RESPONSE TO FSA CONSULTATION PAPER 12/25 – ENHANCING THE EFFECTIVENESS OF THE LISTING REGIME

DECEMBER 2012

This response has been prepared jointly by the Listing Rules Joint Working Party of the Company Law Committees of the Law Society of England and Wales and the City of London Law Society.

The Law Society of England and Wales is the representative body of over 120,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government in both the domestic and European arena. This response has been prepared on behalf of the Law Society by members of the Company Law Committee.

The City of London Law Society (**CLLS**) represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees.

The Listing Rules Joint Working Party is made up of senior and specialist corporate lawyers from both the Law Society and the CLLS who have a particular focus on the Listing Rules and the UK Listing Regime.

We set out below our comments on the specific questions asked in the consultation paper, using the same headings and numbering.

Independent business

Q1: Do you agree with our definitions of a controlling shareholder and an associate of a controlling shareholder? Do you believe that there are other criteria where an entity or a person ought to be deemed controlling shareholder that have not been captured by the proposed definition and if so what are they?

We agree with the general approach to identifying controlling shareholders. We note that the definition of "*controlling shareholder*" refers to any person who "*holds 30% or more of the shares in a new applicant or listed company*". We suggest that this be narrowed slightly so as to refer only to premium listed companies (and new applicants for premium listing) given that the regime will not, we understand, apply to standard listed issuers.

We think that guidance may be helpful as regards situations in which shareholders and their associates will be deemed to be "*acting in concert*". In order to address investors' concerns about the consequences of acting together for the purpose of good corporate governance, the sensible course might be for the guidance to set out examples of situations which would not give rise to a concert party relationship. It would, for example, be worth making it clear that an agreement or understanding between shareholders to vote in a particular way on a resolution to be proposed at a specific general meeting will not make them concert parties and that there needs to be on-going co-operation between them with regard to the control of the company for them to be treated as being in concert.

In addition, the pre-2005 version of the Listing Rules stated that associates would be deemed to be "*acting in concert*" (or, to use the wording given in those rules, "*acting jointly or by agreement"*) with each other until the contrary was proved to the satisfaction of the FSA. Would this deeming provision be replicated in the new rule?

In addition, we are concerned about paragraph (c) of the definition of "controlling shareholder" which envisages a situation where a shareholder would be a controlling shareholder if it holds shares or voting power in a new applicant or listed company ("**B**") or in a parent undertaking ("**P**") of less than 30% but is able to exercise significant influence over the management of B or P. This cuts across the clarity of the 30% test (the accepted level for voting control) but appears to require only holding of "shares and voting rights" to be taken into account. We wonder whether the intention was to catch situations where the holding of "shares and voting rights" together with other rights (for example, a contractual right to appoint a director to the board, or contractual veto rights over, or consent rights in relation to, certain reserved matters) confers the ability to exercise significant influence? We would also welcome guidance on what is meant by "significant influence over the management of B", in particular whether "management" is meant to refer to the managers who manage the day-to-day running of the company, the executive management or the board of the company or something else.

As a separate issue, would the FSA please confirm how the controlling shareholder proposals would apply to dual listed company structures? Such structures can take a number of different forms. For example, the merger may be created through contractual arrangements between two listed entities or through combining their interests structurally so that each listed entity holds shares in a joint intermediate holding company. We do not believe the proposals should lead to one of the constituent listed companies being regarded as a controlling shareholder of the other.

Relationship agreements

Q2: Do you support our proposal in LR 6.1.4ER(1) to require new applicants where a controlling shareholder is present to enter into a relationship agreement?

Yes. It would, however, be useful if the FSA could provide additional guidance on who should be party to a relationship agreement when the controlling shareholder comprises a concert party. Would it be sufficient if only the principal member or members of the concert party entered into the agreement?

Q3: Do you support our proposal in LR 6.1.4FR to require that a relationship agreement must cover certain provisions as described above? Do you think that there are any other provisions that should be considered and if so what are they?

We believe that an obligation for a relationship agreement '*to ensure*' various matters is not appropriate as an agreement cannot ensure that actions are carried out – it can only set out the relevant obligations to which the parties will be bound. We suggest that the drafting in the first line of LR 6.1.4FR is amended so that "ensure that" is deleted and replaced with "*must provide that*".

We support the provisions in LR 6.1.4FR(1) and (2), but we have a number of concerns regarding LR 6.1.4FR(3).

LR 6.1.4FR(3) is a provision not typically seen in current relationship agreements. A controlling shareholder (by definition) can have influence over the issuer's business through its influence on the board. We assume that the concern underlying the proposed LR 6.1.4FR(3) is that the controlling shareholder might bypass the board (and directly influence the executive management of the company) so that the board no longer controls the business. Controlling shareholders should be able to exert strategic influence through the exercise of their shareholder rights and otherwise only through appropriate engagement with the board of directors which should be responsible for making decisions

in light of the interests of the company as a whole, including the independent shareholders.

It is also important to note that individual executive directors may hold shareholdings in excess of 30% or may be considered to be acting in concert with a shareholder who holds more than 30% of the share capital. We assume that it is not the intention of the FSA to prohibit these individuals from holding executive roles within an issuer's group by requiring them to refrain from influencing the day-to-day running of an issuer. If this assumption is correct, an appropriate carve-out from 6.1.4FR(3) (or from the provision inserted in the related party section to cover this, if the FSA accepts our suggestion in the previous paragraph) will be needed. A similar analysis applies to the position of a non-executive director who is himself a controlling shareholder (whether by virtue of being a shareholder or acting in concert with one).

Consequently, we suggest that the first limb of LR 6.1.4FR(3) be amended to read "*no controlling shareholder or associate thereof influences the day-to-day running of the new applicant at an operational level (but excluding any influence on the board of the new applicant and provided that this shall not affect the carrying out by any such controlling shareholder or associate who is a director or executive of the applicant of his duties or responsibilities in his capacity as director or executive).*"

We also note that problems may arise if the issuer is a regulated business, where the controlling shareholder may have its own regulatory obligations to monitor the issuer's activities and set and enforce group compliance and risk policies. It would be helpful to have guidance to clarify that involvement of that sort would not be regarded as breaching this requirement.

