AFME Response to FSA CP12-25 Chapter 7

Independent business

Independent business and controlling shareholders

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?

(1) We agree with the proposed definition of a controlling shareholder as a holder of 30% of existing shares. However, the definition of an associate of a controlling shareholder would benefit from further guidance. Not all agreements for concerted action will indicate an agreement to control a company e.g. an agreement to vote together on a single issue.

(2) We would suggest that shadow parties controlling holders of record who have formal or informal arrangements with a controlling shareholder for control purposes should be considered as associates.

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?

With the reservations noted below, we agree that a new applicant for a premium listing should enter into a relationship agreement with a controlling shareholder, if any.

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 are concerned with the suggested wording that a relationship agreement must "ensure" that various principles are observed. It would be preferable to say that the relationship agreement should provide for stated principles to be in place.

We support the provision in 6.1.4FR(1) .

We would propose that 6.1.4(2) refer to a purpose to disrupt the compliance of the controlling shareholder or associate with the agreement. There is a need for flexibility and accommodation for unintended consequences or for complex circumstances.

We do not support 6.1.4F(3) as currently drafted because it would be impractical and commercially harmful not to allow an active controlling shareholder to act as an executive of an enterprise where his involvement is an important factor of success. A controlling shareholder's actions in running a company on an operational level is not the equivalent of board decision-making. Neither do we support a ban on a controlling shareholder's acquisition of a material holding in one or more significant subsidiaries per se. Of course, such acquisitions should be subject to board review by independent members of the board and must be at arm's length.

The suggested terms of a relationship agreement should apply on a comply/explain basis and not on a mandatory basis. Some further guidance should indicate whether associate parties should be party to the relationship agreement. We are unsure how such an agreement will be effectively enforceable against the controlling shareholders or his associates who will be the primary obligors under a relationship agreement. This will depend on the law governing the agreement, but neither the shareholders nor the company should be penalised where a controlling shareholder refuses to act in accord with the agreement or a court refuses to enforce an agreement. To do so would be to disadvantage those parties who require the protection of a relationship agreement.

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 agree with LR 9.2.2AR(1) that a relationship agreement in principle should be in place as long as there is a controlling shareholder. Where a company with a current premium listing has no relationship agreement with an existing controlling shareholder, there should be a generous transition period from the date that the new requirement goes into force. Issuers should not be penalized where a controlling shareholder refuses to comply with a relationship agreement or to enter into one when first acquiring the controlling stake.

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)?

A listed company should be in material compliance with the relationship agreement at all times on a comply or explain basis. Independent shareholders should be able to permit deviations from the relationship agreement by a majority vote. The terms of the relationship agreement should not be set as requirements in regulation, but could be offered as guidance.

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))?

We note that an issuer may be prevented from being in compliance with the relationship agreement by the actions of an unwilling controlling shareholder. Thus, the requirement should be for the issuer not to itself undermine the relationship agreement.

As noted above, 6.1.4FR(3) is an impractical requirement which confuses the executive actions of a controlling shareholder with his actions as a board member. In our view there should not be mandated terms for the relationship agreement. We urge there to be guidance reflecting the provisions of 6.1.4FR(1) and a modified (2) (see above). This would allow an applicant the flexibility to address the particular circumstances and history of the company while reaching for proper treatment of minority shareholders.

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)?

We have no objection to requiring vote of independent shareholders to approve material changes to a relationship agreement in addition to the approval of a majority of all shareholders. However, we propose that guidance be offered as to which matters are to be considered material in terms of the governance issues underlying these listing rules. Note that a relationship agreement will be a related party transaction under Chapter 11.

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)?

Yes – as far as it goes. We agree that the cumulative effect of all changes since the last vote of independent shareholders on changes to the relationship agreement should be taken into account in determining whether the most recent change constitutes a material change. However, previous changes should not be reversed on the basis of a vote of independent shareholders considering the most recent proposed change. Further guidance is necessary to clarify the correct interpretation of this section.

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 would support a proposal to require a listed company to disclose the current relationship agreement or a summary of its provisions with the proviso that a company would not be required to disclose

provisions which may be commercially sensitive. Subject to the same proviso, we propose that all changes to the relationship agreement during the year be disclosed in summary form in the annual report, as well as an indication whether each change is deemed material or not material.

