-listed companies and require them to engage in discussion with and convince the FCA that they are nevertheless sufficiently independent to merit a continued premium listing.

3. **Independent Directors**

Election of independent directors

The FCA recognises the potential value of a strong group of genuinely independent directors as a check against potential abuse by a controlling shareholder. Amid concerns that cronies of controlling shareholders could be installed as "independent" directors, the FCA is introducing an election procedure which will give a louder voice to independent shareholders, giving them an opportunity to object, for example, to potential conflicts of interest or loyalties. Independent directors will be required to be elected in accordance with a dual voting structure: a first vote by the shareholders as a whole and a separate second vote by the independent shareholders. If the resolution is passed by both votes, the independent director is elected. In the event that the results of these two votes conflict, a further single vote on a simple majority basis, allowing the controlling shareholder to vote, will be required not less than 90 days later. This subsequent vote can, by itself, elect an independent director if the resolution for his or her election is passed.

While this subsequent vote prevents the minority from being able to impose its will, and effectively allows a controlling shareholder to push through independent directors of its choice,

the controlling shareholder may well be deterred from doing so given the potential for fallout with the company's investor base. It should be noted, however, that these changes will not control the make-up of the group of independent directors that a company comes to market with at the time of its initial listing, but only those elected or re-elected once the company has already been listed.

The FCA is also proposing more transparent disclosure in circulars relating to the election or re-election of independent directors. The proposal provides that these circulars should disclose:

- any existing or previous relationship between the proposed independent director and the company or its controlling shareholder; and
- why the company considers the candidate to be effective and independent and the process for selection.

The effect of these disclosures is to bring into the public domain at least some of the analysis that the board will have undertaken for the purposes of the UK Corporate Governance Code in determining that the proposed director is in fact independent.

4. **Cancellation of listing**

Outside the context of a takeover offer, the current rules regarding cancellation of listing effectively require shareholder approval from a majority of not less than 75% of shareholders entitled to vote. The FCA is proposing that companies with controlling shareholders must, in addition, obtain approval from a majority of independent shareholders. In the context of a takeover offer, the current rules permit cancellation of listing if the offeror has gained control of 75% of the company. The FCA is proposing that if a controlling shareholder which already owns more than 50% of the listed company launches a takeover offer, it must gain control of a majority of shares held by independent shareholders in addition to reaching the existing 75% threshold. Essentially, the philosophy behind these proposals is to hand over a delisting decision to the majority of independent shareholders.

IV. **IMPLICATIONS FOR ALL PREMIUM-LISTED COMPANIES**

1. **Continuing obligation to be operating an independent business**

As discussed above, the FCA will require a premium-listed company to be subject to a continuing obligation to carry on an independent business as its main activity. Currently, it is only an eligibility requirement for initial listing. In addition, it will introduce new guidance as to when a company may not in fact be carrying on an independent business. While most of the indications of dependence under this new guidance appear to be targeted at companies with controlling shareholders (see "*Implications for premium-listed companies with a controlling shareholder – Continuing obligation to be operating independently of any controlling shareholder*" above), some of them will apply to all premium-listed companies which will need to consider whether they continue to be eligible for their premium listing.

The following factors (in addition to those discussed above which are relevant to companies with controlling shareholders) are indications that the company is not sufficiently independent:

- the company does not have:
 - strategic control over the commercialisation of its products or its ability to earn revenue; and/or
 - freedom to implement its business strategy; or

- the company's business consists principally of investments in companies in which it does not have positive control, including where its control is subject to arrangements which could be changed without its agreement or could result in loss of that control.

This will essentially require an examination of the facts, but all premium-listed companies will have to undertake this analysis to see that they have not, since their initial listing, ceased to be eligible for their premium listing.

2. **Free float**

In light of investor community suggestions that the existence of controlling shareholders, and related corporate governance problems, have been connected with the current "low" minimum free float requirement of 25%, together with numerous examples where the FCA has allowed a premium listing with an even lower free float, the FCA considered raising the free float requirement to 50% or even more for the premium segment. Balancing the views of market participants on the buy and sell side as well as the FCA's own objectives, it has decided to keep the basic minimum free float percentage at 25%.

While having decided on the basic minimum free float threshold, and having determined that in certain circumstances the FCA will be willing to allow smaller free floats, it has decided to consult on what those circumstances should be. In allowing smaller free floats, the FCA is proposing to consider the following:

- as well as the level of free float within the European Economic Area (the "EEA") (which is where the basic free float is required to be), the free float outside the EEA, even if the shares are not listed there;
- the number and nature of public shareholders, moving away from its original formulation which set the minimum threshold of public shareholders at 100, noting that adequate liquidity may be less likely to materialise if the investor base is predominantly retail. This is to a large extent a recognition that public float is not merely a numbers game; and
- whether the expected market value of the shares in public hands is in excess of £100 million at admission (rather than £250 million as proposed earlier).