We would also query why a controlling shareholder should be prohibited from acquiring a material shareholding in one or more significant subsidiaries. We do not see why any powers which the shareholder may have by virtue of such shareholding cannot be controlled through the relationship agreement in the same way as its exercise of power in relation to the issuer. In any event, guidance on what constitutes a "*material*" shareholding and a "*significant*" subsidiary would be helpful.

We believe that it is important to be clear from the outset that nothing in the new Listing Rules is intended to preclude any of the shareholders (whether "controlling" or otherwise) from exercising their shareholder rights and it would be helpful if an express statement to this effect were published in guidance to LR 6.1.4.

With regard to LR6.1.4FR(4), is the intention here that the relationship agreement should remain in effect for so long as the shares are admitted to listing on *the premium segment* of the Official List? Relationship agreements should not be mandatory for standard listed issuers who happen to have been admitted to the premium segment in the past. We suggest that this is clarified by amending (4) to read "*it remains in effect for so long as the shares are* ***admitted to premium listing*** *and* ***the shareholder remains a controlling shareholder***".

We suggest that it would be helpful to require the relationship agreement to be governed by English law and for the parties to submit to the jurisdiction of the English courts. If other laws govern these arrangements, it may be difficult to establish whether the requirements of LR6.1.4FR are complied with. We also suggest that it would be helpful if the FSA could make it clear that the requirements for contents of the relationship agreement are minimum requirements and that other obligations are permitted (for example, a non-compete provision).

Application on a continuing basis

Q4: Do you agree with our proposal in LR 9.2.2AR(1) that where a company has a controlling shareholder it must have in place a relationship agreement at all times?

We understand the logic in requiring the maintenance of a relationship agreement to be a continuing obligation for new applicants for premium listing which have to enter into such an agreement in order to satisfy the eligibility criteria.

However, it is not clear from the proposals whether a relationship agreement (which complies with LR 6.1.4FR) must be entered into in the following circumstances:

a) where a person acquires shares, or an existing shareholder acquires further shares and becomes a "controlling shareholder" in a premium-listed company following admission; or

b) where an existing premium-listed company with an existing controlling shareholder already has in place a relationship agreement that is deficient in some respect with regard to LR6.1.4FR; or

c) where an existing premium-listed company with an existing controlling shareholder does not have any relationship agreement in place at all.

As the Listing Rules can only impose direct obligations on issuers, the obligation to comply with LR9.2.2AR(1) falls only on the issuer, and not on the controlling shareholder. If an issuer were to be in breach of LR9.2.2AR(1) by failing to conclude a relationship agreement with a controlling shareholder, the sanction for breach of the Listing Rules could only be levied against the issuer, and not against the controlling shareholder(s).

It is possible that a controlling shareholder may simply refuse to enter into a relationship agreement and, in practice, it is not possible for an issuer to force the controlling shareholder to enter into a relationship agreement or ensure that the controlling shareholder fully complies with its terms. As set out in LR9.2.24/25, this may lead to the issuer being delisted or moving to the standard listing segment, thereby leading to a significant reduction in the protection afforded to the independent shareholders whom the rules are attempting to protect.

While there might be a valuation impact for the controlling shareholder in pursuing a non-cooperative approach, not all controlling shareholders respond predictably to this type of risk. We therefore believe that imposing this obligation on existing issuers, which will be retrospective in effect, could operate to the detriment of independent shareholders rather than to their benefit.

In the case of a person becoming a controlling shareholder, if the company is subject to the Takeover Code, the acquirer will usually be required to make a takeover offer for the shares it does not own (the difference between the Takeover Code and Listing Rules definitions of "acting in concert" may mean that this is not the case, as will the possibility that shareholders "coming together" to act in concert trigger the requirement for a relationship agreement but no obligation to make a takeover offer), so the independent shareholders have some protection in this case. However, even in this case, if the acquirer made it clear that it did not intend to enter into a relationship agreement, the independent shareholders would be faced with losing the premium listing and may therefore feel compelled to accept the offer. Independent shareholders in companies not subject to the Takeover Code (or an equivalent regime) would have no protection.

It is also not clear how a company could effectively monitor whether or not it has a controlling shareholder. The Listing Rules must make clear when the obligation to have a relationship agreement takes effect. It seems to us that this could be once the issuer is informed by the

controlling shareholder pursuant to DTR5. However, the determination of whether a person holds 30% or more of the shares or voting power in a listed company will take into account the shares or voting power held by other persons with whom the former may be acting in concert. There is no regulatory requirement for shareholders to disclose the identity of their concert parties other than where they have made a bid for the company pursuant to the Takeover Code (or in certain circumstances in response to a notice from the company under Part 22 of the Companies Act 2006). Would the FSA explain how it expects companies to ascertain whether they have a controlling shareholder in these situations?

Entry into a relationship agreement will in most circumstances amount to a related party transaction under LR 11.1.5 and so will require a general meeting to be held, unless the issuer waits until its next AGM to put the terms of the relationship agreement to shareholders. We note, however, that paragraph 7.70 of the consultation paper, the FSA states that it is appropriate to treat all material amendments to relationship agreements as being "akin to related party transactions given the perception that influence may have been exerted in negotiating the change". In the light of this statement, please could the FSA expressly confirm whether it intends that the entry into, or amendments to, relationship agreements by a premium listed company (including existing premium-listed companies if appropriate) and its controlling shareholder should be classed as "related party transactions" and subject to LR11?

We suggest that in light of:

a) the practical and legal difficulties in imposing amended relationship agreements (or new relationship agreements) on existing controlling shareholders of existing listed issuers;

b) the fact that a great many such existing listed issuers have in place relationship agreements that cover the principal points set out in LR6.12.4AR; and

c) the practical and legal difficulties in identifying new controlling shareholders and with imposing relationship agreements on them,

the FSA should limit the mandatory requirement for relationship agreements (which comply with LR 6.1.4 FR) to new applicants for premium listing. The FSA could “grandfather” existing premium listed companies and provide that, where they have or subsequently acquire a controlling shareholder but do not put a compliant relationship agreement in place within a specified period, they should indicate publicly whether they intend to comply or not with the new rules. It would then be left to the shareholders of those companies and the market to decide whether to retain their shares or invest in the company.

