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Alert Memo

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FSA Consults on Changes to the Listing Rules to Enhance the Effectiveness of the Regime

I. Overview

On October 2, 2012, the UK Financial Service Authority (the "FSA") published a consultation paper (the "Consultation Paper")[1] proposing a number of changes to the UK listing rules (the "Listing Rules") that aim to "enhance the effectiveness of the Listing Regime".

This alert memo summarises the key proposals outlined in the Consultation Paper, which will be of interest to all London listed UK and overseas issuers, in particular those that already have or are considering a UK standard or premium listing of securities, as well as their sponsors.

The proposed changes come after a long period of discussion in the UK market regarding the influence of controlling shareholders on the corporate governance of London listed issuers. While there was discussion of major changes that were of concern to many market participants, such as an increase of the free float eligibility requirement to something above 50%, introducing some form of probation period (potentially on the standard segment) for issuers before they could be admitted to the premium segment, and even introducing a subjective analysis on the part of the FSA, the proposals that have been put forward in this Consultation Paper appear to be a measured and proportionate response to the concerns raised by investors.

The deadline for submission of comments on the proposals outlined in the Consultation Paper is January 2, 2013[2]. The FSA intends to publish feedback in Spring 2013.

In addition, the FSA has announced new rules for sponsors which will take effect on December 31, 2012, and other changes to the Listing Rules, which are now in effect.

[1] http://www.fsa.gov.uk/static/pubs/cp/cp12-25.pdf

[2] Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2012/cp12-25-response.shtml, or in writing to Victoria Richardson, Primary Market Policy, Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS.

II. Executive Summary

The main proposals put forward by the FSA in the Consultation Paper are as follows:

- *Corporate governance*
  - Controlling shareholder checks and balances:
    - Reinstatement of the pre-2004 provision that a premium listed issuer must be capable of acting independently of a "controlling shareholder" (i.e. any person/ persons acting in concert holding at least 30% of the shares or voting power in the issuer).
    - Reinstatement of the requirement for a relationship agreement to be in place to govern the relationship between a premium listed issuer and a controlling shareholder, introduction of mandatory content requirements for the relationship agreement and rules to require independent shareholder approval of material amendments.
    - Requirement for a majority of independent directors on the board of a premium listed issuer which has a controlling shareholder and requirement that independent directors of issuers with controlling shareholders must be approved both by the shareholders as a whole and the independent shareholders.
  - Inclusion of guidance within the Listing Rules on the circumstances when an issuer may or may not control most of its business (as opposed to assets) and may or may not be carrying on an independent business as its main activity.
  - Obligation on issuers to inform the FSA without delay of any breach of any of their continuing obligations.
- *Free-float provisions*
  - For premium listed issuers, contrary to market fears, the FSA proposes to retain the current minimum free float requirement of 25%, and to provide guidance on the limited circumstances in which it will consider a lower threshold – though it proposes to set an effective floor of 20% .
  - For standard listed issuers, proposal that the FSA bases the free-float requirement solely on liquidity, effectively paving the way for a free-float of much less than 25% if liquidity allows.
- *Listing principles*
  - Proposal to extend the listing principles that state the issuer must maintain adequate procedures, systems and controls and that the issuer must deal with the FSA in a cooperative manner to standard listed issuers (including issuers with GDRs and debt listed in London).

- Introduction of two new listing principles for premium listed issuers, which state that all equity shares in a class must carry an equal number of votes, and that where an issuer has more than one class of listed equity shares, the aggregate voting rights of the shares in each class should be proportionate to the relative interests of those classes in the equity of the issuer.

In addition, the FSA has introduced certain amendments to the Listing Rules, which have now taken effect (other than the changes to the sponsor regime, which take effect as of December 31, 2012):

- *Sponsor regime*
  - Requirement to appoint a sponsor to provide the fairness opinion in relation to a related party transaction ("RPT").
  - Requirement for issuers to cooperate with its sponsor and provide them with required information.
  - Requirement for sponsor to comply with principle of "honesty and integrity", specific standard of care to apply to sponsor, and FSA to have the right to request confirmation from the sponsor on the issuer's compliance with the Listing Rules on an ongoing, real time basis.
- *Reverse takeovers requirements*
  - Amendments designed to ensure that reverse takeovers cannot be used by otherwise ineligible issuers as a back door route to a premium listing.
- *Related party transaction and significant transaction regimes*
  - Abolition of the requirement for transactions to be "of a revenue nature" to qualify for the ordinary course exemption from the RPT and significant transaction ("ST") regimes, and the clarification of RPT aggregation rules.
- *"Externally managed companies"*
  - Requirement for premium issuers to satisfy the FSA that the board has discretion to make strategic decisions on behalf of the issuer in the absence of recommendations from external input.

