SNAPSHOT

- In February 2013, Nat Rothschild lost a high-profile struggle to restructure the board of Bumi plc, a UK-listed mining company with activities in Indonesia that has been mired in controversy since its flotation in 2010.
- The recent experience of Bumi and other foreign issuers with a UK listing has raised questions about the impact of controlling shareholders on UK corporate governance.
- But it is a mistake to believe that good governance can be 'guaranteed' by more stringent listing rules. Such an approach panders to the laziness of those investors wishing to pass responsibility for investment risk to regulators.
- The IoD believes that calls for tighter regulation of boards in companies with controlling shareholders should be resisted. As long as such companies are transparent and operate in an ethical manner, there is room on the London market for issuers with a plurality of ownership structures.

Bumi or bust – the corporate governance implications of foreign issuers in London

Dr. Roger Barker, Director of Corporate Governance and Professional Standards at the IoD, assesses whether the Bumi saga justifies fundamental changes to the UK's corporate governance regime.

On 21 February 2013, aristocratic financier Nat Rothschild lost one of the most high-profile boardroom struggles of recent years. Shareholders rebuffed his attempt to replace the Bumi board of directors with a completely new boardroom team. This landmark shareholder vote was the culmination of several years of highly publicised strife between Rothschild, the board and its major shareholders.

The experience of Bumi and a number of other London-listed mining companies from emerging markets has raised concerns about the impact of foreign listings on the integrity of the UK corporate governance system. In particular, it has highlighted the difficulties that the UK regime faces in coping with significant or controlling shareholders. How should the UK respond to this challenge?

THE BUMI STORY

The Bumi saga is one of the many unintended consequences of the Sarbanes-Oxley Act of 2002. Issuers from emerging markets were unnerved by the US's stringent new regulatory regime. As a result, they turned their attentions to the London Stock Exchange (LSE). London was soon inundated with foreign listings led by metals and mining companies. The FTSE 100 index, in just eight years, saw the weight of its natural resource sector increase from 3% (in 2003) to 17.8% (in 2012).

This was the environment in which Nat Rothschild devised the idea of floating a listed corporate shell on the LSE, and using the proceeds of the flotation "to acquire a single major business or operational asset in the global metals, mining and resources sector".

Rothschild believed he could "unlock" the value "trapped" in these emerging markets businesses by getting proven managers to run them and by imposing a UK-style corporate governance regime.

Although the original owners might still retain a large equity stake, their influence over a business would be held within strict limits. Respected independent non-executive directors – working on behalf of shareholders as a whole – would direct the company and ensure that there was a fair distribution of rewards to all shareholders.

The so-called 'Rothschild model' has been succinctly described as follows:

> *You unlock this value by putting a respectable board of directors on top of the notepaper, by appointing managers with a strong following in financial markets, by pledging to follow all relevant corporate governance codes and by listing the shares on the London Stock Exchange, preferably on a scale that gets them into the FTSE 100 index. Suddenly investors who might previously have run a mile are queuing up to buy.*[1]

Vallar

In July 2010, Rothschild invested £100m of his own money into a new stock market-listed shell company, Vallar. Most of the remaining £700m needed for the venture was contributed by leading institutional investors, including Schroders, BlackRock and the Abu Dhabi Investment Council.

Following the flotation, Rothschild proclaimed that investors in Vallar would secure a return of "two or three times their money". This initially appeared plausible when the share price rose from £10 to £14 shortly after the flotation, despite the fact that, at that stage, investors had no idea what specific assets the company would be investing in.

Working with JP Morgan Cazenove, Rothschild soon identified Bumi Resources, Indonesia's largest coal miner which was controlled by the prominent Bakrie family, and Berau, its fifth-largest, as potential acquisition targets.

Following negotiations, Vallar took a 25% stake in Bumi Resources and a 75% stake in Berau. On the other side of the deal, the Bakries took a 47% stake in the London-listed company, although their voting rights were capped at 29.9%.

[1] Richard Lambert, "Lessons in capitalism for the FTSE 100", *Financial Times*, 27 June 2011.

"Whilst the current board may claim a Pyrrhic victory, they should be under no illusions that independent shareholders are demanding new leadership and management."