Independent shareholders

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

We agree.

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?

We agree with the proposal. We propose that each failure to comply be categorised as material or non-material.

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?

We are concerned that the listed factors to be taken into consideration in determining whether a company has an independent business under proposal 6.1.4D may not be indicative of dependence. For example, a company may not have had a need for external financing yet be financially sound. The section should include reference to the need to consider such factors in terms of the company's business circumstances and history as a whole. Any relationship agreement should also be taken into account in considering the terms of whether the business is run as an independent entity.

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 are concerned that the new standard substitutes a theoretical approach for a more practical, clear standard referencing specific assets. There are a number of overlapping provisions (6.1.4B et seq) bearing on independence, and it is not clear how they will interrelate in the regulator's consideration.

Purpose of control and situations where it may not exist

Q14: Do you agree that 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 do not agree with the proposed guidance. We are concerned by 6.1.4BG (1)(c) which requires a business to have "unfettered" ability to implement its business strategy. This term is susceptible to varying broad interpretations whereas many independent businesses can be said to have some factors which affect their ability to implement a strategy. We would propose that the word "unfettered" be deleted.

We note that a negative veto power (6.1.4BG(2)(a)) can be effective control in closely balanced circumstances. And we do not believe that any company with such an arrangement must automatically be considered ineligible for premium listing.

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?

It would be helpful to have clarity on the policy concern which underlies this proposal. We do not agree with the guidance as expressed because it is not clear what is meant by "non-controlled interests". Where the controlling shareholder has successfully operated the non-controlled interest as well as the other elements of the applicant, as a practical matter the ability of the applicant to go forward need not be impacted.

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 believe that the requirement to demonstrate control on a continuous basis must be clarified. For example, a listed issuer's confirmation that no material changes in the control of the company since the latest annual report should be sufficient under regulatory requirements.

Independence of directors

The Corporate Governance Code

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

We strongly support Option 2 which affords flexibility for a board to determine whether there are sufficient independent members to allow the board to prevent domination by a controlling shareholder and his associates. We are concerned that Option 1 would open the possibility

that directors representing a minority of shareholders could effectively control the board. We understand the principle underlying Option 1 but we also note that many of the most controversial instances of overreach were by controlling shareholders in companies complying with the Corporate Governance Code.

Defining independence

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

If option 2 is adopted, there would be no need for a definition of independent director. We have no objection to the concept of using the relevant sections of the UK Corporate Governance Code as a reference point to guide boards in their determination of who is an independent director. The UK corporate governance code definitions are well understood by investors, issuers and other market participants.

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))?

We do not agree. Diminishing the flexibility in board composition would be a significant discouragement to non-UK applicants for a premium listing. We note that the HKSE and the NYSE both have governance arrangements that protect the interests of minority shareholders of controlled companies without mandating a majority independent board. Please also see our responses to Q.17 and Q.18.

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 a requirements in respect of composition of the board as set out in LR 6.1.4ER(2)?

This proposal would not be needed if Option 2 is adopted. If Option 2 is adopted, we propose that there be no time limit set specifically to replace an independent director. The comply/explain discipline of the UK Corporate Governance Code should apply. If a time limit must be set, we suggest that the guideline be extended to 12 months to allow sufficient time to avoid a rush to the bottom and unnecessary harm to shareholders.

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)?

If Option 1 is adopted, the more complicated voting arrangements here proposed would not be needed.

If Option 2 is adopted, we have no objection in principle to this proposed regulation for the election of independent directors and the resolution of conflicting vote results. However, we note that in most cases directors will be appointed for remainder periods until the next applicable annual meeting at which time the performance of the director will have been noted. In such cases it may be unnecessary to require the more complicated voting method. Also there ere may be practical difficulties in determining which shares are in independent hands over time. The principle that all shareholders are equal would also be subtly undermined by the proposed voting method. We note that two round voting would create a need for controlling shareholders to consider governance appointments carefully to avoid the second round vote, which is positive. Whether the uncertainty during the period between an unsuccessful first round and the second round is a positive for shareholders, however, can probably only be assessed in hindsight, if the measure is adopted.