III. Corporate Governance

The FSA has made a series of proposals in the Consultation Paper which, if adopted, would impose greater corporate governance and ongoing compliance requirements on premium listed issuers, and in particular those with a controlling shareholder. These proposals are outlined below.

Independent Business

- Currently, a new issuer in the premium segment must demonstrate at the eligibility stage that it controls most of its assets and that it will be carrying on an independent business as its main activity. The FSA proposes to split this rule up and set out the two requirements as separate rules accompanied by guidance describing the factors that we would take into account in considering whether the new applicant is capable of meeting these requirements.

- The FSA proposes to reinstate the express provision that a premium listed issuer must be capable of acting independently of a controlling shareholder and its associates, which was removed from the Listing Rules following a consultation in 2004. The threshold whereby a shareholder is deemed to be a "controlling shareholder" has been set at 30% as per the pre-2004 rules and the FSA has proposed provisions to aggregate shareholders that are acting in concert[3].

- In addition, the FSA has proposed guidance to be included in the Listing Rules which describes situations where it believes an issuer would not be considered to be capable of carrying on an independent business, namely, if one or more of the following criteria applied to all or substantially all of the issuer's business:

    - most of the revenue generated by the issuer's business is attributable to business conducted with a controlling shareholder;
    - lack of strategic control over commercialisation of the product and/or the ability to earn revenue by the issuer;
    - an issuer cannot demonstrate that it has or has had access to independent financing; or
    - an issuer has granted or may be required to grant security over its business in connection with the funding of a controlling shareholder.

Relationship Agreements

- The FSA proposes to reinstate the express requirement for a relationship agreement to be in place to govern the relationship between the issuer and a controlling shareholder.

[3] The FSA will "draw heavily" on the sponsor in this regard and considers that the presence of a controlling shareholder would be within the scope of the sponsors declaration under LR 8.4.2R (1).

- Whilst the requirement for a relationship agreements largely reflects current market and FSA practice, the FSA has also proposed certain mandatory content requirements for the relationship agreement, including the following:

    - transactions and relationships with a controlling shareholder must be conducted at arm's length and on normal commercial terms;
    - a controlling shareholder must abstain from doing anything that would have the effect of preventing a new applicant from complying with its obligations under the Listing Rules;
    - a controlling shareholder must not influence the day to day running of the new applicant at an operational level or hold or acquire a material shareholding in one or more significant subsidiaries;
    - the relationship agreement must remain in effect for so long as the shares are listed and the issuer has a controlling shareholder; and
    - any material[4] amendment to the relationship agreement may only be made in a manner akin to the RPT regime – that is pursuant to an approval by the independent shareholders.

- In addition, the Consultation Paper proposes that the issuer should be required by the Listing Rules to comply with the relationship agreement at all times, to include a link to the relationship agreement within its annual report, together with a compliance statement - the directors of the issuer must state that the issuer has complied with the relationship agreement throughout the financial year. Where this is not the case, the directors would have to include a description of the provisions of the relationship agreement that the issuer has not complied with that enables shareholders to evaluate the impact of the non-compliance on the issuer along with a confirmation that the FSA has been informed.

Control of Business[5]

- The FSA is proposing to require the issuer to demonstrate that it controls the majority of its "business", as opposed to the majority of its "assets" (as per the current formulation).

- The FSA has put forward examples of situations where it believes that the issuer does not have an unfettered ability to drive forward its strategy and so does not control its business:

[4] In determining what constitutes a material changes, the issuer should have regard to the cumulative effect of all changes since the shareholders last had the opportunity to vote on the relationship agreement, or if they have never voted, since admission.

[5] It is proposed that the "control of business requirement" will not apply to mineral companies.

- where an issuer is able to exercise only negative control or only has veto rights over significant decisions affecting the management of the business by other parties;
- a situation where an issuer has precarious control of the business that relies on contractual arrangements that may be altered without the agreement of the issuer; or
- contractual arrangements are in place the effect of which is a temporary or permanent loss of control of the issuer's business[6].

- Currently, the issuer must demonstrate that it has controlled the majority of its assets for the period covered by the historical financial information, at admission, and going forward as a continuing obligation. The FSA proposes to remove the first part of this requirement only, so that the issuer will not have to show it has controlled the majority of its business for the period under review, however the FSA proposes to include a statement that the issuer may not be eligible for a premium listing if non-controlled interests have represented the majority of the issuer's business for a significant part of the period covered by the historical financial information[7].

Independent Directors

- A premium listed issuer is currently required to "comply or explain" non-compliance with the main principles of the UK Corporate Governance Code in its annual report.