In effect, the transaction allowed the Bakries to 'reverse' a significant proportion of their assets into a London-listed entity. Rothschild's listed shell company made this a much easier process than would have been the case if the Bakries had wanted to bring their enterprises to the London market directly. Rothschild became co-chairman alongside Indra Bakrie.

However, soon after the launch, the price of coal fell significantly, with negative implications for the Bumi share price. By the summer of 2012, reports of serious financial irregularities in the Indonesian operations began to emerge. On the basis of claims made by a whistleblower, major Bumi shareholders were alleged to have siphoned off more than $1bn of assets into other Bakrie family-controlled companies by means of related party transactions.

Rothschild's resignation

In October 2012, Nat Rothschild resigned from the board, arguing that a new board was needed in order to legally pursue the Bakries for the missing funds and subsequently execute a clean split from the Bakrie Group.

For its part, the remaining board members agreed with Rothschild that a separation from the Bakries was necessary. But they also argued that Rothschild risked plunging the business into costly and time-consuming litigation. In the board's view, such a confrontation with the Bakries would result in a stalemate that would actually make it more difficult to achieve a satisfactory separation from the Bakrie family.

In the face of such a fundamental difference in strategy, Rothschild demanded, in January 2013, the convening of an Extraordinary General Meeting for the purpose of restructuring the board. But at the EGM vote on 21 February, Rothschild's attempt to replace the chief executive, Nick von Schirnding, and Sir Julian Horn-Smith, the deputy chairman, was rejected by 61% of the shareholder vote. Overall, 19 out of the 22 resolutions proposed by Rothschild were rejected by shareholders.

After the vote, Rothschild said that, "Whilst the current board may claim a Pyrrhic victory, they should be under no illusions that independent shareholders are demanding new leadership and management, an end to looting and corruption at Bumi, and robust and proper action to recover shareholders' stolen funds".

THE GOVERNANCE IMPLICATIONS OF BUMI

The most obvious implication of Bumi's problems has been a substantial loss of value for those shareholders who invested in the original Vallar investment vehicle.

After falling 60% below the IPO price, Bumi's shares were suspended from trading in April 2013, following problems in finalising the 2012 accounts. Bumi subsequently reported a pre-tax loss for the year of $2.4bn. More recently, new financial irregularities have emerged at its Berau mining subsidiary relating to expenditures of more than $200m with "no clear business purpose".[2]

The Bumi/Vallar saga represents a salutary lesson for the 'sophisticated' investors that originally provided funds for the venture without knowing what assets they would ultimately be investing in. It is hard to avoid the conclusion that their decision to back the venture was based mainly on the reputation and 'good name' of those involved rather than any form of robust investment analysis.

From a governance point of view, the underlying problem with Bumi was that, contrary to the original concept of the 'Rothschild model', the independent directors lacked the power to control the company in the face of the overwhelming power of controlling or large shareholders.

The UK's corporate governance framework

The UK corporate governance framework for listed companies has largely been developed in a business environment of diffuse share ownership. The main ownership role in UK plc is played by UK and foreign institutional investors with highly diversified investment portfolios.

In such an ownership context, individual shareholders have small percentage stakes in individual companies and, as a result, exercise relatively little direct power. Although they can ultimately exit their shareholdings by selling the shares, shareholders primarily rely on the board of directors to safeguard their interests and ensure good governance.

The structure and functioning of a UK board are, in turn, strongly influenced by the recommendations of the UK Corporate Governance Code which is applied on the basis of 'comply of explain' by companies with a Premium listing on the LSE.

An important recommendation at the heart of the UK Governance Code is the idea that the board of a major listed company should be an overwhelmingly independent body that promotes the best interests of the company as a whole (including minority shareholders). Reflecting this approach, the Code advocates that board members that might represent a particular vested interest, such as management or large individual shareholders, should not be in the majority around the boardroom table.

Although the UK's single tier unitary board structure can include senior executives (such as the CEO) or other 'connected' non-executive directors with existing links to the company or its shareholders, the Code recommends that a majority of board members, including the chairman of the board, should be independent non-executive directors.

[2] Christopher Thompson and Ben Bland, "Bumi reveals tally for missing payments stands at $201m", *Financial Times*, 31 May 2013.

However, the presence of a large blockholder on the share register potentially offers a challenge to the functioning of this governance framework.

