Primary Markets Policy team
Financial Conduct Authority
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London
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21 July 2017

Dear Sir or Madam,

Response to Consultation Paper CP17/21: Proposal to create a new premium listing category for sovereign controlled companies

Thank you for giving the Institute of Directors (IoD) the opportunity to provide written evidence in response to your consultation on proposed changes to the UK listing rules. Issues of this nature are of considerable interest to the IoD and its membership and we are therefore pleased to present our views in respect of your proposals.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 30,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. IoD members are represented on a number of FTSE boards, but the majority of our membership, some 70%, are directors of small and medium-sized enterprises (SMEs), ranging from long-established businesses to start-up companies. IoD members' organisations are entrepreneurial and growth-orientated, and more than half (57%) export goods and services internationally.

Issues of corporate governance are of particular concern to the IoD. According to our Royal Charter, one of the IoD's key objectives is "to promote the study, research and development of the law and practice of corporate governance, and to share findings." We strongly believe that an effective system of corporate governance is a key underpinning of UK economic performance and business legitimacy.

Summary of our view

- The IoD is supportive of efforts to ensure that UK equity markets remain competitive in a post-Brexit world.
- However, any changes to the listing rules must serve to enhance rather than diminish the UK's reputation for world-class corporate governance.
- This consultation paper fails to provide a convincing justification for why listing rules relating to premium category issuers should be waived or removed in cases where the issuer has a controlling sovereign shareholder. If anything, we believe that listing rules should be strengthened for this category of issuer given its distinctive governance challenges and risks.

- We recommend that all existing rules applying to premium listed companies – such as those relating to related party transactions and controlling shareholders – should remain in place for sovereign-controlled issuers.
- Furthermore, the independence of the board of directors of such companies should be enhanced. In particular, we recommend that the appointment of independent directors should be ratified by a binding vote of independent shareholders as well as by the vote of the shareholder constituency as a whole.

Our overall perspective on the Consultation Paper

As the UK heads towards an exit from the European Union, it is appropriate to consider if the listing rules relating to UK equity markets are fit for purpose. We agree with the view expressed by the Chancellor of the Exchequer in his letter to the FCA in March 2017: that London's role as a leading international financial centre is an important underpinning of sustainable economic growth.

However, an important aspect of the UK's attractiveness as a financial centre is its commitment to world-leading standards of corporate governance. Good corporate governance serves to enhance business performance, protect investors and maintain the reputation of UK Plc.

We do not believe that the proposed reforms to listing rules contained in this consultation paper contribute towards this objective. Indeed, we are concerned that, if implemented, the proposed changes could exert a detrimental impact on the reputation of the UK for sound corporate governance.

At best, they are changes that have been formulated without regard to available evidence concerning state-owned or state-controlled enterprises. At worst, they could be interpreted as an opportunistic attempt at boosting short-term primary issuance which ignores the longer-term implications for the overall UK corporate governance regime.

The key aim of the proposals is to create a sub-segment of the existing premium listing category which is devoted to sovereign-controlled companies. In other words, the reforms are seeking to facilitate – by changes to the FCA rulebook – the listing of state-owned enterprises from around the world on the London Stock Exchange.

This is not in itself an unreasonable ambition. The IoD is committed to sustaining the City of London as a global financial centre, and the attraction of global companies to the UK capital market can be seen as an important aspect of that strategy. Furthermore, a London-listing can potentially play an important role in disseminating UK corporate governance standards and practices to a wide range of global economies and companies.

However, state-owned enterprises give rise to distinctive corporate governance challenges. According to the latest edition of the OECD's Guidelines on Corporate Governance of State-Owned Enterprises (2015), these are likely to include one or more of the following major issues:

- There is potential for undue hands-on and politically-motivated ownership interference over the company by the state apparatus, leading to unclear lines of responsibility, a lack of accountability and efficiency losses;
- The ability of the Board of Directors to exercise independent oversight over a state-controlled company is likely to be limited due to the power of the sovereign shareholder to appoint or remove board members, or to override their decisions;
- The sovereign shareholder is in a strong position to assert its interests at the expense of other shareholders or stakeholders, particularly minority shareholders;
- The state authorities may demand that the company fulfils public policy objectives as well as its commercial activities. The full extent and nature of this agenda may or may not be apparent to external investors or stakeholders. Reflecting these pressures, it is common for key corporate decision-makers (e.g. board members and top management) to have intrinsic conflicts of interest which can lead to decisions based on criteria other than the best interests of the company;
- There are often significant difficulties in enforcing national laws and regulations against state-controlled in their domestic jurisdictions;
- Two key sources of private sector corporate discipline – the possibility of takeover and bankruptcy – are likely to be minimal or absent in state-controlled entities.