- In circumstances where the issuer has a controlling shareholder, the FSA has put forward a more stringent proposal whereby issuers must either have a board that has (i) a majority of independent directors or (ii) an independent Chairman and independent directors together making up at least half the board. This requirement would constitute one of the eligibility criteria for listing, and would apply on a continuing basis (with a 6 month grace period when the issuer has informed the FSA of non-compliance as a result of, for example, the resignation of a director).

- In addition, the Consultation Paper proposes a dual voting structure whereby independent directors of premium listed issuers with controlling shareholders

[6] In assessing whether majority control exists for these purposes, the FSA proposes to look to the class tests and have regard to the proportion of the issuer's group that is not controlled and proposes to take into account factors such as the relative values of the assets and businesses, and the relative contributions to profits and market capitalisation, of the non-controlled businesses as compared to the group as a whole.

[7] The FSA proposes that scientific research based companies will be exempt from this aspect of the "control of business requirement" only.

must be approved both by the shareholders as a whole and the independent shareholders. In the event that the results of these two votes conflict, it is proposed that a further vote takes place not less than 90 days later on a simple majority basis.

Shareholder Voting

- The FSA has proposed that all shareholder votes that are required to be undertaken by a premium listed issuer by virtue of its premium listing (for example those relating to significant transactions and related party transactions) should be decided by holders of shares that are themselves premium listed[8].

- This proposal would prevent a share structure which allowed matters subject to a shareholder vote imposed by the premium listing regime to be decided by holders of an unlisted share class. The FSA considers that such a share structure would be more appropriate for a standard listing than a premium listing.

Duty to Notify FSA of Non-Compliance with Continuing Obligations and Listing Category "Downgrade"

- Currently, premium listed issuers are only under an obligation to inform the FSA that they are not in compliance with their continuing obligations in the event that they breach the 25% free-float requirement discussed below. The FSA proposes to modify the obligation to state that issuers must inform the FSA without delay of any breach of any of their continuing obligations.

- In addition, it is proposed that where a premium listed issuer has not complied with its continuing obligations, it shall be directed by the Listing Rules to consider either "downgrading" its listing category to a standard listing or cancelling its listing.

IV. Free-Float Provisions

The current free-float requirements which are set out in the Listing Rules provide that at least 25% of the class of an issuer's listed shares or depositary receipts must be in public hands. This rule is derived from European law[9] with the primary aim of ensuring sufficient liquidity in listed securities and the formation of a proper secondary market. The FSA has the authority to agree to a lower level of free-float if liquidity allows.

[8] The FSA has proposed three exceptions to this rule: (i) special share arrangements designed to protect national interests; (ii) dual listed company voting arrangements; and (iii) voting rights attaching to preference shares or similar securities that are in arrears.

[9] Consolidated Admissions and Reporting Directive (2001/34/EC)

Proposals – Issuers with a Premium Listing

There has been some debate among market participants as to whether the current 25% threshold is too low for premium listed issuers, and whether a higher threshold would provide better protection for minority investors. The Consultation Paper states that the FSA does not propose to increase or make significant changes to the existing free-float requirements for premium issuers, on the basis that this requirement is designed to "speak primarily to liquidity" and is not a "proportionate way to address the governance issues that have been raised in this context". Instead, the FSA has made the following proposed clarifications and changes to the current regime:

- shares that are subject to a lock-up period of longer than 30 days are to be excluded from the calculation of shares in public hands (as they don't contribute to liquidity);

- guidance is to be provided in the Listing Rules on the circumstances when the FSA may use its existing power to relax the 25% requirement. The proposed criteria include issuers where (1) the number of public shareholders exceeds 100 holders and (2) the expected market value of shares in public hands at admission is greater than £250 million. In addition, the FSA expects that that even if these two criteria are met, it is unlikely to agree to a free-float of below 20%, other than in exceptional circumstances;

- holdings of individual fund managers in an organisation should be treated separately provided that investment decisions with regard to the acquisition of shares are made independently; and

- 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 towards the public float[10].

It should be noted, however, that under the FTSE Ground Rules, premium listed issuers that wish to be included in the FTSE UK Index series must maintain a minimum free float of at least 25% for UK-incorporated companies and 50% for non-UK companies[11].

[10] Except where the provider of a contract for difference acquires a long position in shares underlying the contract for difference which results in the provider having an interest of 5% or more of the relevant class of shares, when aggregated with its other interests.

[11] FTSE has made it clear that the new 25% threshold will not be waived by FTSE, even in cases where the FSA has granted a waiver in respect of the 25% free float requirement under the Listing Rules, as outlined in our previous alert memo "FTSE Announces Change to Minimum Free Float Requirements".

