Enhancing the Effectiveness of the UK Listing Regime – implementation

May 16, 2014

Significant new rules to strengthen the UK premium listing regime have come into force today (The Listing Rules (Listing Regime Enhancements) Instrument 2014). The rules have been the subject of two rounds of consultation by the UK Financial Conduct Authority ("**FCA**") and are designed in particular to improve the governance of premium listed companies with a controlling shareholder. Feedback on the responses received has also been published today by the FCA (**PS14/8: Response to CP13/15 – Enhancing the effectiveness of the Listing Regime**).

We summarise the main elements of the new regime below, which are largely as proposed by the FCA in its previous consultation document (see our **Client Memorandum dated November 7, 2013**). Companies contemplating a premium listing will need to consider the new rules as part of their IPO process and, over the coming months, existing premium listed companies with controlling shareholders will need to implement a number of new measures to comply with the new rules.

Controlling shareholders and the relationship agreement

The FCA's package of reforms includes important protections for independent shareholders in premium listed companies with a controlling shareholder. The rules impact applicants at the eligibility stage for a premium listing (and on a continuing basis once listed) as well as existing premium listed companies.

The definition of 'controlling shareholder' has been narrowed in the final version of the new rules. A 'controlling shareholder' is any person who exercises or controls 30% or more of the voting rights, either on their own or with a person with whom they are acting in concert. Votes held by associates are no longer included within the definition, in response to feedback that the definition would be too broad and complex to be applied with certainty. There is no guidance on the meaning of acting in concert, and so issuers will need to assess whether two or more shareholders are acting together to control 30% of the voting rights. The FCA has commented that it would not regard two institutional shareholders coming together to consider a specific resolution to be acting in concert.

Relationship agreement

One of the key features of the new rules is that premium listed companies with a controlling shareholder must enter into a 'relationship agreement' containing certain provisions safeguarding the company's independence.

The agreement between a premium listed company and its controlling shareholder will need to expressly provide that (i) transactions and arrangements with the controlling shareholder and its associates are conducted at arm's length and on normal commercial terms; (ii) the controlling shareholder and its associates do not take any action that would prevent the company from complying with its obligations under the Listing Rules; and (iii) no controlling shareholder or associate will propose or procure the proposal of a shareholder resolution which is intended to or appears to be intended to circumvent the proper application of the Listing Rules. These provisions are referred to as the 'independence provisions'. In its policy statement, the FCA has clarified that shareholders who accept a takeover offer, give an irrevocable undertaking or purchase shares in the market in connection with a takeover offer would not be viewed as breaching the obligations set out in (ii) and (iii) above.

Where a company has more than one controlling shareholder, it does not have to enter into separate agreements with each of them if one controlling shareholder could, with reasonable certainty, procure the compliance of the other(s) with the agreement:

The final version of the new rules clarify that separate agreements will not be required where:

- the company reasonably considers in the light of its understanding of the relationship between the controlling shareholders that one of them can procure the compliance of the other(s) (and their associates) with the independence provisions in the agreement; and
- the agreement includes this procurement obligation and the names of the non-signing controlling shareholder(s).

Existing premium listed companies will have up to and including November 16, 2014 to put a relationship agreement in place, or amend an existing agreement to include the required independence provisions. A six month transitional period will also apply to premium listed companies that acquire a controlling shareholder in the future. New applicants with controlling shareholders will need to have an agreement in place at admission.

The FCA has confirmed in its policy statement that it would not see either the amendment of an existing agreement or entry into a new one as being related party transactions where this is purely intended to address the requirements of the new rules.

As a continuing obligation, a premium listed company will need to comply with the requirement for a relationship agreement at all times. The company's annual report will need to contain a statement by the board of directors that the company has entered into the required agreement and that it and (so far as it is aware) the controlling shareholder has complied with the independence provisions throughout the relevant financial year. If this is not the case, the company must give a description of non-compliance (including confirmation that the FCA has been informed of such non-compliance).

If (i) the company fails to put a relationship agreement in place; (ii) an independence provision contained in the agreement is not complied with; or (iii) an independent director does not agree with the related statements required to be included in the company's annual report, all subsequent transactions with the relevant controlling shareholder must undergo prior independent shareholder approval, regardless of the size of the transaction. This special regime will remain in place until publication of the company's next annual report in which the board is able to make a clean statement of compliance in relation to the entire preceding financial year.

Additional voting power when electing directors

As a result of the rule changes, premium listed companies with a controlling shareholder will be required to provide for a dual-voting structure for the election of independent directors, with separate approvals required by the shareholders as a whole and by the independent shareholders. If the results of these two votes conflict, approval for the election of the director(s) in question may be obtained by way of a further, single, majority vote at a meeting to be held at least 90 but not more than 120 days after the original vote.

Increased disclosure requirements will now apply for circulars relating to the election or re-election of a proposed independent director, in particular to make shareholders aware of any existing or previous relationship between the independent directors and controlling shareholder(s) and to describe how the company has determined that the proposed director is independent.

These arrangements will need to be put in place for the company's next annual general meeting (unless the company has already given notice of the meeting, or notice is given within three months of the event which made the company have a controlling shareholder).

Cancellation of a premium listing

Premium listed companies with a controlling shareholder that wish to apply for a cancellation of their premium listing or a transfer to the standard segment must now:

- obtain a majority of at least 75% of the votes attaching to the shares voted on the resolution (as under the current regime); and
- gain approval by a majority of the votes attaching to the shares of independent shareholders voted on the resolution.