A basic principle of UK company law stipulates that directors can be appointed and removed by means of a simple majority vote of shareholders. However, a lack of concentration in share ownership normally means that the direct appointment or removal of directors by shareholders is an unusual occurrence at UK-listed firms.

Controlling shareholders

However, in a company with a controlling shareholder, or a connected group of blockholders, the capacity of shareholders actively to remove or appoint directors is much greater. The concentration of voting power in the hands of a single shareholder effectively empowers shareholders relative to the board or management.

It creates a system which has been described by Professor Mark Roe of Harvard Law School as consisting of 'weak managers, strong owners', in contrast to the situation in the typical Anglo-American company with dispersed ownership of 'weak owners, strong managers'.[3]

A controlling shareholder ultimately has the power to exercise significant control over the board and thereby the company. In principle, a controlling shareholder could populate the entire board with his own representatives or associates.

Despite their legal duty to act independently and promote the best interests of the company as a whole,[4] such nominees are likely to feel an overriding loyalty to the blockholder that appointed them rather than to minority shareholders or other stakeholders.

[3] Mark Roe (2002).
[4] Companies Act 2006, section 172, although this fiduciary duty does not apply to the directors of companies incorporated outside the UK.

Nat Rothschild

"The ability of a shareholder to control a significant proportion of voting shares is a potent governance power."

In practice, UK-listed companies with controlling shareholders typically choose to appoint a significant number of independent non-executives to the board, and to comply with other elements of the UK Corporate Governance Code.

But the UK's 'soft law' approach to corporate governance – based on 'comply or explain' – does not oblige them to do so. If they prefer to deviate from provisions of the Code, they can choose to provide explanations for those deviations in their annual report.

Independent directors may have some leverage over a controlling shareholder due to the negative publicity and adverse market sentiment that would be created if they were expelled from the board. And blockholder power over a company is constrained to some extent by legal protections for minority shareholders which are embedded in UK company law and listing requirements.[5]

However, the extent of these checks and balances should not be exaggerated. The ability of a shareholder to control a significant proportion or an outright majority of a company's voting shares is a potent governance power, as was demonstrated in the case of Bumi.

Ultimately, directors (both independent and otherwise) retain their positions at the pleasure of the controlling shareholder. Consequently, in the absence of regulatory curbs over shareholder voting rights or a genuine willingness on behalf of the blockholder to refrain from interference in company affairs, the board may find it difficult to exercise independent authority over the company.

WHAT SHOULD BE DONE – THE POLICY RESPONSE TO CONTROLLING SHAREHOLDERS

One obvious way to counter the power of controlling shareholdings would be to increase the minimum free float requirements of companies with a Premium listing on the London Stock Exchange, i.e. the proportion of voting shares which may be freely traded and which therefore are not under the control of any major blockholders.

According to European legislation,[6] the minimum free float for a company trading on a regulated market is 25%, and this threshold is reflected in UK listing rules. However, the UK Listing Authority (UKLA) has the power to grant exemptions to large cap companies with a substantial amount of market liquidity in their shares despite having a lower percentage free float.

Since 2007, the UKLA has granted such an exemption to a number of foreign controlled companies, including Fresnillo (a Mexican silver producer controlled by the billionaire Alberto Baillères); Essar (an Indian oil and energy group majority-owned by its founder Ravi Ruia and his brother Shashi Ruia); Evraz (a steel business part-owned by the Russian billionaire Roman Abramovich); Ferrexpo (a Ukrainian iron ore group controlled by the business tycoon Kostyantin Zhevago); and Eurasian Natural Resources Corporation (ENRC), a Kazakh mining company 44% owned by three oligarchs.

[5] For example, a Premium listing on the London Stock Exchange requires the issuer to comply with significant disclosure requirements and respect pre-emption rights.
[6] Consolidated Admissions and Reporting Directive (2001/34/EC).

In the view of many investor organisations – including the Association of British Insurers and the National Association of Pension Funds – the current free float threshold is too low. In addition, the exemptions granted by the UKLA mean that some large cap companies can achieve a Premium listing on the LSE with less than 20% of their shares in public hands.