Proposals – Issuers with a Standard Listing of Shares or Depositary Receipts

In the standard segment, the FSA proposes to base its decision on whether or not to allow a percentage lower than 25% entirely on the liquidity of the issuer, and going forward will be prepared to allow very small free float percentages provided that sufficient liquidity will be present. In effect, this would remove the requirement for a minimum absolute percentage free-float for issuers with a standard listing of shares or depositary receipts[12].

V. Listing Principles

The six Listing Principles are set out in LR 7.1 and currently only apply in the case of a premium listing. The FSA proposes that two of these principles should also become applicable in the case of standard listings, including listings of GDRs and debt securities, and that two new listing principles are to be created, as outlined below.

Global Principles – for all listed issuers

	Draft Text	Comment
	A listed company must take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations.	Will potentially create even greater focus on such systems and controls at the time of listing.
	A listed company must deal with the FSA in an open and cooperative manner.	

[12] In assessing the liquidity of the shares or depositary receipts of the new issuer in the standard segment, the FSA proposes that it will have regard to the number, nature and diversity of holders post admission. Issuers that have the same securities listed elsewhere will potentially be able to demonstrate a track record of liquidity based on historical share turnover.

Premium Principles – for premium listed issuers only

	A listed company must take reasonable steps to enable its directors to understand their responsibilities and obligations as directors.	No change from existing listing principle 1, however disclosure and specific reference in annual report is to be required.
	A listed company must act with integrity towards the holders and potential holders of its listed equity shares.	No change from existing listing principle 2.
3	All equity shares in a class that has been admitted to premium listing must carry an equal number of votes on any shareholder vote.	New listing principle.
4	Where an issuer 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 issuer.	New listing principle.
5	A listed company must communicate information to holders and potential holders of its listed equity shares in such a way as to avoid the creation of a false market in such listed equity shares.	No change from existing listing principle 4.
6	A listed company must ensure that it treats all holders of the same class of its listed equity shares that are in the same position equally in respect of the rights attaching to such listed equity shares.	No change from existing listing principle 5.

VI. Introduction of Changes to the Listing Rules Applicable to a Premium Listing

Sponsor Regime (to take effect as of December 31, 2012)

- Key changes include:

- Requirement to appoint a sponsor[13] to provide the fairness opinion in relation to an RPT[14] (currently issuers have flexibility over whether to appoint its sponsor or another independent advisor).

- Requirement for premium listed issuers to "cooperate with its sponsor by providing the sponsor with all information reasonably requested by the sponsor for the purpose of carrying out the sponsor service".

- More onerous requirements for sponsors themselves, including:

    - requirement to comply with principle of "honesty and integrity";

    - specific standard of care (in addition to the current requirement of "due care and skill") to "take such reasonable steps as are sufficient to ensure that any communication or information it provides to the FSA in carrying out the sponsor service is, to the best of its knowledge and belief, accurate and complete in all material respects"; and

    - FSA to have the right to request confirmation from the sponsor on the issuer's compliance with the Listing Rules on an ongoing, real time basis (in addition to the sponsor's current obligation to disclose non-compliance).

Other Changes (now effective)

The FSA also announced other changes to the Listing Rules, including:

- amendments to the reverse takeovers requirements relating to cancellation and suspension of shares, which are designed to ensure that reverse takeovers cannot be used by otherwise ineligible issuers as a back door route to a premium listing;

- changes to the RPT and ST regimes, which include the abolition of the requirement for transactions to be "of a revenue nature" to qualify for the ordinary course

[13] There does not appear to be a requirement for the appointed sponsor to be the same entity that acted as sponsor in relation to the listing.

[14] This requirement applies in relation to (i) the statement to be made to the FSA in relation to small RPTs with all class test results exceeding 0.25% but less than 5% and (ii) in the RPT circular to be provided to the shareholders in relation to other RPTs with one or more class tests reaching or exceeding the 5% threshold.

exemption from the RPT and ST regimes, and the clarification of RPT aggregation rules;[15] and

- new restrictions on "externally managed companies" which require issuers that are seeking a premium listing to satisfy the FSA that the board has discretion to make strategic decisions on behalf of the issuer in the absence of recommendations from external input, and to comply with this requirement on a continuing basis.

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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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[15] The new rules require aggregation of both de minimis RPTs (i.e. where all Class Test ratios are below 0.25%) and small RPTs (i.e. where each of the Class Test ratios is less than 5%, but one or more of the percentage ratios exceeds 0.25%) with all other RPTs over the previous 12 months (previously it was unclear whether de minimis and small RPTs needed to be aggregated

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