If the UK wishes to encourage state-controlled enterprises to list on the London market, it is important that its listing regime is tailored to address - to some degree at least - these kinds of governance risks and challenges.

However, the proposed rule changes for the new premium listed category do not seek to do that. They simply represent a watering down of existing listing obligations based on the argument that such rules could “discourage” potential sovereign issuers.

Specifically, the paper proposes that a sovereign controlling shareholder should not be considered a related party in any related party transactions. Furthermore, it also proposes that many of the controlling shareholder rules introduced in 2014 – in the wake of the ENRC, Buni and Essar Energy debacles - should be waived for sovereign-controlled enterprises.

These include a requirement for a binding relationship agreement between the company and the controlling shareholder as a means of ensuring the independent functioning of the company. They also provide independent shareholders with their own separate vote on the appointment of independent directors which can potentially delay their appointment by up to 90 days.

We do not understand how removing these rules for, specifically, sovereign-controlled companies can be justified. In our view, the need for such checks and balances on controlling shareholder power are as great, if not greater, in cases where the controlling shareholder is a nation state rather than a private person.

Indeed, the asymmetry of power between a state shareholder and other corporate stakeholders is likely to be particularly overwhelming - without some kind of meaningful check over the state’s capacity to use the

company to pursue its own agenda, the corporate governance of the issuer is likely to be significantly compromised.

The recent experiences of foreign issuers - ENRC, Bumi and Essar Energy – which ended in the ignominious exit of all three companies from the London market after years of controversy, is testament to the wider impact of poor governance experiences on the reputation of the London market.

The fact that the governance lessons from such cases, which led to the recent changes in the UK listing rules, are now to be "unlearnt" by the current proposals is a worrying development which will not serve the long-term interests of UK Plc.

Our recommendations

As stated above, we believe that the listing rules for premium-listed companies with a sovereign controlling shareholder should be strengthened rather than weakened in order to reflect their distinctive governance challenges.

As a minimum, the existing rules on related party transactions and controlling shareholders should continue to be applied to sovereign-controlled entities. In addition, we propose the following additional measures to strengthen the governance of sovereign-controlled entities:

Firstly, the shareholder voting process on the appointment of independent directors – which allows independent shareholders to vote separately from the controlling shareholder - should be binding in nature.

In other words, the independent shareholders should be granted a veto – not just a delaying power - over the appointment or removal of independent directors. This would strengthen the ability of the Board of Directors to exercise a measure of independent oversight over the company.

Secondly, the company should be required to explain in its annual report the extent to which its governance arrangements are consistent with the OECD's Guidelines on Corporate Governance of State-Owned Enterprises (2015) or an equivalent UK guidance.

These are principles which any good state-controlled enterprise should seek to take account of, and represent a good benchmark against which investors and other external stakeholders could assess their commitment to good governance.

In addition, we wish to register our concern about the likely compliance of sovereign-controlled enterprises with the UK Corporate Governance Code.

The Code is applied by premium-listed companies on a "comply or explain" basis. Engagement between issuers and investors plays an important role in the application of the Code. However, in instances where most of the company's equity is in the hands of a sovereign controlling shareholder, it would be relatively straightforward for the issuer to ignore numerous aspects of the Code and simply provide some kind of

explanation in its annual report. This could serve to undermine the credibility of the UK's Code-based system of corporate governance.

Meaningful compliance with the UK Corporate Governance Code should be monitored carefully by the UKLA and the FRC. We do not rule out the need to make certain aspects of the Code mandatory for sovereign controlled issuers, e.g. provisions recommending a majority of independent board members, if the spirit of the Code is not respected by new issuers.

Specific responses to Consultation Questions

Q1: Do you agree with the overall proposal outlined in this paper of creating a premium listing category for sovereign controlled companies?

In principle, we do not disagree with idea of creating a new listing category for sovereign or state-controlled enterprises. However, the listing rules relating to these kinds of companies should, if anything, be strengthened in order to reflect their distinctive governance problems and challenges.

Unfortunately the proposals presented in this document do not address these issues. Indeed they argue for a watering down of the listing rules which are currently applied to issuers controlled by non-sovereign shareholders. There is no evidence presented in this paper which justifies such an approach.