The FSA's response

However, in October 2012, the Financial Services Authority (FSA) declared its opposition to any increase in the free float requirements for a Premium listing.[7] According to the FSA, higher free float requirements were a "blunt tool" with which to check the power of controlling shareholders. In order to have the desired effect on the ownership power structure, the free float would need to be set at a prohibitively high level.[8]

In any case, the main purpose of a free float requirement was to ensure adequate market liquidity, not to influence corporate governance. For this reason, the FSA found it justifiable in certain circumstances to permit a free float of below 25% (although the FSA conceded that any exemption beneath 20% would be unlikely to be granted "other than in exceptional circumstances"). In addition, any increase in the minimum free float would "risk damaging London's attractiveness as a market for IPOs".

[7] FSA Consultation Paper CP12/25, *Enhancing the effectiveness of the UK Listing Regime,* October 2012.
[8] To prevent any blockholder from having significant power over a company, the free float would probably need to be set as high as 70%. This would be consistent with the Takeover Code which defines an equity stake of 30% of the voting shares as the ownership level at which effective control of a company is obtained.

Bumi Plc CEO Nick von Schirnding

"Does the experience of Bumi and others require fundamental changes to UK corporate governance?"

The FSA further argued that that the widespread use of indexation by investors was also not an adequate reason to change the UK listing regime. The listing rules existed to create a regime that was "based on the provision of information to allow investors to make active and properly informed decisions". It was up to investors to change their investment approach or index benchmark if existing strategies resulted in the ownership of inappropriate companies.

However, the FSA did acknowledge that there were grounds to make some changes to "accommodate situations where disparate shareholders are less able to exert influence on an issuer's governance...In these situations we believe there is a case for incorporating into the Listing Rules some requirements for Premium listed issuers that are at present only part of the comply or explain provisions of the FRC's (UK Corporate Governance) Code".

The FSA's proposed changes to listing rules in the premium segment include the following key measures:

- Re-introducing the legal concept of 'a controlling shareholder' (defined as a shareholder controlling 30% or more of the voting shares) and requiring that a relationship agreement is put in place to regulate the relationship between such a shareholder and the company.[9] Amongst other things, the relationship agreement should stipulate that a controlling shareholder will not influence the day-to-day running of the company and will conduct its relationship with the company at arm's length and under normal commercial terms. The directors should confirm in the annual report that the relationship agreement is being adhered to.

- A mandatory requirement to have a majority of independent directors on the board of a company with a controlling shareholder, and the introduction of a new dual voting requirement for the election of independent directors at such companies. According to this new voting procedure, independent directors must be approved both by the shareholders as a whole and the independent shareholders (i.e. excluding the controlling shareholder). In the event that the results of these two votes conflict, a further vote of all shareholders should take place not less than 90 days later on a simple majority basis.

ASSESSING THE FSA'S PROPOSALS

As the FSA itself has recognised, companies with an overseas asset base controlled by a majority shareholder will continue to represent a sizeable proportion of the companies seeking to list in London. However, does the experience of Bumi and other emerging markets companies with controlling shareholders require that fundamental changes be made to the UK's corporate governance regime?

The benefits of pluralism

In the IoD's view, the FSA was correct in rejecting calls for an increase in the free float requirements of a Premium listing. However, rather than

[9] All other shareholders are defined as 'independent shareholders'.

basing this decision on a desire to attract foreign IPOs, a more constructive justification would have been to highlight the governance benefits of pluralism in the structure of UK company ownership.

Contrary to the claims of many institutional investors, dispersed share ownership is not necessarily a superior ownership structure to that of concentrated ownership. While the presence of controlling shareholders may create concerns for the protection of minority shareholders, dispersed ownership brings its own problems.

A widely-recognised problem of the UK and US corporate governance systems is that listed companies are only weakly held to account by dispersed shareholders. Due to their small percentage ownership stakes, individual shareholders have relatively little incentive or capacity to become actively involved in governance.

As a result, companies tend to fall under the de facto control of their management, which may manifest itself in spiralling levels of executive pay and a short-termist approach which is sub-optimal from the perspective of long-term value creation.[10]

There are many examples of highly successful companies around the world with controlling shareholders. Many of the major listed companies in continental Europe remain under the control of families or founders. This has brought benefits in terms of being able to pursue a longer-term business strategy which is less exposed to the short-term fluctuations of financial markets or the business cycle.

Towards increased prescription

However, the IoD is less convinced by the FSA's other proposed reforms to the listing rules (which will potentially be implemented by the FSA's successor organisation, the Financial Conduct Authority).