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.

Subject to comments made in our responses to Q. 3 and 4, we have no objection

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))?

Subject to our responses to Q. 3 and 4, we have no objection.

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?

Subject to our responses to Q. 3 and 4, we have no objection.

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.

Subject to our responses to Q. 3 and 4, we have no objection.

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 propose that shares subject to a lock-up period of *more than* 180 days should be excluded from the calculation of the free float to allow flexibility in the distribution plan. This is in line with the customary 180 day market standard. We note that a 30 day lock up period could create volatility as stabilization expires on the 30th day.

We do not propose any other exclusions from the free-float calculation.

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?

We believe there should be more flexible criteria for decisions to allow free-floats of less than 25% of outstanding shares. The reference to extraordinary circumstances should be made clearer. We take it to mean that free floats below 25% will still be granted if the deal size is very large. For purpose of admission and for indexation, free float is designed to accomplish different things, as you have noted.

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 support this approach to secondary listings with the observations that a standard listing is not a competitive draw in favour of the UK market and investors would be more protected by a premium listing even with reduced percentage held by shareholders holding listed shares.

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?

In our view, a specific floor in terms of shareholders and shares outstanding should be stipulated by regulation.

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?

Yes – we agree.

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?

The application of the proposed guidance is not clear. Whether a cfd writer is wholly or partially hedged through a holding of the referenced shares, the shares held as a hedge should be counted for purposes of calculating the public hands threshold. Where a cfd provider holds shares in excess of 5% as a hedge against his cfd obligations, there seems to be no reason to exclude such shares from the free float calculation after listing is completed. We request clarification of the policy and application of this proposed rule. It would be helpful to understand the mischief being addressed by the proposal.

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?

We do not support these provisions which are unnecessary if an appropriate controlling shareholder regime is implemented. We are concerned that the voting provisions will be seen as not proportionate and ultimately ineffective in the absence of draconian enforcement measures.

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 FSA powers of modification.

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?

Yes - we agree but would propose that the Rule refer to "known material non-compliance" and that a disclosure to the FSA be made "without undue delay". Non-material lapses should be handled in the annual statement on a comply/explain basis.

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 note that LR 9.2.25G refers to companies which are "unable" to comply with continuing obligations which is a different criterion from a criterion of not being in compliance. Companies should have the necessary time to come into compliance. We would propose that companies which are "unable or unwilling to comply by taking prompt steps pursuant to an articulated plan" should consider the stipulated actions.

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 support the proposal but suggest that the possibility to cross reference prior disclosures and publicly available documents be allowed.

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 objection to this proposal. We are not aware of other factors that should be disclosed in relation to smaller related party transactions.

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 have no objection.

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?

We support the proposal to delete the requirement which in our experience is rarely applicable.

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?

We agree.

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.

We agree.

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?

We agree.

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?

We note that the guidance should consider the following factors. A chairman is not able to "ensure" the understanding of other board members and directors' duties may not be fiduciary in nature in some countries. We suggest that the term "fiduciary" be clearly defined, if it is to be used.

We propose that the section refer to disclosure of steps taken by the chairman to inform the directors regarding the regulatory requirements applicable to a company with a premium listing and the legal requirements regarding director's duties applicable in its country of incorporation.

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.

We do not support the proposed requirement and note that some existing premium listed companies have a variable voting power arrangement in place. The application of this provision is not clear in respect of schemes of arrangement and class rights, and bars to voting by certain shareholders in the Listing Rules. We note that this Rule will have an effect on the competitiveness of the UK listing market. We suggest that further clarification be offered in respect of the anticipated application of the proposal in various contexts.

Note: We understand from prior listing regime consultations that no new instances of premium listed non-voting shares will be considered. To the extent Q44 is designed to address issues which may exist among currently listed companies on the premium segment, then care needs to be taken that any post hoc disenfranchisement which may result from this proposal does not itself undermine the attractiveness of the premium segment.

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)?

We have no objection except to note that some will see this as contradictory to proposal in Q.44 above.

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?

We agree.