In takeover offer situations, an equivalent requirement based on acceptances will now apply, except that when an offeror who is interested in 50% or more of the voting rights has acquired or agreed to acquire more than 80% of voting rights, no further approval/acceptances by independent shareholders would be required to cancel the premium listing. Essar Global referenced this new requirement in its recent announcement declaring its offer for Essar Energy wholly unconditional and stating that it would seek a delisting.

The Listing Rules allow cancellation to occur following a takeover or restructuring of an issuer effected by a scheme of arrangement without shareholder approval. No change has been made in this regard, on the basis that the statutory framework provides adequate protection to shareholders.

Other changes affecting all premium listed companies

Free float

The Listing Rules require a company to have at least 25% of its shares in public hands (known as the 'free float' requirement).

The final version of the new rules gives more explicit guidance about the limited circumstances where the FCA may use its existing power to modify the 25% free float requirement where it considers that there is sufficient liquidity for the market to operate properly. The FCA will look at the number and nature of shareholders as one of the factors in determining whether a modification is appropriate, as well as whether the expected market value of the shares in public hands at admission exceeds £100 million. Shares subject to a lock up of longer than 180 days will be excluded from the calculation of the free float. In practice, exclusion of such locked-up shares from the free float calculation should have limited incremental impact in the context of new applicants for listing, as the types of persons who tend to be subject such lock-ups, for example directors and major shareholders, are already excluded from the free float calculation.

The final version of the new rules makes it clear that individual fund managers in a group will be treated separately for free float calculation purposes, provided that investment decisions with regard to the acquisition of shares are made independently.

Independent business

The longstanding eligibility requirement for a new applicant to demonstrate that it controls the majority of its assets and has done so for a three-year period has now been removed. The new rules focus on a company being able to demonstrate that it will be carrying on an 'independent business' as its main activity — this requirement is tested at the time of eligibility and remains as a continuing obligation following admission.

The new rules take into account the level of control an issuer has over its businesses as part of the overall assessment of whether an independent business is present. The related guidance describes a number of factors that may indicate that a company does not satisfy the independent business requirement, including where a majority of the revenue generated by the applicant's business is attributable to business conducted with one controlling shareholder, or where the applicant does not have

strategic control over the commercialisation of its products, ability to earn revenue or freedom to implement its business strategy.

Structural changes to prevent avoidance

The new rules have introduced two new Listing Principles for premium listed companies: (i) all equity shares in a class listed must carry an equal number of votes; and (ii) where more than one class of shares is listed, 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.

These two new Listing Principles will prevent super voting shares, or other structures that allow voting power to be kept within a small group of shareholders.

Further, under the new rules two of the established Listing Principles will now also apply to companies with a standard listing (including those companies with listings of GDRs or debt securities), meaning that standard listed companies must now "take reasonable steps to establish and maintain adequate systems and controls" and "deal with the FCA in an open and co-operative manner". Until these changes, the Listing Principles only applied to premium listed companies.

In addition, to ensure that corporate structures cannot be used to evade the protections for shareholders provided by the Listing Regime, under the new rules only holders of premium listed shares may now vote on matters that require shareholder approval by virtue of the company's premium listing (that is, excluding votes of holders of unlisted share classes in the company). Examples of situations where this is relevant include the need for shareholder approval for significant transactions and related party transactions.

Additional continuing obligations

A premium listed company must notify the FCA without delay if it no longer complies with the continuing obligations requiring an independent business, at least 25% of its shares in public hands and holders of premium listed shares only to vote on certain matters, or if there is any non-compliance with any of the independence provisions (as described above) – this can be given on an awareness basis in respect of breaches by the controlling shareholder.

Under the new rules, a premium listed company's annual report must now set out all of the disclosures required by LR 9.8.4R (such as details of LTIPs) in a single identifiable section or include a cross-reference table to the relevant disclosures. This requirement will apply to annual reports for financial years beginning on or after September 1, 2014.

If a premium listed company finds itself unable to comply with any of the continuing obligations set out in LR 9.2 (which include eligibility requirements that have continuing effect and the new independence requirements, as well as compliance with the Disclosure and Transparency Rules and the Model Code, amongst other matters), under the new rules it is required to consider seeking a cancellation of its listing or applying for a transfer of its listing category. Early consultation with the FCA would be appropriate in these circumstances.

Related party transactions

The new rules now require immediate market announcement of details of smaller related party transactions (rather than waiting for the next annual report to disclose them as has historically been the case). These transactions will require a premium listed company to obtain confirmation from a sponsor that the terms are fair and reasonable as far as the shareholders of the company are concerned, but will no longer be pre-vetted by the FCA.

Mineral and scientific research based companies

Under the new rules, both mineral and scientific research based companies are required to comply with the rules relating to controlling shareholders and, in a departure from previous requirements, under the new rules they must also comply with the eligibility requirement that a new applicant demonstrate that it will be carrying out an independent business as its main activity.

Implementation issues for existing premium listed companies

As a result of the new rules, existing premium listed companies with a controlling shareholder may need to amend existing relationship agreements to comply with the new independence provisions outlined above (or put a new agreement in place).

They will also need to check their constitutional documents to ensure that they are not incompatible with:

- the dual voting process for independent directors (any necessary changes to the constitution can be approved at the company's next AGM); and
- the requirement that only the holders of premium listed shares can vote on matters that require shareholder approval by virtue of the company's premium listing (any necessary changes to the constitution must be made by May 16, 2016).

Further, premium listed companies must ensure that annual reports for financial years beginning on or after September 1, 2014 include a separate section (or a cross reference table indicating where the information is set out) which make the disclosures required by LR 9.8.4R, including the new confirmations relating to independence described above.

Finally, premium listed companies should review their internal continuing obligation guidelines, manuals and processes to ensure that they are updated to reflect the changes described above and the new procedure for the announcement of and other requirements for smaller related party transactions.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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