If the FSA were to follow this course, it may be appropriate to require existing premium-listed companies to disclose in their annual report whether or not they have relationship agreements in place which may or may not conform to the proposed new Listing Rules so that their position is subject to investor scrutiny and judgement.

The FSA notes in CP12/25 that:

“*the underlying concerns are* ***not a systemic weakness but may represent the beginning of a long-term pattern*** *of misaligned behaviour, which* ***if allowed to become more prevalent*** *would risk undermining the integrity and effectiveness of the Listing Regime*” (our emphasis).

The FSA also refers to the proposed new general functions of the UKLA and the need to have regard to:

“*the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction*”.

Given the FSA's acknowledgement that the concerns intended to be addressed in CP12/25 are more to do with arresting trends in behaviour than overturning current market practice, and in light of the need for proportionality in imposing burdens and restrictions (noting that this is broader than financial costs), it is not clear that there is sufficient justification for the FSA to impose LR6.1.4ER and LR6.1.4FR and the related continuing obligations in effect retrospectively rather than applying them only to new applicants. We do recognise the argument in favour of having all premium listed issuers subject to the same continuing obligations irrespective of when admitted to listing, but we believe that, on balance, the arguments set out above outweigh this benefit.

If the FSA does not agree and if the requirement to enter into a relationship agreement (which complies with LR 6.1.4FR) is to be imposed equally to new applicants with a controlling shareholder and to all the scenarios listed in (a) to (c) at the beginning of our answer to Q4 above, we suggest that the FSA gives existing premium listed companies a sufficient period to comply with LR 6.1.4FR and introduce provisions to protect independent shareholders from a potential delisting or transfer to the standard segment in circumstances where the controlling shareholder refuses to enter into the required relationship agreement. Similar issues arise in relation to companies that become subject to the obligation to have a relationship agreement as a result of a shareholder acquiring shares and becoming a controlling shareholder, whether or not an obligation to make a takeover offer arises.

The FSA should also elaborate on how, in practice, the terms of a relationship agreement will be imposed on existing or new controlling shareholders.

In addition, we suggest that, instead of permission being granted under Listing Rule 9.2.2BR for an issuer to be in breach of 9.2.2AR for up to six months, 9.22BR should set out a time limit within which an issuer must comply with 9.2.2AR after becoming aware that it has a controlling shareholder.

Q5: Do you support our proposal to subject a listed company to a continuing obligation to comply with a relationship agreement at all times (LR 9.2.2GR)?

As explained in our response to Q3 above, we believe that an obligation for a relationship agreement '*to ensure*' various matters is not appropriate and as a result, we suggest that the drafting in the first line of LR 6.1.4FR is amended so that "ensure that" is deleted and replaced with "*must provide that*".

The listed company will generally have rights rather than obligations under a relationship agreement. So we do not think that it is logical to impose a continuing obligation on the issuer to comply.

If the controlling shareholder were to fail to comply with the terms of a relationship agreement, we consider that the sensible and practical course would be to leave it to the independent directors to decide whether and how to enforce the company's rights under the relationship agreement. The Listing Rules could include appropriate provisions to require issuers to confer the necessary powers on the independent directors and to report publicly on their decision.

Q6: Do you support our proposal that a listed company must at all times comply with the content requirements for a relationship agreement as set out in LR 6.1.4FR, where applicable (LR 9.2.2AR(1))?

As stated above, we have reservations about this proposal. These are set out above in our response to Q4 and Q5. Please also refer to our response to Q34.

Amendments to the relationship agreement

Q7: Do you support our proposal to subject material changes to the relationship agreement to an independent shareholder vote (LR 9.2.2CR)?

No, as given that most amendments to relationship agreements will be related party transactions under LR 11.1.5R, we believe that either amendments to relationship agreements should be carved out from LR 11.1.5R or an extra sub-paragraph (4) should be added to LR 11.1.5R to provide that amendments to relationship agreements are related party transactions. It seems inconsistent to us to propose that independent shareholders should vote on amendments to relationship agreements under LR 9.22CR, but not to require a sponsor to be appointed, as will now be required under proposed LR 8.21R(7) for related party transactions.

Q8: Do you support our guidance on the factors that the listed company should have regard to in determining whether a change to the relationship agreement is material (LR 9.2.2DG)?

We support the principle. We assume that the FSA's intention is that the listed company should consider the effect of all changes which have been made to the relationship agreement since it was last voted on and that, if the listed company considers that all these changes taken together represent a material change from the version of the agreement which was last approved by shareholders, then it should treat the proposed change as material. If this is correct, we suggest that this is made clearer in the drafting. We also suggest that the FSA clarifies whether it is only changes to the provisions required by the Listing Rules that are relevant or not when considering what is a material change.

Q9: Do you support our proposal to require a listed company to disclose the current relationship agreement in the annual report (LR 9.8.4R(15))?

We agree with the proposition that the relationship agreement should be publicly available but, given the current pressure to "de-clutter" annual reports, we suggest that it should be sufficient for the relationship agreement to be made available on the website of the listed company.

Independent shareholders

Q10: Do you agree with our definition of an independent shareholder?

Yes.

Annual report disclosure

Q11: Do you agree with our proposals to amend LR 9.8.4R to include an obligation to make a statement on the compliance of the listed company with the relationship agreement (LR 9.8.4R(14)) as described above?

Yes, although please see our response to Q5 and Q34.

Independence in other circumstances

Q12: Do you agree that the proposed guidance (LR 6.1.4DG) contains the key factors indicating that the new applicant may not carry on an independent business? Do you think that there are any other factors that should be considered and if so what are they?

LR 6.1.4DG(2) may be problematic for applicants who are reliant on property owned by a third party, for example, licences to use key intellectual property rights required to operate their business (such as a brand licence) or leases of a real property estate. We are aware of businesses of this kind which have obtained a premium listing and we assume that this is just one factor that the FSA will consider when assessing eligibility. We would welcome more guidance as to what situations are intended to be caught by LR 6.1.4DG(2) or a confirmation that the FSA is not adopting a more restrictive approach in relation to legitimate businesses that depend on third party intellectual rights provided that they satisfy other independent business criteria.

In LR6.1.4DG(1), we suggest the FSA adds the words "*directly or indirectly*" after the word "*conducted*".

Control of business

Eligibility requirement

Q13: Do you agree with the proposal to amend the requirement for control of assets to control of business (LR 6.1.4AR)?