Importantly, where the FCA grants a smaller free float below the 25% threshold, it will consider withdrawing the derogation if there is evidence that the free float is in fact illiquid. Consequently, premium-listed companies with free floats of less than 25% that had originally been blessed by the FCA will need to re-examine their existing liquidity levels to assess the risk of having their premium listings cancelled by the FCA. In practice, the FCA is likely to give companies time to pursue options that would increase their liquidity before using the ultimate sanction – a delisting.

In addition, the FCA has decided to go ahead with changes that would exclude shares subject to a lock-up period of longer than 180 days from the free float calculation. Since the obligation to have a compliant free float is not just an initial eligibility requirement, but an ongoing listing obligation, companies should consider what exposure they may have to a breach of the public float requirement in the event that selling shareholders enter into lock-ups of more than 180 days.

3. **Premium listing protections for premium-listed shares only**

The FCA has for some time been concerned about share structures that undermine the protections in the Listing Rules designed for the benefit of holders of premium-listed shares on an equal basis. Super voting shares and share structures involving multiple classes designed to allow control to rest with a small group of shareholders, for example, have been a cause for concern for the FCA.

The FCA has therefore introduced a number of changes so that voting rights related to premium Listing Rules are controlled evenly by holders of the premium-listed shares, and where there are

more than a single class of premium-listed shares, that voting rights are shared on a proportionate basis across classes. Numerous premium-listed companies will have to take active steps to fix the terms of various classes of their share capital to bring themselves into compliance with these new rules, without the benefit of a transitional period after these rules are expected to come into effect in the middle of next year.

4. **Related party transactions**

Under the existing rules, there is a substantial degree of flexibility about the level of disclosure in a company's annual report in relation to small related party transactions (those within 0.25% to 5% range of significance according to the FCA's Class Tests). The FCA has proposed to limit this flexibility by requiring details of such transactions to be announced via an RIS at the time that they take place rather than waiting to be reported in the company's next annual report and accounts. The announcement must include enhanced disclosure so that in addition to the identity of the related party and the value of consideration (as were required previously), it must include a brief description of the transaction and the fact that it falls within the small related party transaction regime.

V. **IMPLICATIONS FOR ALL STANDARD-LISTED COMPANIES**

1. **New listing principles targeting systems and controls**

The Listing Principles⁴ have been applicable only to premium-listed companies since their inception. For the first time, they are being expanded to capture standard-listed companies. All listed companies, including companies with GDR listings and listings of bonds, whether traded on the regulated market or the Professional Securities Market, will be subject to an overarching Listing Principle requiring them to take reasonable steps to establish and maintain adequate procedures, systems and controls to enable them to comply with their obligations. Another Listing Principle is being expanded to require standard-listed companies to deal with the FCA in an open and cooperative manner.

Companies should undertake a rigorous review of all of their continuing obligations and their systems and controls to ensure that they have formal mechanisms in place to enable substantive compliance with these obligations. This should include, for example, ensuring that the existing set of directors are aware of their obligations as a listed company and reviewing the systems which analyse whether information held throughout the corporate group is inside information requiring disclosure to the market. The increasing focus on regulatory compliance of companies in the emerging markets, many of which have standard listings of either shares, GDRs or bonds, means that this ought to be an important area of review for all such companies in particular.

2. **Free float**

While the FCA appears to be more inclined to allow smaller free floats for standard listings of shares or GDRs than for premium listings, if the minimum 25% free float requirement has been reduced, the FCA will consider withdrawing that concession if it considers the actual trading in the company's securities to be illiquid. Accordingly, while there may be additional flexibility for standard listings upon initial listing, more companies may end up being susceptible to delisting

⁴ The Listing Principles were originally introduced in 2005 to encourage issuers and their advisors not to adopt a literal interpretation of each rule but to promote compliance with the overarching standards of the Listing Rules. The Listing Principles are enforceable in the same way as other Listing Rules and so breaches of them will attract the same sanctions, the most drastic of which are the suspension and cancellation of listing.

depending on the liquidity that in fact develops. In practice, the FCA is likely to give companies time to pursue options that would increase their liquidity before deciding to delist their securities.

The FCA is also proposing to exclude shares and GDRs that are subject to a lock-up period of longer than 180 days from the free float calculation. Since the obligation to have a compliant free float is not just an initial eligibility requirement, but an ongoing listing obligation, companies with standard listings of shares or GDRs would have to consider what their exposure to a breach of the public float requirement would be in the event that selling shareholders enter into lock-ups of more than 180 days.

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Please feel free to call any of your regular contacts at the Firm or any of our partners and counsel listed under “Capital Markets” or “Corporate Governance” in the Practices section of our website (<http://www.clearygottlieb.com>) if you have any questions.

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