In Practice

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FSA's proposals for free float and corporate governance

This In Practice article considers the recent proposals by the FSA on the effectiveness of the Listing Regime.

In January 2012, the FSA published a consultation paper asking: "*What, if any, changes to the Listing Rules may be necessary to provide additional protection to investors?*". This question continued the broader debate occurring in London, spurred by the global financial crisis, over the efficacy of the existing IPO process and the effectiveness of the Listing Regime.

In particular, the debate has brought into focus the free float requirements and corporate governance model of the UK Listing Authority's (UKLA) Premium Listing segment, especially as they relate to some overseas companies. To be eligible for a Premium Listing (the UKLA's "gold plating" of the minimum standards required under EU legislation), a company must list shares, have a 25% free float and comply with the UK Corporate Governance Code (the Code), or give reasons for not complying. The UKLA has the discretion, however, to reduce the minimum free float requirement if satisfied about liquidity (in the case of some of the large overseas businesses that have listed in London, the free float has been reduced to nearer 20%). Global depositary receipts issued by overseas companies and debt are listed on the Standard segment.

A Premium Listing is a pre-requisite for inclusion in the FTSE UK Series Indices (including the attractive FTSE 100). Under FTSE rules companies that are not incorporated in the UK must maintain a minimum free float of at least 50%. This has resulted in some large overseas businesses reincorporating in the UK in order to be eligible for a Premium Listing and indexation at the lower 25% free float. Concerns have arisen from the perception that the UKLA has applied a "light touch" approach to these large overseas businesses and relaxed its standards to enhance the City's position as an international financial centre. For most of these companies, ownership was and continues to be concentrated in the hands of a small number of overseas shareholders, raising concerns about adequate protection for minority shareholders.

The debate has been sharpened by the emergence of Asia as an alternative market to London and, since April 2012, the relaxation of rules for emerging growth companies listing in the US following implementation of the US JOBS Act. Concerns have also been raised that European technology companies may choose to list in the US over London. Proposals in the UK to reduce the minimum free float requirement for high-growth companies are expected before the end of 2012.The FSA's consultation paper also followed December 2011 amendments by the FTSE Group to the minimum float requirement for inclusion in the FTSE UK Securities Indices. The amendments raised the minimum float from 15% to 25% for UK-incorporated companies and stated that, in cases where the UKLA waives the 25% free float requirement for a Premium Listing, the FTSE will maintain its 25% threshold. Companies incorporated outside the UK remain subject to a 50% free float requirement.

In October 2012, the FSA announced the results of its consultation and published a set of proposals for comment by 2 January 2013. The FSA intends to publish feedback on the responses to the consultation in the spring of 2013. The proposals make it clear that the FSA does not view increasing the free float requirement as the right tool for protecting minority shareholders. Instead, the FSA has proposed: (i) incorporating certain of the "comply or explain" provisions of the Code into the Listing Rules, making them requirements for a Premium Listing; (ii) increasing the tools available to minority shareholders to influence the governance of the companies in which they invest; and (iii) ensuring that listed companies are managed independently of any dominant shareholders. The proposals for new listings fall under two headings: free float provisions and corporate governance. The free float provisions include proposals to (a) detail the circumstances in which the UKLA may consider reducing the 25% free float requirement for Premium Listings, with reductions beneath 20% being unlikely, and (b) remove the requirement for a minimum absolute percentage free float within the Standard segment, provided that sufficient liquidity is present.

The corporate governance proposals include (i) introducing the concept of a "controlling shareholder"; (ii) requiring a "relationship agreement" between such controlling shareholder(s) and the listed company and ensuring such agreement is complied with on an ongoing basis; (iii) where a controlling shareholder exists, insisting on a majority of independent directors; and (iv) introducing a new dual voting procedure to allow independent shareholders to have more say in the appointment of independent directors. The FSA opted not to follow the FTSE free float requirements and stated that the Listing Regime should be driven by active investor choice rather than the needs of issuers to seek indexation or of passive investors who invest in index trackers. The FSA observes that although the number of shares in public hands plays a role in giving minority shareholders sufficient power to counterbalance a dominant shareholder, low free float is not, on its own, indicative of poor corporate governance or a means to address related party issues. The FSA intends that the minimum free float requirement should address liquidity and ensure the formation of a proper secondary market, not protect minority shareholders.

The FSA notes that disagreement persists between the sell-side and the buy-side regarding free float requirements and shareholder protection. Unlike in the US, where retail investors are active participants in the market, the UK does not have a significant retail investor base, and so the sell-side believes that the more fundamental question of who is being protected (rather than how) should be considered. The sell-side has also argued that free float is not a meaningful indicator of liquidity and that increasing the minimum will make the London market less attractive. Participants on the buy-side note that the proposals may still not go far enough to protect minority investors.

The FSA's proposals continue the debate but do not conclude it. They are a positive step in dealing with a pattern of issues that, if not addressed, could undermine the effectiveness of the Premium standard in the eyes of significant market participants. They will, once implemented, in whatever form, provide increased clarity to overseas companies and their advisers, with respect to the expected standards of, and requirements for a Premium Listing. It is unlikely, however, that when the FSA adopts final amendments, this will be last word on the matter. ■