We agree that the requirement for control of assets should be amended to control of business as at admission. We can foresee difficulties if the amended LR 6.1.4AR is to be complied with by listed companies as a continuing obligation. We have seen several situations where, after admission, listed companies have entered into contractual arrangements (such as joint venture agreements) which grow in importance (relative to the other businesses of the issuer) so that, after time, these contractual interests may come to represent the majority of the issuer's business. In that case, the issuer still retains control of its assets but it cannot be said that it controls its business. We query whether the FSA intends to capture such arrangements? It should not be the case that companies in these circumstances should be made to move to the standard segment. If this rule does apply as a continuing obligation, we suspect that this would have a detrimental effect on the competitiveness and attractiveness of the premium listing segment and, therefore, we would favour retaining the existing formulation of "control of assets".

If the proposed amendments were made, could the FSA please confirm how this requirement would apply to dual listed company structures?

Purpose of control and situations where it may not exist

Q14: Do you agree with the proposed guidance (LR 6.1.4BG) regarding control of business? Do you think that there are any other indicators that should be considered and if so what are they?

We have some concerns with regard to LR6.1.4BG(2)(c).

The use of the words "*unfettered ability*" is unhelpful, as in reality no company can claim to have an unfettered ability to implement its business strategy as there will always be market or other restraints. We therefore suggest that (c) (and also the reference in LR6.1.4BG(2)) is amended to read simply "*the new applicant is free to implement its business strategy"*.

Secondly, there are likely to be a number of issuers that have assets subject to security in favour of finance providers. The provision of security over a business or assets should not be regarded as "*contractual arrangements which result, or could result, in a temporary or permanent loss of control of its business*". In addition, issuers (particularly those in the

property, energy and mineral and technology sectors) may be investors in joint ventures (or carry on much of their business via joint ventures) that are controlled businesses with the meaning of LR6, but which are subject to default provisions that could lead to a temporary or permanent loss of that control (for example, put and call options). Again, we do not feel that such businesses should be regarded as non-controlled for the purposes of LR6. We would welcome clarification of these situations.

Application where changes of control occur

Q15: Do you agree with our proposal to supplement guidance in LR 6.1.3EG(7) as set out above?

Having read the commentary in paragraphs 7.82-7.84 of CP12/25 and the proposed wording of LR6.1.3EG(7), we do not understand what particular mischief the FSA is seeking to prevent, and we therefore believe that the wording of LR6.1.3EG(7) should be clarified to make clearer what is meant by "*non-controlled*" interests in this context.

7.83 refers to entities that "*have been owned but not controlled*" as being the target of the FSA's concern, but it is not clear to us what this is intended to capture. In particular, it would be helpful to clarify *by whom* control should have been exercised during the three-year period in order for LR6.1.3EG(7) *not* to apply.

It is common for businesses to undergo a group reorganisation at or shortly before admission in the context of an IPO or demerger. In many situations, control of the entities that comprise the business of the group "passes" to the issuer entity at or shortly before admission. We would suggest that the guidance should be amended to make it clear that it is not intended to capture situations of this type.

Assuming that the FSA is referring to management control in this context, we are aware of transactions having been proposed in the past whereby two or more businesses are combined under a single issuer holding company at or shortly before admission. This can take the form of an acquisition of one business by the other or the insertion of a common holding company above both businesses. Again, in the formal sense, ownership control "passes" at or shortly before admission. Is the intention that a combination of businesses *immediately* prior to admission would be a bar to eligibility?

Paragraph 7.83 of CP12/25 is explicit in stating that acquisition of entities within the track record period is not a bar to eligibility. If it is indeed the FSA's intention that a combination of businesses immediately prior to admission would render the applicant ineligible, then it follows that the question of eligibility will in some cases turn on the length of time between an acquisition completing and admission. Is the FSA able to give some guidance on how short a period is acceptable?

We would appreciate confirmation that our understanding of the proposed rule change is correct and suggest that the FSA takes the opportunity to clarify both the nature of the mischief that is being prevented and also the wording of LR6.1.3EG(7). In particular, we would suggest that the FSA clarify the meaning of "*owned but not controlled*" in paragraph 7.83 of CP12/25 and that the reference to "*non-controlled interests*" in LR6.1.3RG(7) is revisited.

Q16: Do you agree that control of business should be demonstrated at admission and on continuous basis rather than for the entire period covered by the historical financial

information? If not, then please outline your thoughts on the way in which control of business should be demonstrated.

We agree.

INDEPENDENCE OF DIRECTORS

The Corporate Governance Code

Q17: Do you agree with Option 1 or Option 2 above?

We note that paragraph 7.88 of the consultation paper refers to "*an independent Chairman and independent directors making up at least half the board*" but that LR6.1.4ER(2) says "*(b) an independent chairman and independent directors who together make up a majority of the board or equivalent body"*. We think this has caused some confusion as to what the FSA is proposing. For the purposes of this response, we have assumed that the listing rule text reflects the FSA's intention behind the proposals. The Joint Working Party was split in favour of each of the proposed Options 1 and 2. We set out the reasons for favouring each option below.

Option 1

Certain members of the Joint Working Party are in favour of Option 1 as it presents a structure in which, combined with the relationship agreement undertaking that nothing be done to prevent compliance with the Listing Rules, would provide a real constraint on the behaviour of controlling shareholders. An independent board, that is confident of its ability to maintain that independence, is in a strong position to resist undue influence by a controlling shareholder. The role of independent directors is fundamental to the proposed framework of protecting independent shareholders and so it is important that they represent a majority on the board to exert effective control over key decisions relating to the company's business.

We would also note that a modification of Option 1 may be worth considering, which would involve treating as independent for these purposes, any executive director who has no relationship or connection with the controlling shareholder. Such executives are not independent for purposes of the UK Corporate Governance Code but may well contribute to the Board's ability to resist shareholder control.

Option 2

Other members of the Joint Working Party are in favour of Option 2. The Supporting Principle underlying the relevant section of the UK Corporate Governance Code states that:

"The board should include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking."

It would be disproportionate for the FSA to require that a majority of the board comprise independent directors, as that may be well in excess of the number required to ensure that a controlling shareholder does not control the board. A board that depends on a majority group outvoting a minority group is likely to be dysfunctional.