The existing rules relating to related party transactions, relationship agreements with controlling shareholders and approval of independent director appointments by independent shareholders are even more necessary in the case of an issuer controlled by a sovereign shareholder. Far from being redundant, these checks and balances on the power of the sovereign controlling shareholder need to be further strengthened.

Q2: Do you agree that the changes proposed are best effected through the addition of a new listing category?

We do not agree with the proposed changes – see above – although we have no objection *per se* to the creation of a new listing category for state-controlled enterprises. However, a new listing category needs to be combined with listing rules that are appropriately tailored to the governance and investor protection issues that are commonly experienced by these kinds of companies.

Q3: Do you agree that the threshold for control should be set at 30%?

Yes. Such a control threshold is consistent with existing regulatory definitions in other areas and seems appropriate.

Q4: Do you agree that eligibility for the new category should not be restricted on grounds of national identity of the controlling shareholder? Do you agree that it should also not be restricted on grounds of country of incorporation of the company?

We agree. The London equity market and its various listing categories should be open to issuers from any country, regardless of their state of incorporation or nationality of shareholders. In principle, we welcome the prospect of state-controlled enterprises from around the world floating all or part of their equity on the UK stockmarket. However, such listings need to be combined with an appropriate governance framework for issuers both to protect investors and the wider reputation of UK Plc.

Q5: Do you agree that independent shareholder approval should be required for a transfer from an existing premium listing into the new category?

Yes. This is an important protection for minority shareholders.

Q6: Do you agree that the sovereign controlling shareholder should not be considered a related party for the purposes of the Listing Rules?

No, we disagree. We cannot understand why a sovereign controlling shareholder should be exempt from these rules. The related party transaction rules are, if anything, more important in the case of sovereign controlling shareholders than they are with private controlling shareholders.

For example, there are a variety of circumstances in which national governments may seek to use state-controlled enterprises to pursue politically-motivated or public policy driven goals. In such circumstances, state shareholders are by definition a related party.

It cannot be seen as good governance for such shareholders to be able to participate in a shareholder vote concerning the approval of transactions relating to these related party activities. Such shareholders will be inherently conflicted, and hence unable to take an objective view of the best interests of the company.

Q7: Do you agree that MAR-mandated disclosures are sufficient to secure the necessary at-the-time transparency?

In principle, this should be possible. However, one of the underlying problems of insider-dominated enterprises is that there can sometimes be an inherent bias against openness and transparency. In such circumstances, corporate managers and board members may perceive their main priority as protecting the interests of the sovereign controlling shareholder. Compliance with transparency and disclosure requirements may be viewed as less important.

Checks and balances on the overwhelming power of controlling shareholders, e.g. from an independently-minded board of directors, provide an important counterweight to a corporate culture that may be biased against transparency.

Q8: Do you agree that controlling shareholder provisions should not apply in respect of the sovereign controlling shareholder for companies listed in this category?

No, we disagree. Once again, we can identify no convincing reason as to why these rules should apply to privately-controlled issuers but not issuers controlled by sovereign shareholders.

For example, we believe that a binding relationship agreement – one of the existing controlling shareholder provisions - between the company and the sovereign controlling shareholder is essential in order to ensure that the issuer operates as an independent corporate entity (at arm's length from the controlling shareholder).

Furthermore, such an agreement is important in order to ensure that the sovereign shareholder cannot use its voting power to make changes to the company's constitutional framework (e.g. articles of association) in a way that prevents compliance with listing rules.

If anything, the controlling shareholder provisions should be strengthened for sovereign-controlled issuers. In particular, we recommend that the separate vote of independent shareholders on the appointment of independent directors should be made binding rather than merely advisory.

According to the current controlling shareholder provisions, independent shareholders can only delay the appointment of independent directors for 90 days. A binding vote of independent shareholders would help ensure that any independent directors appointed to the board are not simply placeholders who remain at the pleasure of the sovereign shareholder. It would allow them to be more genuinely independent and hence potentially better placed to make decisions which reflect the interests of the company as a whole.

Q9: Do you agree that DRs over equity shares should be eligible for this category?

No response.

Q10: Do you agree that full pass-through of voting and other rights on the basis described should be a requirement for eligibility of DRs for listing in the proposed category?

No reponse.

Q11: Do you agree with the proposed consequential changes to the Listing Rules and to the Fees manual set out in Appendix 1?

No – see above responses.

I hope you have found our comments helpful. If you require further information about our views, please do not hesitate to contact me.

Kind regards,

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