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LISTING REGIME REFORMS

FCA PUBLISHES FURTHER DETAILS OF CHANGES AND TIMING

Further details of reforms to the listing regime that will take effect later this year were published by the FCA just before Christmas. The long-awaited changes represent the most far-reaching reforms of the listing regime for two decades. This briefing highlights the key issues for companies that have ordinary shares already listed or that may be considering a listing.

Overview

CP 23/31, which was published on 20 December 2023, summarises the extensive feedback the FCA received from market participants on its previous proposals, which were published in May 2023 (see our briefing), and gives further detail about the changes the FCA now proposes to make and when they will take effect. Generally the FCA intends to implement its original proposals: in particular, the premium and standard segments will be collapsed into a single segment for equity shares of commercial companies (i.e. non-investment companies) (ESCC) whose rules will be based mainly on the current premium segment rules but with some eligibility criteria and continuing obligations dropped or simplified (see the box right summarising the key features). However, in a few places the FCA has decided to modify its original proposals to reflect feedback.

The changes will result in a completely new “UK Listing Rules” sourcebook (UKLR). CP 23/31 includes a first tranche of draft rules that will apply to companies in the new ESCC category; a second tranche of draft rules, including amended Listing Principles, transitional provisions and rules relating to SPACs and overseas companies, will be published later in Q1 2024.

Equity Shares in Commercial Companies category: key features

- Significant transactions (25% or more in any class test) will not require shareholder approval; but the transaction announcement will have to include more details than at present.
- Shareholder approval will continue to be required for a reverse takeover and certain other specific types of transaction.
- Related party transactions (RPTs) will also not require shareholder approval; but the other main safeguards will remain, including the requirement for a sponsor’s “fair and reasonable” opinion.
- For the purposes of both the significant transactions and RPT rules, there will be additional guidance on which types of transactions are exempt on the basis that they are within a company’s “ordinary course of business”.
- A company with a controlling shareholder will have to (i) demonstrate it can carry on business independently from its controlling shareholder and (ii) enter into a relationship agreement with the controlling shareholder that includes certain prescribed terms.
- To make it easier for companies to list, some of the eligibility criteria that currently apply on the premium segment will be relaxed; and companies will have more leeway to adopt a dual class share structure (DCSS) if they wish.
- The sponsor regime will be retained, but sponsors will have a role on fewer transactions.

Timing

Consultation on the new UKLR, including on the second tranche of rules to be published in Q1 2024, will run until 22 March 2024. We expect to see refinements made in some areas. Final rules will be published “at the start of the second half of 2024” and come into force two weeks later. When the new listing regime goes live, existing listed companies will be “mapped” to one of the new listing categories that will be created: see further below.

New ESCC category: key rules

Significant transactions

As originally proposed, an ESCC company that enters into a non-ordinary course of business transaction that represents 25% or more in any class test (which is currently categorised as a Class 1 transaction) will not need to obtain shareholder approval or publish an FCA-approved circular. Removing these requirements is designed to enable UK listed companies to compete for assets more effectively against global competitors. However, the question of whether to drop the requirement for shareholder approval divided market participants: see the box below headed "*Dropping the requirement for shareholder approval: key arguments*".

In order to ensure that investors are given sufficient information, and to help ensure boards conduct a robust assessment of the benefits and risks attached to a transaction, a company will have to include more information about the transaction in its RIS announcement than is currently required. Under the draft rules published for consultation, the announcement would have to include some of the information that under current premium segment rules must be included in a Class 1 circular: see the box below.

By enhancing the disclosures required, the FCA has responded to some of the concerns raised by market participants about the removal of shareholder approval. However, pulling together all the information specified – particularly target financial information - and obtaining suitable comfort on its accuracy and to support statements to be made by the board is likely to be onerous and add significant delay and cost to the transaction process. We therefore expect this to be an area where refinements are made during the next phase of the consultation process. In any event, because the onus of deciding whether to enter into a significant transaction will now lie solely with the board, existing governance processes around transactions may need to be enhanced.

Significant transactions: information to be included in the announcement

In addition to the information currently required under premium segment rules, an announcement of a significant transaction will have to include:

- Risk factors
- A statement by the board that the transaction is, in the board's opinion, in the best interests of shareholders as a whole
- (Generally) audited historical financial information (HFI) on the target covering at least the last two financial years, and details of any significant change in the financial position of the listed company or target since the end of the most recent year. But where such HFI is not available, the announcement will have to explain how the consideration was arrived at and include a statement by the board that it believes the consideration to be fair as far as shareholders are concerned
- Details of material litigation relating to the listed company or the target
- Details of material contracts of the listed company or the target
- Details of any break fee arrangement
- If the transaction is a joint venture, details of any exit arrangement

Certain additional information will be required if the company includes (i) details of estimated synergies or other quantified estimated financial benefits expected to arise from the transaction; or (ii) pro forma financial information to illustrate how the transaction would have effected the company's historical financial results.