The Corporate Governance Code recognises the need for flexibility in two regards. First, the requirement for independent non-executive directors (excluding the Chairman) to comprise at least half of the board does not apply to "smaller companies", being those not

included in the FTSE 350 which comprise the majority of premium listed commercial companies by number. Secondly, the underlying principle of comply-or-explain allows issuers to determine how many independent non-executive directors are required in order to prevent one group of individuals (be they executive directors or appointees of a controlling shareholder) from dominating decision taking and to avoid incurring excessive cost by appointing large numbers of independent non-executive directors.

The FSA states in paragraph 7.53 that its proposed approach in this area is based around "*providing shareholders with the tools to exercise effective influence over companies' boards*". The members in favour of Option 2 agree with this approach. However, the proposal to require a majority of independent directors on the board of an issuer with a controlling shareholder would go significantly further than this, and would in effect hand control (rather than influence) to minority independent shareholders. Certain members of our committees do not think that this is justified, and agree with the views described in paragraph 7.49, i.e. that it would be extremely unattractive to possible applicants for listing. With this in mind, we note that other major exchanges, such as NYSE[1], provide specific regimes for controlled companies, exempting them from requirements similar to the UK Code requirement on board balance. There are strong arguments in favour of allowing a board to be controlled by a controlling shareholder, provided independent shareholders are afforded sufficient protection from abuse of this control (for example, through rules regulating related party transactions). However, it is acknowledged that, in the current UK investor environment as described in the introduction to CP12/25, it is difficult to argue successfully for a special UK governance regime for controlled companies along the lines of the NYSE rules. Bearing in mind the substantial protection against abuse of board power as already afforded to independent shareholders by Chapters 10 and 11 of the Listing Rules (and the additional protection afforded by the proposed amendments to Chapters 6 and 9), members of our committees feel that the long-standing and well understood comply-or-explain principle remains the best means of ensuring that appropriate board composition is achieved in all cases.

Members in favour of Option 2 also see this as preferable to Option 1 for the reason that it will not require the FSA to make determinations as to who is independent. The proposed definition of "independent director" leaves it to the board to determine independence (see our response to Q18). Implementing Option 1 effectively would not be possible without clarity on the consequences of what happens where the board determines that an individual is independent, but the FSA does not agree with this determination.

Although the FSA does not identify specific corporate governance failures that have given rise to the proposal for these changes to the Listing Rules, many of the controversial governance situations of recent years have involved boards that have complied with the Corporate Governance Code requirements as to board balance. If the proposed mandatory provisions on board balance would not have altered behaviour in those situations, then it is questionable whether it is proportionate to introduce them.

Defining independence

Q18: Do you agree with our proposed definitions of independent director and independent chairman?

No definition of "*independent chairman*" should be required if Option 2 is adopted.

(I)

[1] See NYSE Listed Company Manual, Section 303A Corporate Governance Standards

The definition of "*independent director*" refers to the new applicant/issuer determining a director to be independent. Under the UK Corporate Governance Code, it is the board of the new applicant/issuer that determines independence, rather than the new applicant/issuer itself, so the definition in the Listing Rules should reflect this.

It is unclear what the consequences would be if a board determined a director to be independent and the FSA disagreed with that determination. Would the directors' judgment still prevail?

Application on a continuing basis

Q19: Do you support our proposal to extend the requirement for board composition as set out in LR 6.1.4ER(2) as a continuing obligation (LR 9.2.2AR(1))?

See Q17. The problems identified above are in relation to companies that have an existing controlling shareholder or who subsequently acquire a controlling shareholder. The continuing obligations will be effective only if the company has a relationship agreement in place.

Period of time to rectify non-compliance

Q20: Do you agree with our proposal in LR 9.2.2BR to allow for a period not exceeding 6 months from the time of notification to the FSA to rectify the non-compliance with requirements in respect of composition of the board as set out in LR 6.1.4ER(2)?

We question whether a six month period to make appointments to the board to maintain the required balance is sufficient. A director could leave unexpectedly (for example due to ill health) and the Governance Code requires a formal and thorough process for searching for and selecting a replacement. Companies which are complying with the Governance Code would need to satisfy themselves too that they are recruiting someone with the appropriate attributes in terms of the experience and diversity represented on the board and may need to engage with shareholders in this connection. Even when an appropriate candidate is found, that person may not be able to start immediately due to his or her other commitments. If the period is left at six months, there is a risk that companies may be forced to appoint someone they would not otherwise have appointed just in order to meet the deadline, So we think that a period of 12 months would be more reasonable.

If the period were to be left at six months, the FSA should have the flexibility to allow a longer period where there are extenuating circumstances for the delay (and it would be helpful if the guidance could make this clear), and in addition, if the constitutional documents of a company do not allow the board to fill a vacancy so that the company has to put the election of the new director to shareholders, it would give additional flexibility to such companies to allow them until the expiry of six months and the date of the next annual general meeting, whichever is the longer.

As a drafting matter (and before taking account of the above point), LR9.2.2BR should read "*A listed company that has equity shares listed will be allowed a period of not more than 6 months to rectify any breach of* ***LR9.2.2ER(2) in respect of LR6.1.4ER(2)***".

Election of independent directors

Q21: Do you support our proposal for election of independent directors by two rounds of voting as described above (LR 6.1.4ER(3), LR 9.2.2ER and LR 9.2.2FR)?

We consider that the new proposed election mechanism has some merit. However, it is important to note that in practice most independent directors will in the first instance be appointed by the board either to fill a casual vacancy or as an additional director. Provided such an appointee is determined by the board to be independent within the meaning of the UK Corporate Governance Code, he or she will count towards any prescribed board balance criteria as proposed by LR6.1.4ER(2). The process outlined in LR9.2.2ER and LR9.2.2FR then only becomes relevant if and when the director is proposed for re-election. Election of directors at the first AGM after their appointment is a comply-or-explain requirement of the UK Corporate Governance Code. Please could we have clarification as to whether the proposed election procedures would apply to the annual re-elections of directors at the AGM?

It would be helpful if the FSA would confirm whether independent directors who are already in place would need to be re-elected following the implementation of the new rules and we would welcome guidance on any proposed transitional arrangements.

