PRI STATEMENT: FCA CONSULTATION CP23/10

PRIMARY MARKETS EFFECTIVENESS REVIEW: FEEDBACK TO DP22/2 AND PROPOSED EQUITY LISTING RULE REFORMS

London, June 2023

Context

In May 2023, the FCA published a consultation paper (CP 23/10 UK Primary Markets Effectiveness Review - Feedback to DP22/2 and proposed equity listing rule reforms) proposing additional changes to the UK listing regime in the context of declining number of UK listed companies. The proposed regime is set to replace standard and premium listing share categories with a single listing category for commercial company issuers of equity shares. A single equity category would remove eligibility requirements that can deter early-stage companies, be more permissive on dual class share structures (DCSS) and remove mandatory shareholder votes on transactions such as acquisitions.

Key recommendations

The PRI **expresses concern over these changes** that could weaken existing corporate governance standards, expose institutional investors to undue risk and undermine the effectiveness of their stewardship activities. **We recommend that the FCA reconsiders the proposed reform that could reduce investor confidence in the UK market**.

To this end, the PRI recommends maintaining:

- the requirement that enhanced voting rights can be used only to prevent a change of control or to protect a founders' position as a director: we strongly oppose the proposal that enhanced voting rights would be able to be exercised on all matters and at all times;
- the current five-year sunset period for DCSS, not extending it to 10 years;
- the listing eligibility requirement for companies to have three years of audited historical financial information representing at least 75% of their business;
- the requirement for mandatory independent shareholder approval of Related Party Transactions (RPTs) at or above the 5% threshold; and
- the requirement for mandatory independent shareholder approval of significant transactions at or above the 25% threshold and related requirements for shareholder circulars.

The UK serves as a global reference on corporate governance, and **relaxation of existing standards can have a ripple effect on corporate governance practices globally**. Moreover, these proposals run counter to FCA measures to improve investor stewardship and plans to align companies' governance, incentives, and competencies with sustainability-related considerations.

Dual class share structure (DCSS)

We strongly oppose the introduction of a flexible approach to DCSS, which would allow enhanced voting rights to be exercised on all matters and at all times, along with the extension of the sunset period to 10 years. Instead, we recommend maintaining the limitation of enhanced voting rights to prevent a change of control or protect a founder's position as a director.

Engagement and voting are key tools for shareholders to enhance risk-adjusted portfolio returns, strengthen governance and accountability, address system-level risks and achieve sustainability outcomes.[1] The PRI considers that the 'one-share, one-vote' share structure is optimal for companies, as differential share ownership structures like DCSS hinder investors from attaining these objectives by restricting their voice and influence.

The proposed changes by the FCA could curtail escalation opportunities and undermine the impact of stewardship efforts. DCSS may also discourage engagement or disincentivise stewardship activities altogether. The resulting lack of opportunities to challenge management decisions could weaken accountability mechanisms and have a detrimental effect on governance quality and business success.

For instance, differential voting rights in large technology companies in the US have negatively impacted minority shareholders' leverage and rendered engagement ineffective, as evidenced by the PRI's collaborative engagement focused on improving tax transparency in those companies.[2]

Furthermore, academic research and the International Corporate Governance Network (ICGN) [3,4] indicate that DCSS do not benefit minority investors or companies in the long term, contradicting claims that they foster a better environment for long-term planning and execution. Companies with DCSS often exhibit lower governance quality, as highlighted by academic studies.[5]

Where DCCS are in place, we recommend implementing clear mechanisms that ensure accountability, transparency, and a transition away from DCSS while preserving company value and shareholder rights. In this context, we suggest **maintaining the current five-year sunset period**, considering the likely diminishing benefits of DCSS post-IPO[6] and the potential for value deterioration[7], as opposed to the proposed 10-year threshold by the FCA.

Audit requirements

We recommend maintaining the listing eligibility requirement for companies to have three years of audited historical financial information that represents at least 75% of the issuer's business. While there may be some challenges and costs associated with meeting audit requirements for companies,[8] the benefits of transparent financial information, historical perspective, and alignment with global standards outweigh these concerns. It is in the best interest of companies to adopt transparent and consistent accounting practices as this can enhance their credibility, attract a wider investor base, and ultimately benefit from increased access to capital and growth opportunities.

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[1] PRI (2023), How policy makers can implement reforms for a sustainable financial system: stewardship
[2] PRI (2020), Engagement on tax transparency: outcomes report
[3] ICGN (2020), UK Listings Review Call for Evidence
[4] ICGN (2017), Differential share ownership structures: mitigating private benefits of control at the expense of minority shareholders.
[5] Larcker, D. and Tayan, B. (2016), Corporate Governance Matters. Retrieved from: ICGN (2017), Differential share ownership structures: mitigating private benefits of control at the expense of minority shareholders
[6] Bebchuk, L. A., and Kastiel, K. (2017), The Untenable Case for Perpetual Dual-Class Stock
[7] SEC's Commissioner Robert J. Jackson Jr. (2018), Perpetual Dual-Class Stock: The Case Against Corporate Royalty
[8] FCA (2023), CP23/10: Primary Markets Effectiveness Review: Feedback to DP22/2 and proposed equity listing rule reforms p. 92

Related Party Transactions (RPTs)

We recommend maintaining the requirement for mandatory independent shareholder approval of RPTs at or above the 5% threshold and related requirements for shareholder circulars. Removing this requirement diminishes investor protection and deprives shareholders of the opportunity to halt potentially harmful transactions.

This requirement holds even greater significance when it comes to RPTs involving controlling shareholders. Without adequate checks and balances, these transactions could lead to abuse of controlling power and the exploitative use of their privileged position within the ownership structure.

Significant Transactions

We recommend maintaining the requirement for mandatory independent shareholder approval of significant transactions at or above the 25% threshold and related requirements for shareholder circulars. This change could prevent investors from terminating potentially value-destructive transactions in portfolio companies. While some investors would still be able to engage on these transactions, it is likely that companies would be less receptive to investor asks in the absence of a mandatory vote. We believe voting on significant transactions is fundamental for securing investor interests and improving accountability, given that these transactions have a profound impact on long term value and sustainability. We, therefore, strongly urge the FCA to reconsider.

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI is now a not-for-profit company with over 5,000 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles with approximately US $121 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.