In all cases, the announcement will also have to include "*any other relevant circumstances or information necessary to provide an understanding of, and to enable the shareholders to assess, the terms of the transaction and its impact on the listed company, having regard to the purpose of* [the significant transaction rules]".

However, the announcement will not have to include a working capital statement; and it will not be necessary to (i) re-state the target's historical financial information in accordance with the accounting standards used by the listed company (or obtain a third party opinion on the re-statement); or formally repeat or disavow any extant profit forecast made by the listed company or the target.

As originally proposed, no announcement will be required under the ESCC rules for a transaction that represents 5% in any class test but less than 25% in each test (which is currently categorised as a Class 2 transaction). But a company will need to consider whether it needs to disclose certain information in order to keep the market fully informed under its general disclosure obligations.

Giving a high-value, exceptional indemnity, and entering into or exiting from a joint venture arrangement, will continue to fall within the scope of the significant transaction rules, but shareholder approval will no longer be required.

Helpfully, the FCA intends to:

- provide new guidance on which types of transactions will (and will not) be treated as falling within the "ordinary course of business" for the purposes of both the significant and related party transactions rules;
- remove the profits test, because it frequently produces anomalous results; and
- specify that agreeing to pay a break fee, however large, will not of itself constitute a significant transaction.

Related party transactions

Similarly, as originally proposed, an ESCC company will not need to obtain shareholder approval for a transaction with a related party. However, where a non-ordinary course transaction represents 5% or more in any of the class tests (larger RPT), the company will need to make a RIS announcement that includes certain prescribed information. Broadly this will be the same information as premium listed companies are currently required to disclose, although there will also be an explicit requirement to include "*any other relevant circumstances or information necessary to provide an understanding of, and to enable the shareholders to assess the terms of the transaction and its impact on the listed company, having regard to the purpose of* [the RPT rules]". The modified requirements that currently apply for transactions above 0.25% and below 5% in the class tests will be dropped.

As under the current premium segment rules, a sponsor will have to be consulted and confirm that the terms of the transaction are fair and reasonable as far as shareholders in general are concerned.

Fewer transactions will be caught by the RPT rules because a shareholder will be treated as a "substantial shareholder", and hence as a related party, only if they hold 20% (instead of 10%) of the voting rights in the company. The FCA seeks views on whether a "related party transaction" should be defined by reference to accounting rules (principally IAS 24) rather than a bespoke definition in the Listing Rules.

Sensibly, the FCA has decided that ESCC companies will not also have to comply with the RPT rules in DTR 7.3, which originate from the EU Shareholder Rights Directive and are similar but slightly different to the RPT rules in the Listing Rules.

When shareholder approval will be required

An ESCC company will have to obtain shareholder approval for a reverse takeover (which broadly means a transaction in which the listed company buys an asset at least as large as itself or that results in a fundamental change of business or in a change in board or voting control); delisting; non-pre-emptive issue of shares at more than a 10% discount; certain employee share schemes; and certain share buyback arrangements.

Dropping the requirement for shareholder approval: key arguments

Market participants who opposed dropping the requirement – primarily UK buy-side firms and pension schemes - were primarily concerned that:

- *"Without the prospect of a shareholder vote, boards might commit UK listed companies to large deals that shareholders disagreed with… Company boards might be too insulated from shareholder views or have slightly different (personal) incentives that may not fully align with shareholders, so it could not be assumed boards would always act in shareholders' best interests.*

  Shareholder voting offers all shareholders, including minority shareholders (institutional and retail), the opportunity to voice their concerns and ultimately block a transaction to preserve value and, without it, institutional shareholders would lose a vital stewardship tool."

- More generally, there would be a "race to the bottom' in regulatory standards that may reduce investor confidence.

But those in favour of dropping the requirement pointed to:

- The negative impacts for UK listed issuers: "*Many pointed to their experience of UK listed issuers being screened out from being short-listed on competitive M&A auction processes due to the contingency risk of requiring prior shareholder approval. This was despite the fact the vote is usually carried. To address this contingency, companies were having to pay a material premium over other bidders to be considered, and also pressured to agree high break-fees. These impacts would be felt no matter what transaction size-threshold was set for requiring a shareholder vote.*"

- The fact that most other major listing venues (apart from Hong Kong), do not require shareholder approval for significant transactions, and investors who favour retaining a shareholder vote in UK rules also allocate significant assets to overseas equity markets where no such vote is required.