Mineral companies

Q22: Do you support our proposal to amend LR 6.1.9R to subject mineral companies to the requirement to demonstrate the ability to carry on an independent business together with additional requirements where a controlling shareholder is present? If you do not support this proposal, please outline your reasons for doing so.

We would support such a proposal provided that the additional requirements where a controlling shareholder is present are modified as suggested by us in our responses to Q3 and Q4.

Q23: Do you support our proposal to subject a mineral company to a continuing obligation to comply with LR 6.1.4CR, and if applicable, LR 6.1.4ER and LR 6.1.4FR at all times (LR 9.2.2AR(2))?

We would support such a proposal provided that the additional requirements where a controlling shareholder is present are modified as suggested by us in our responses to Q3 and Q4.

Scientific research based companies

Q24: Do you support our proposal to amend LR 6.1.12R to subject scientific research based companies to the control of business requirement, the requirement to demonstrate the ability to carry on an independent business together with additional requirements where a controlling shareholder is present as discussed above?

We would support such a proposal provided that the additional requirements where a controlling shareholder is present are modified as suggested by us in our responses to Q3 and Q4.

Q25: Do you support our proposal to extent the continuing obligation in LR 9.2.2AR(1) to scientific research based companies in the same way as it currently applies to commercial companies? If you do not support these two proposals, please outline your reasons for doing so.

We would support such a proposal provided that the additional requirements where a controlling shareholder is present are modified as suggested by us in our responses to Q3 and Q4.

SHARES IN PUBLIC HANDS (OR 'FREE FLOAT')

Shares subject to a lock up period

Q26: Do you support our proposal to exclude shares subject to a lock up period from the calculation of shares in public hands (LR 6.1.19(4)(f))? Do you think that 30 calendar days is the right time period to dictate exclusion? Do you think that there are any other instances where shares should be excluded from a free-float calculation and if so what are they?

We welcome the FSA's clarification that the principal aim of the shares in public hands requirement is to ensure liquidity in an issuer's shares. However, while we see the logic in the proposal to exclude shares which are subject to a lock up period, we are concerned that an exclusion of shares locked up for 30 days or more from shares in public hands will adversely affect the ability of issuers to execute IPOs in the London market.

It is common for pre-IPO shareholders of an issuer to be locked up following an offering of shares. These lock-up arrangements can vary in length from as little as 6 months to several years. In addition to pre-IPO shareholders entering into lock-up arrangements, there have been instances of IPO investors agreeing to lock-up arrangements for a short period post-offering, typically 3 to 6 months. Such investors are sometimes known as "cornerstone" investors.

Often, shares held by such locked up shareholders will in any event be excluded from shares in public hands by one of the other heads of LR6.1.19R(4)(a)-(e). However, in the absence of one of the other exclusions of LR6.1.19R(4)(a)-(e), we would suggest that the relevant maximum lock-up period should be one year or that the FSA assesses each lock-up on a case by case basis when assessing the eligibility of the applicant.

This would remove the incentive for issuers to attempt to execute an IPO without appropriate lock-up arrangements.

We note that FTSE recognised the need to make allowance for post-IPO lock-up arrangements in this way in amending its own free float rules[2].

Ability to modify the free-float requirement in the premium segment

Q27: Do you support our proposal to amend LR 6.1.20G to set out criteria based on which the FSA may modify the requirement for a 25% free float as described above?

In general, we support the clarification.

If the FSA does not accept our suggested change set out in our response to Q26, we suggest that short term lock ups of less than one year that do not cause liquidity to fall

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[2] Seer paragraph 4.2.3 of the FTSE UK Index Series Ground Rules v11.3

below acceptable levels during their operation should constitute “exceptional circumstances” within the meaning of this rule.

In addition, we assume that the reference to "*public shareholders*" refers to those shareholders who form part of the "free float" calculation but please could the FSA clarify this?

Ability to modify the free-float requirement in the standard segment

Q28: Do you support our approach to companies wishing to list on the standard segment as described above?

Yes. We agree that this would promote the competitiveness of the London market. In particular, we agree that this would enable companies to issue or offer smaller quantities of securities initially and give them the possibility to issue or offer such securities in greater quantities at a later stage if the issue or offer was successful. Consequently, we support the statement that appears in paragraph 1.30 of the "Overview" section of the consultation paper which states that a relaxation of the free float requirement would enable companies with smaller floats "to test the market".

Q29: Do you agree with the proposed criteria for assessing potential liquidity outlined above? Are there any other criteria to which we should have regard in considering the potential liquidity of shares within the standard segment?

We agree. We would, however, welcome guidance as to how, in practice, the FSA proposes to have regard to the criteria in making its assessment – in particular, we note that the criteria refer to liquidity post admission whereas the free float requirement is an eligibility requirement assessed pre-admission. Guidance as to what the FSA may accept in demonstrating that the criteria will be met, bearing in mind that there is no obligation to appoint a sponsor on a standard listing, would be helpful.

Holdings of individual fund managers

Q30: Do you agree with the proposed new guidance in the Listing Rules (LR 6.1.20AG) clarifying that holdings of individual fund managers in an organisation will be treated separately provided investment decisions with regard to the acquisition of shares are made independently?

We agree with the intention behind the proposed new guidance. Our understanding of the reference in LR6.1.20AG to “*investment decisions*” is that it is intended to capture only buy/sell decisions and not voting decisions, on the basis that the intention behind these rules is to ensure liquidity. It would be helpful if this could be clarified in guidance.

Financial instruments with a long economic exposure to shares

Q31: Do you agree with the proposed new guidance in the Listing Rules (LR 6.1.20BG) explaining that we consider that financial instruments that give a long exposure to shares, but do not control the buy/sell decision in respect of the shares, should not normally count as an interest for the purpose of the public hands threshold?

Our understanding is that the new LR6.1.20BG is intended to prevent a shareholder from artificially boosting the “*shares in public hands*” of an issuer by “sheltering” shares with a CFD counterparty. The following is an example of a situation in which this might arise:

- A holds 75% of the shares issued by an issuer XYZ plc.
- The 75% holding of XYZ plc shares are not "*shares in public hands*".
- A transfers a 4% shareholding to a CFD provider B, which writes a CFD between A and B such that A has long financial exposure to the 4% shareholding and B has short financial exposure to the 4% shareholding.
- B has no net financial exposure because its long and short positions are hedged.
- Because B holds only 4% of the issuer's shares, the shares will now be "*shares in public hands*" unless another exclusion applies.
- B is likely to hold its 4% holding of XYZ plc shares as long as the CFD is in place, and in practice may choose to transfer the holding to A when the CFD is unwound.
- This means that the "*shares in public hands*" of XYZ plc are boosted by 4% without increasing the liquidity of XYZ plc's shares.