As a matter of shareholder democracy, if a shareholder is able to win the support of more than 50% of the voting shares, it should be able to determine who sits on the board. While a largely independent board may well be in the best interests of minority shareholders, this is not something that should be forced on a company if it is not accepted by a majority of shareholders.

In addition, the FSA's proposed changes would move the UK further towards a more prescriptive governance regime. They would effectively begin a process of overriding the 'comply or explain' principle in the case of companies with a particular kind of ownership structure.

The provisions of the UK Corporate Governance Code were originally intended to provide best practice recommendations that could be adjusted to reflect the specific circumstances of individual companies. Although they are usually sensible and a good starting point for governance dialogue, they are not necessarily underpinned by conclusive empirical evidence linking them to improved company performance.

"A worrying trend is for the provisions of the UK Corporate Governance Code to be seen as ends in themselves."

However, a worrying trend is for the provisions of the Code to be seen as ends in themselves. According to this approach, if companies are not complying with them, they should be forced to do so.

[10] These issues have been examined in detail in recent reports by Professor John Kay and Sir George Cox.

It is ironic that the 'comply or explain' principle has been widely accepted in continental Europe in recent years – both by national regulators and the EU Commission – despite the fact that controlling shareholders are a common feature of European listed companies. And yet the UK – the inventor and main advocate of comply or explain – appears willing partially to abandon it as soon as controlling shareholders make an appearance in its own market.

Dual voting procedure and relationship agreements

With regard to the proposed dual voting procedure for independent directors, the wishes of the controlling shareholder would only be delayed for 90 days by the minority shareholders. Thereafter, the will of the majority of shareholders would prevail. This mechanism would do little, therefore, to affect the relative power of controlling and minority shareholders, and could add complexity and uncertainty to the board appointments process.

Finally, there are grounds for scepticism regarding the proposed emphasis on relationship agreements. These are supposed to limit the influence of the controlling shareholder and allow the board and the non-executives to run the company without shareholder interference.

However, Bumi provides an example of the limited worth of such agreements. It was on the basis of a relationship agreement with the Bakries that Nat Rothschild sought to claim that Bumi would be run by its board, with negligible interference from the company's major blockholders. However, as we have seen, this proved to be an unjustified hope.

Protecting investors

The most important regulatory tool at the disposal of the UK Listing Authority remains its Disclosure and Transparency regime. In the IoD's view, London can best protect investors and sustain its reputation as a leading global capital market by ensuring the disclosure of timely and high quality information from its listed issuers. It is through greater transparency that investors can make informed choices regarding the quality of a company's governance framework.

If a company is controlled by a blockholder and undertakes the bulk of its activities in emerging markets, that is not in itself a problem. As long as the company's activities and ownership structure are fully visible to the market, and subject to independent audit, investors should be able to make their own decisions about whether to buy or sell the shares.

Furthermore, if the company chooses to deviate from the provisions of the UK Corporate Governance Code, that should also not be interpreted as a governance 'failure' as long as the company provides a full explanation.

Of course, the absence of a majority of independent directors on the board of a blockholder-controlled company (or deviations from other Code provisions) may well deter investors from investing in the company. Minority shareholders may conclude that the company is not taking the necessary steps to safeguard their interests.

But the emergence of any resulting governance 'discount' – in the company's share price or reputation – would be the company's own choice. As long as investors are able to observe and assess the governance choices that the company had made, they can draw their own investment conclusions.

TOWARDS GREATER INVESTOR RESPONSIBILITY

It would be a mistake to believe that good governance can be 'guaranteed' by more stringent listing rules. Such an approach panders to the laziness of those investors that wish to pass responsibility for investment risk to regulators.

This brings us to the lesson of the Bumi story. The problems of Bumi are unlikely to have been avoided through more stringent board regulation. But things might have turned out differently if investors had thought more carefully about the inherently risky nature of the venture to which they were subscribing. For good governance, we need more engaged investors than those described by another aristocratic banker, Carl Furstenberg, more than a century ago:

> “*Shareholders are stupid and impertinent – stupid because they give their money to somebody else without any effective control over what this person is doing with it – impertinent because they ask for a dividend as a reward for their stupidity.*”

[11] As quoted in Rajan and Zingales 2003.