Ultimately the FCA was persuaded that, even without a requirement to obtain shareholder approval, investors will have sufficient mechanisms to engage with and influence boards and to assess and respond to the risks and benefits of significant transactions:

> *"While buy-side views remained sceptical that this would be as effective as a vote, there was acknowledgement that large investors, in particular, would already expect to have regular engagement with an issuer's management and may also be wall-crossed in advance of a major transaction. These larger investors were therefore of the view that the votes were less important as they felt that the issuer's management would seek their approval through this route. Many of the buy-side participants agreed that effective board engagement was a key piece in stewardship, and there would be levers for ex-post sanction by removing board members or disinvesting, albeit if a transaction had resulted in share price depreciation post-event, this risked crystalising poorer returns on capital.*
>
> *Engagement with senior buy-side representatives in roundtables indicated that some – but not all – felt that these levers provided sufficient safeguards and mechanisms for ensuring that investors can exercise influence in relation to transactions and that company boards had an incentive to keep (particularly larger) shareholders informed."*

Companies with a controlling shareholder

An ESCC company with a controlling shareholder (broadly, a person who holds 30% or more of the voting rights) will have to (i) demonstrate it can carry on business independently from its controlling shareholder and (ii) enter into a relationship agreement with the controlling shareholder that includes certain prescribed terms designed to ensure that transactions with the controlling shareholder are conducted at arm's length and on normal commercial terms. The latter is a change from the FCA's original proposals, where it suggested that such companies should be allowed to explain why a relationship agreement was not needed. However, the FCA has left the door slightly ajar on this front, saying it is open to views on whether there are any alternative arrangements that could sufficiently demonstrate that a company can carry on business independently from its controlling shareholder – for example, where the controlling shareholder will not sign a relationship agreement. As under the current premium segment rules, such a company will also have to ensure that its constitution provides for the (re-)election of independent non-executive directors to be subject to approval by a majority of independent shareholders as well as by all shareholders (a dual vote).

If a company with a controlling shareholder fails to put in place a relationship agreement and/or its provisions are breached, it will have to notify the FCA. The FCA will be able to take any action it considers necessary. Presumably this could include suspending the company's shares - although it seems likely this would occur only if the FCA believes the company cannot carry on business independently of the controlling shareholder.

Annual disclosure requirements

ESCC companies will have to make most of the annual report-related disclosures currently required of premium segment companies, including the extent to which they comply with the UK Corporate Governance Code and the extent to which they have disclosed all the climate-related information mandated by the TCFD framework. Board diversity disclosures will also be required.

But non-UK incorporated companies that currently have a secondary listing of shares on the standard segment will not have to start reporting against the UK Corporate Governance Code: under the rules of the new *Secondary Listing* category (see below) they will be able to report against a code of their choice.

Sponsor regime

The sponsor regime will be retained but in a modified form. ESCC companies will require a sponsor when first applying for admission, and a sponsor declaration to the FCA will be required on IPO. But a sponsor declaration will not be required on a significant transaction.

A sponsor's role will therefore be primarily confined to transactions that involve a further issue of securities where a prospectus is required; larger related party transactions (where a sponsor must give a "fair and reasonable" opinion); transfers into or out of the ESCC category; and instances where a company needs to seek guidance, a modification or waiver from the FCA.

Eligibility criteria for admission

Generally the eligibility criteria for the ESCC will be based on the current premium segment criteria. But a company will not be required as a condition of listing to:

- demonstrate it has an independent business and operational control over its main activities (but see above in relation to companies with a controlling shareholder);
- demonstrate a three-year revenue-earning track record. This will make it easier for high growth and pre-revenue companies to join the ESCC;
- ensure its historical financial information covers at least 75% of its business. This will make it easier for companies that have been very acquisitive to join the ESCC; or
- give a clean working capital statement.

By removing the requirement to have an independent business and to exercise operational control over main activities, the FCA hopes to make it easier for “franchise” type companies and strategic investment companies to list and remain listed. In respect of all these issues, appropriate disclosures will need to be included in the company’s IPO prospectus, where they will be scrutinised by the FCA. Together, these changes are designed to provide a shorter and broader path to listing and to allow investors to decide for themselves whether and on what terms to invest in a company with an unusual history or structure.

Under a proposed new rule, the board of a company applying for admission will have to confirm in writing to the FCA that the company has in place systems and controls that will enable it to comply with the listing regime. As a company’s sponsor already needs to satisfy itself and make a declaration to the FCA to this effect, the new requirement is unlikely to add significantly to existing IPO procedures.