We agree that shares held under a structure of the type described above should not be "*shares in public hands*". However, we do not believe that the proposed drafting captures the above situation for a number of reasons:

- the reference to "*long-term economic exposure*" in the first line of LR6.1.20BG should instead be a reference to "*long economic exposure*";
- the rule requires that the *aggregate* exposure of the CFD provider be above 5% for the shareholding to be excluded. This implies that a *net* exposure of greater than 5% is required (although this is not entirely clear). In the above example, the CFD provider has no net exposure, so arguably the shares held by B would in any event be "*shares in public hands*";
- if, on the other hand, "aggregate" in this context means gross rather than net, it would mean that B's other interests should be aggregated with the 4% held pursuant to the above arrangement. It would be odd for the extent of entirely unrelated arrangements to which B is party to dictate whether the 4% holding described above is "*shares in public hands*". B may also have a 2% shareholding held through a trading desk or fund management affiliate, which should have no bearing on this type of arrangement;
- it would in any event be open to A to set up similar arrangements with a syndicate of CFD providers, each of whom provides long CFD positions of less than 5% and each of whom holds less than 5% of XYZ plc's shares. It should not be open to a shareholder to boost "*shares in public hands*" artificially simply by using several counterparties.

For these reasons, we suggest that an alternative approach be adopted, whereby shares held by a CFD provider who has short exposure to an issuer's shares are excluded from "*shares in public hands*" (irrespective of the size of the holding), but only where the long counterparty to the CFD holds a net interest in more than 5% of the issuer's shares. Consequently, we suggest that LR 6.1.20B should be amended to read as follows:

"*A financial instrument that provides a long economic exposure to shares, but does not provide for control over decisions in respect of those shares, should not be treated as an interest for the purposes of LR 6.1.19R(4)(e) except for the purposes of determining*

whether the party to a contract for difference which has a long interest under it has an interest of 5% or more of the relevant class of shares when aggregated with its other interests."

CONTINUING OBLIGATIONS

Voting by premium listed shares

Q32: Do you support our proposal in LR 6.1.25R and LR 9.2.22R to require that where a shareholder vote must be taken under the provisions of LR 5.2, LR 5.4A, LR 9.2.2CR, LR 9.4, LR 9.5, LR 10, LR 11, LR 12 or LR 15, such votes must be decided by a resolution of the holders of premium listed shares as discussed above?

No, we do not support this proposal. We believe that this proposal is disproportionate and not necessary provided that the proposed controlling shareholder regime is implemented (subject to our comments set out in this response paper).

Guidance on LR 9.2.22R

Q33: Do you support the FSA having the power to modify the requirement imposed in LR 9.2.22R in exceptional circumstances (LR 9.2.23G)? Are there any other exceptions that should be specifically catered for within this guidance?

Yes, we support this power. We also believe that the application of LR9.2.23G to dual listed companies' structures should be set out in more detail.

Duty to notify the FSA of non-compliance

Q34: Do you support our proposal to delete LR 9.2.16R and replace it with a requirement in LR 9.2.24R for a listed company to notify any non-compliance with continuing obligations as set out in LR 9.2 to the FSA without delay?

We think that this should only require notification of non-compliance with LR9.2.2A – that is, the continuing requirements for eligibility for premium listing, so that it does not have the effect of imposing a general obligation on all premium listed issuers to notify breaches of the continuing obligations set out in LR 9.2. This obligation has been debated before and has been rejected. We continue to think that as a matter of principle, it is inappropriate to impose such an obligation. This obligation would lead to a fundamental change in the relationship of all issuers with the FSA and we submit that it should have been accorded more significance in the consultation paper so as to ensure that it was properly understood.

Should the FSA not agree, then as a minimum, notification of non-compliance should be limited to "material" breaches which are known to the issuer. We suggest that the test for assessing what is a "material" breach should be similar to the test used in section 118(6)(C) FSMA in relation to assessing information likely to have a significant effect on price so that non-compliance should only be notified if the non-compliance relates to information of a kind which a reasonable investor would consider significant as part of the basis of his investment decisions to acquire, continue to hold or sell the equity shares.

Cancellation or transfer of listing category

Q35: Do you support our proposal to delete LR 9.2.17G and replace it with guidance in LR 9.2.25G to consider LR 5.2.2G(2) and LR 5.4A.16G in relation to its compliance with the continuing obligations as set out in LR 9.2?

We believe that this proposed change attempts to address one of the most important areas of the current debate about the effectiveness of the Listing Regime. Assuming market participants can reach a broad consensus about the desired standard that premium listed companies are expected to meet, there remains the question as to what should be done about breaches of that standard.

We have set out above our view that it is inappropriate to penalise an issuer (and its independent shareholders) for a breach of Listing Rules that result from actions of a controlling shareholder. Where the issuer has a relationship agreement in place that complies with LR 6.1.4FR, the issuer will have legal rights against the controlling shareholders to prevent such behaviour. If there is no relationship agreement in place, a controlling shareholder may cause a breach of the free float rules to arise. Many controlling shareholders will not be subject to the provisions of Rule 9 of the Takeover Code (because they hold more than 50% of the issuer's shares). In this situation, if the controlling shareholder were to acquire more shares or cause the issuer to repurchase shares on the market, the free float threshold may be breached. If the FSA were to delist the issuer or transfer it to the standard segment, independent shareholders could be stripped of the very protections upon which they had been reliant. We also note that this situation may arise where the controlling shareholder holds less than the 75% of the issuer's shares.

In relation to LR 9.2.25, does the FSA envisage that a shareholder resolution would be needed to transfer to the standard segment or delist where it is instigated by the listed company or by the FSA? If so, would the controlling shareholder be allowed to vote on the resolution?

Disclosure in the annual report

Q36: Do you support our proposal to amend LR 9.8.4R to require a listed company to disclose all matters that need to be disclosed under LR 9.8.4R in the annual report and accounts in a single identifiable section?

