TETRACTYS PARTNERS BRIEFING NOTE CP13/15, ENHANCING THE EFFECTIVENESS OF THE LISTING REGIME

BRIEFING 02, NOVEMBER 2013

INTRODUCTION

On 5th November 2013, the Financial Conduct Authority (the ***FCA***) published Consultation Paper 13/15 (***CP 13/15***), which seeks comments on proposals on enhancing the effectiveness of the Listing Regime which evolved from CP 12/25, together with some draft rules.

The CP and draft rules are designed to address concerns that have arisen in respect of corporate governance and the rights of minority shareholders in listed entities where there is a limited free float and/or control residing with a minority of shareholders, particularly where the controlling shareholding does not maintain an appropriate relationship with the premium listed entity.

The FCA has sought to avoid excessive rulemaking and the effectiveness of the proposed changes will, to a significant degree, rest on the willingness of shareholders to enforce contractual arrangements which will be required by these proposed rules. Also avoided is any requirement to increase the free-float and the additional burdens this might impose on the listed entity.

The FCA has focused on premium listed entities as it considers that these should set the benchmark for good governance.

It should be noted that, unusually, this CP combines draft rules on which **no** comment is invited, and more consultations in respect of the FCA's wider engagement concerning the Listing Regime for continuing engagement.

"It is key to the regime, and the FCA's strategic objective to make markets work well, that shareholders are actively engaged and able to take important decisions on a properly informed basis."

– CP 13/15 page 6.

FCA FOCUS AND CONCERNS

The FCA is concerned to address issues that arise where a premium listed entity has a very limited (e.g. 25%) proportion of its capital in public hands (the "free float") with control residing in a small group of shareholders (often

family or closely connected parties) and the controlling shareholder does not maintain an appropriate relationship with the premium listed entity. Recent governance failures, such as those at Bumi, have made it clear how smaller shareholders participating in a limited free float can have their interests adversely affected by poor governance, conflicts of interest and related party transactions. They have also highlighted an absence of effective levers with which smaller shareholders can exercise sufficient influence to protect their interests.

The FCA has responded with proposed measures in three areas:

- Creating specific requirements concerning the interaction between a premium listed company and a controlling shareholder, where one exists, via a mandatory 'agreement';
- Providing additional voting power for minority shareholders when electing independent directors where a controlling shareholder is present; and
- Enhancing voting power for the minority shareholders where a company with a controlling shareholder wishes to cancel its premium listing.

The FCA believes that this package of measures will give minority shareholders a legally enforceable framework within which interaction with the controlling shareholders can take place. The package also makes it easier for minority shareholders to ensure that they are properly represented on the Board by genuinely independent non-executive directors, rather than placemen of the controlling shareholder. Finally the package makes it harder for controlling shareholders to exit the listing regime when they become uncomfortable with the scrutiny it brings by giving significant additional rights to minority shareholders to improve their chances of blocking such a cancellation.

The proposed agreement between the company and the minority shareholders is prescriptive to the extent it requires certain independence provisions which the FCA sees as central to good governance. It is proposed that where there is an inappropriate relationship between a premium listed company and a controlling shareholder that risks damaging the interests of independent shareholders, enhanced oversight measures would come into force and give minority shareholders the rights to vote on all transactions between a controlling shareholder and the company, and even veto them should they so wish.

Such measures would only take effect where the company has failed to implement an agreement with any controlling shareholder, or an independence provision in the agreement is not being complied with, or an independent director disagrees with statements in the annual report. These measures would remain in place until the publication of the next annual report.

With regard to independent directors, premium listed companies with controlling shareholders must ensure that their constitutions provide for the election of independent directors by a dual voting structure so that independent directors must be separately approved both by the shareholders as a whole and the independent shareholders as a separate class. If the necessary majorities are not achieved, then the firm has to wait 90 days to re-present and on this occasion a simple majority would suffice. Enhanced disclosure requirements in respect of non-executive directors are also proposed to ensure that there is sufficient clarity around any connections with the firm or the controlling shareholders. It should be noted that the FCA refers to "any" relationship, so being thorough here will be essential.

In respect of the attempts by the controlling shareholder to cancel the premium listing, FCA is consulting on two approaches. The first would be to retain the status quo (given that this was the preferred route during the last consultation in 2003). The second would be to give enhanced voting powers to the independent shareholders and require that a majority of them have to agree the cancellation in order for it to go ahead.

Other measures include anti-avoidance provisions such as preventing the creation of super-voting shares amongst the premium listed shares, and only allowing premium listed shareholders the right to vote on matters relating to the premium

listing. These measure should help to curb covert attempts to circumvent the FCA's desired outcomes from this package of measures.

The FCA is also proposing to broaden the reporting of breaches to cover all matters related to the premium listing.

Greater transparency through disclosure will be achieved by introducing a requirement to notify smaller related party transactions as they arise, rather than waiting for disclosure in the annual report – and in the annual report the disclosures should all be in the same section rather than scattered through the report.

Finally, the FCA is proposing to broaden the scope of the Listing Principles requiring all listed companies to maintain appropriate systems and controls and also to deal with us in an open and co-operative manner to include standard listed companies.

The FCA believes that the majority of premium listed entities to which the new regime will apply are already in compliance with the requirements and so such an agreement will represent merely the codification of existing practice. Premium listed entities to which the requirements apply will have a transitional period of six months in which to implement the requirements and where there is a takeover by such an entity, six months from the date of the takeover.

KEY MESSAGES AND NEXT STEPS

The key message from this CP is that the FCA is not prepared to tolerate abuses by controlling shareholders and that it hopes to prevent such abuses through measures which are relatively light in terms of regulatory burden (though not in terms of the sanctions that can be applied). This is to be welcomed.

The effectiveness of the proposed new regime will be dependent upon the willingness of smaller investors to use these powers to protect their interests.

In terms of next steps, premium listed entities and their advisors should start considering the form their agreements with controlling shareholders will take, as well as ensuring there are appropriate mechanisms and controls in place for making the enhanced disclosures required in relation to independent directors and dealings between controlling shareholders and the company. The appropriate changes to the company's constitution will also need to be effected.

It would also be sensible for firms and their advisers to have clear and demonstrably effective processes for ensuring disclosures about candidates for independent directorships are comprehensive and can withstand any regulatory scrutiny in the event of any questions being raised about the quality of such disclosures.

It will also be essential for advisers to ensure that they can demonstrate that they have provided appropriate training and guidance for the management of companies affected by these provisions, as without such training company management can deflect some, but not all, criticism back onto their advisers.

Investors should be thinking about engagement with the company in respect of the creation of the formal agreement between the company and the controlling shareholder, with a view to raising any concerns with the FCA if the requirements are not met within the prescribed timeframe. Given the levers this proposed arrangement will provide, it might be sensible for smaller shareholders to look at ways of working together to make these proposals really effective in the event of non-compliance.

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HOW TETRACTYS CAN HELP YOU

Tetractys has extensive experience of working with companies and advisers in the listed space. We can review any existing arrangements and benchmark them against FCA expectations, as well as supporting the development of effective controls and governance to evidence effective adherence to these requirements. For a no-obligation discussion, please call Gary Pitts on 07795 830 636 or email gary.pitts@tetractyspartners.com.