Dual class share structures (DCSS)

DCSS are controversial in the UK, with many buy-side investors keen to preserve the “one share, one vote” principle. Ultimately, though, the FCA believes that regulation of DCSS should be kept to a minimum, and investors should be left to assess and price in the risks on a case by case basis. An ESCC company that wants to adopt a DCSS from IPO will therefore be given more leeway than is currently afforded to premium segment companies. In particular:

- the high vote shares will be able to cast multiple votes on any resolution proposed at any time, apart from a resolution to approve an issue of shares at a discount over 10%, a delisting, a transfer between listing categories or an employee share scheme;
- there will be no limit on the voting ratio; and
- there will be no time limit on a DCSS arrangement (whereas the FCA had originally proposed a ten year limit).

The high vote shares will have to be held by (i) a director; (ii) a natural person who is an investor or shareholder; (iii) an employee or (iv) a vehicle controlled by such a person (whereas the FCA had originally proposed that only a director should be able to hold the high vote shares).

These changes should help attract founder-led companies to join the ESCC - although in practice founders may need to accept tighter restrictions in order to attract (IPO) investors.

If the high vote shares enable the holder to exercise 30% or more of the votes able to be cast “on all or substantially all matters at general meetings of the company”, the holder is likely to be treated as a “controlling shareholder”: see above.

Closed-ended investment funds and SPACs

The rules around closed-ended investment funds will continue largely unchanged. In particular, shareholder approval and an FCA-approved circular will continue to be needed for a significant transaction (25% or more in any class test) that falls outside the scope of the company’s investment policy. A transaction with the company’s investment manager will continue to be treated as a RPT and require a sponsor to provide a “fair and reasonable” opinion if any class test is 0.25% or more; and, if the transaction is 5% or more in any class test and falls outside the scope of the company’s investment policy, shareholder approval and an FCA-approved circular will also be required. The role of sponsors in relation to closed-ended investment funds will remain broadly unchanged.

For SPACs (cash shells), some of the current rules will be amended. In particular, to be eligible for the new *Shell companies (SPACs)* category, a SPAC’s constitution will have to set a deadline of 24 months from admission for it to complete an acquisition (although this could be extended in certain circumstances) and it will have to ensure that money raised from public shareholders is appropriately ring-fenced. Transitional rules will apply to SPACs that are already listed. Refinements will also be made to the process that must be followed where a SPAC makes an initial acquisition (reverse takeover); but most of the other rules that apply on a continuing basis will be left unchanged.

Listing categories

Overall, five new listing categories will be created: *ESCC*; *Shell companies (SPACs)*; *Transition*; *Secondary listings*; and *Non-equity shares and non-voting equity shares* (such as preference shares and deferred shares). Various existing categories will be retained, including *Closed-ended investment funds*; *OEICs*; *Depositary receipts*; *Debt securities*; and *Warrants, options and other miscellaneous securities*. A table summarising how companies would be mapped to the five new categories can be found on page 115 of the consultation paper. The FCA will notify companies in advance of the category it proposes to move them to: see the box below.

What will happen to companies that are already listed

Existing premium segment companies will automatically be "mapped" to the ESCC. For them, the changes they experience will mostly be de-regulatory, although they will need to modify their systems and controls, particularly around significant transactions and RPTs, to reflect the new rules.

For existing standard segment companies, the changes will be more significant. Joining the ESCC category will require them to satisfy its eligibility criteria and comply on an ongoing basis with various rules to which they are not currently subject. In order to avoid such companies facing a material increase in their obligations or a cliff edge, two new listing categories will therefore be created for issuers of equity shares with voting rights:

- **Transition category**: on day 1, all existing standard listed companies that are not mapped to another category will be moved to this category, whose rules will be based on the current standard segment rules. It will have no end date, although the FCA may consult in future on closing it. Companies that are mapped to this category will therefore be able to continue indefinitely "as they are". They will be able to apply to transfer to the ESCC category or another category if and when they choose to do so. Transferring to the ESCC will require a sponsor to be appointed; but there will be a "modified transfer process" under which some of the usual eligibility criteria will be disapplied.
- **Secondary listing category**: this category will be designed for non-UK incorporated companies that have a primary listing overseas; its rules will also be very similar to the current standard segment. Compliance with the rules of primary listing will generally be sufficient. In particular, companies in this category will be permitted to report against a corporate governance code of their choice.

Indexation

The FCA does not control the index rules, so the consultation paper does not deal with indexation; but we expect FTSE Russell to consult its members shortly on changes to the FTSE UK eligibility criteria in response to the FCA's proposals. We anticipate that the updated index inclusion criteria will continue to be based on objective tests - such as liquidity in the company's shares - rather than subjective tests relating to, for example, a company's corporate governance arrangements. A key issue will be how FTSE Russell decides to deal with companies that have a DCSS.

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