We can see that there might be merit in this requirement provided that companies can satisfy the requirement by including an index or checklist of this information, with page number references to the items required under LR 9.8.4R or alternatively, cross refer to the company's website which will list the information and again, move away from unnecessary clutter in the annual reports. Furthermore, any proposals to amend LR 9.8.4R will need to be aligned with the amendments arising from the BIS consultation of the draft Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 which were published on 18 October 2012.

Disclosure of smaller related party transactions in annual report

Q37: Do you support our proposal to amend LR 9.8.4R(3) to extend the period of time over which disclosure of smaller related party transactions as required by LR

11.1.10R(2)(c) should be included in the annual report and accounts to include comparative information for the previous 2 financial years?

We have no strong objection to this proposal but we query whether it would be preferable for the annual report to cross refer to the relevant sections which disclose the smaller related party transactions in previous annual reports so as to avoid the inclusion of unnecessary detail in annual reports.

Q38: Do you support our proposal to amend LR 11.1.10R(2)(c) to set out minimum disclosure requirements that need to be set out in the listed company's next published annual accounts as described above? Do you think that there are other factors relating to the smaller related party transaction that should be subject to disclosure requirements in the company's next published annual accounts and if so what are they?

We do not understand why percentage ratios resulting from applicable class tests need to be publicly disclosed. These calculations have always been dealt with by the sponsor with the issuer and we are not aware of any concerns or disquiet from shareholders over the details of such calculations. Could the FSA please confirm why it believes that such calculations should be disclosed?

Warrants or options to subscribe

Q39: Do you believe that we should introduce a continuing obligation that a listed company must comply with LR 6.1.22R at all times (LR 9.2.21R) or alternatively that we should delete the existing eligibility requirement?

If there is no longer a compelling commercial rationale for this requirement, then we suggest that it is deleted entirely.

THE LISTING PRINCIPLES

Application

Q40: Do you agree with our proposal to amend LR 7.1.1R to make Listing Principles applicable to standard listed issuers?

Yes.

Principle 6 – open and co-operative

Q41: Do you support our proposal to amend LR 7.2.1R as described above? If not please provide an explanation for objection to each principle.

Yes.

Guidance on the Listing Principles

Q42: Do you support our proposal to amend the guidance in LR 7.2.2G and 7.2.3G to enable the application of the guidance to the relevant Principles?

Yes.

Continuing obligation arising from Premium Listing Principle 1

Q43: Do you support our proposal to amend LR 9.8.6R(5) by including a specific disclosure obligation on the application of Principle B4 of the Code along with the accompanying guidance in LR 9.8.6BG?

Yes, subject to the following drafting comments. We suggest that the obligation for the listed company to set out how the chairman has "***ensured*** *that the directors have a sufficient understanding of the regulatory requirements*" is too onerous an obligation. Instead, we suggest that the listed company sets out how the chairman "***has taken the necessary steps to enable*** *the directors to have a sufficient understanding of the regulatory requirements…..*"

Please could the FSA confirm whether the proposed new rule should apply to UK listed companies only? LR 9.8.6R makes it clear that the listed items must be included in the annual financial report for a listed company incorporated in the United Kingdom. However, the new amendment in LR 9.8.6R(5) states that the chairman must ensure that the directors have sufficient understanding of the legal requirements regarding fiduciary duties "*applicable in its country of incorporation*" which suggests that the rule may apply to other non-UK issuers.

In addition, we suggest that the directors should understand their duties as directors rather than as "*fiduciaries*". Therefore, "fiduciary duties" should be deleted from the guidance and replaced with "*directors' duties*".

Premium Listing Principle 3 – voting power of a premium listed share

Q44: Do you support the requirement that each premium listed share in a class must have equal voting power (Premium Listing Principle 3)? If you do not support this principle, please outline your view on how the Listing Regime can operate effectively if shares within the same class have various voting power.

There does not appear to be any cogent explanation given for the introduction of this requirement. In addition, such a rule would preclude the grant of enhanced voting rights for long term holders, a proposal which is being considered at EU level. In any case, there are a number of situations where this requirement might not be met. For example:

- premium listed shares may be divided into different classes when voting to approve a scheme of arrangement, thereby effectively carrying different numbers of voting rights;
- class rights votes may be required under the UK Companies Act or other equivalent local rules that cause shares effectively to carry different numbers of votes;
- some provisions of the Listing Rules themselves require the holders of certain shares to refrain from voting, such as the related party rules and the proposed new mechanism for election of independent directors;
- in some circumstances, the articles may provide that a shareholder may not exercise voting rights, for example, if they have not complied with a notice requesting information about interests in the shares, or in order to meet residency or nationality limitations for certain types of companies; and

- this requirement may also affect shareholding structures which might be adopted in relation to dual listed company structures.

If this principle were introduced, it would be helpful to have guidance from the FSA that these situations would not offend this Premium Listing Principle. In other words, the proposed Premium Listing Principle 3 should be qualified by reference to the requirements of the Listing Rules themselves and of the law of the jurisdiction of incorporation of an issuer.

Principle 4 – aggregate voting rights of the shares in each class

Q45: Do you support the requirement that, 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 (Premium Listing Principle 4)?

No, we do not support this requirement. We believe that the principle of "one share, one vote" is adequately protected by investors choosing not to invest in companies that do not adhere to it. Attempting to regulate in this area raises extremely difficult questions as to what "*broadly proportionate*" means. We do not believe that there is sufficient benefit to be derived from regulating in this area to justify the cost entailed. In any event, it is not clear what is meant by "*relative interests….in the equity of the company*". We assume that the FSA is referring to "*relative* ***economic*** *interests*"?

Guidance on Premium Listing Principle 4

Q46: Do you support our proposal for guidance on Principle 4 (LR 7.2.4G) as to the factors the FSA will have regard to in assessing whether the voting rights are proportionate? Are there any other factors that the FSA should have regard to in applying this principle and if so what are they?

Subject to our response to Question 45, yes.

Implementation of AIFMD

Q47: Do you agree with our proposed approach to articulate in the Listing Rules our expectations of the board of a premium listed investment entity rather than use a more prescriptive solution?

Yes, we do.

Q48: Do the proposed rules capture adequately the role of the Board?

We believe that they do.

December 2012