Polishing the family silver

Response to the FSA's Consultation Paper CP12/25 – *Enhancing the effectiveness of the Listing Regime*

November 2012

Structure of the response

RAID's response to FSA's Consultation Paper CP12/25 – *Enhancing the effectiveness of the Listing Regime*is informed by our detailed research into London-traded mining companies and regulatory compliance. An introductory section (I) provides the perspective from which we our commenting, including the need for fundamental regulatory reform to encompass determining the suitability of applicants for a listing, the need to scrutinise implementation, and the need to simultaneously address compliance and standards 'downstream' in junior markets. Our specific comments (II) on the FSA's proposals to enhance the effectiveness of the Listing Regime are informed and qualified by these overarching views on wider reform. Our response ends with (III) concluding observations. For convenience, a table summarises our responses to a number of the questions posed in the consultation.

I.Introduction: RAID's perspective on regulatory reform

RAID promotes respect for human rights and responsible conduct by companies abroad and is along-standing contributor to the debate on corporate conduct during and after the devastating war in Democratic Republic of Congo (DRC). In July 2012, RAID produced a report *Asset Laundering and AIM: Congo, corporate misconduct and the market value of human rights,* based upon an earlier highly detailed complaint submitted to the London Stock Exchange and Financial Services Authority (FSA) concerning regulatory compliance of certain London-traded mining companies.[1]RAID's response to the FSA's Consultation Paper CP12/25 is informed by this work. Whilst our focus has been upon the Alternative Investment Market (AIM), wider lessons with pertinence for the main market arise from the work.

[1] RAID, *Asset Laundering and AIM: Congo, corporate misconduct and the market value of human rights*, July 2012, available at: <http://raid-uk.org/docs/AIM/AIM_Report_2012.pdf>.

Premium standards based on tarnished assets

Poor governance issues and misconduct concerning London-listed mining companies – such as Eurasian Natural Resources Corporation (ENRC) and Bumi plc – have damaged London's reputation and resulted in the FSA's current and recent proposals on more effective listing rules.[2]

It is our experience that the controversies surrounding mining companies with Congolese mining assets traded on AIM ultimately became problematic for – and will continue to affect the reputation of – the main market. A case in point is the acquisition of the Central African Mining Company (the subject of a detailed complaint submitted by RAID to AIM Regulation and the FSA in May 2011) by ENRC.[3]It is our experience that failures of due diligence, misapplication of the class tests, and breaches of disclosure rules under the AIM regime have allowed assets derived from conflict and weak governance zones to be traded and attract capital investment on the junior market before being transferred (by acquisition) to the main market. This process is akin to asset laundering and threatens to contaminate and damage the reputation of the main market.

Yet to enhance the effectiveness of the Listing Regime at one end of the spectrum, with an onus upon the premium segment, runs the risk of widening the gulf between standards in this segment and what is deemed acceptable conduct in the less rigorously regulated markets – unless steps are simultaneously taken to tighten compliance and raise standards in the latter.[4] Indeed, unless these failings 'downstream' are also addressed, the message sent is that high standards in corporate conduct are only required and brought to bear after tainted assets have already been nurtured under a junior market regime which is *laissez-faire* by design.

The need for a fundamental shift in regulation

Whilst RAID welcomes some of the FSA's proposals to tighten regulations in respect of governance issues, we disagree with the FSA's judgement that problems have arisen merely because of 'misaligned behaviour'; rather, it is our view that recent failures are symptomatic of the need for a fundamental shift in the current regulatory framework. There are two aspects to this shift: a move away from a culture that supresses instances of non-compliance, requiring the transparent implementation of existing rules; and an assessment of the suitability of companies applying for or retaining a listing.

Neglecting compliance

Many of the areas of regulation discussed in CP12/25, such as the influence of controlling shareholders, meaningful continuing obligations, disclosure of better quality information, are common to both the junior and main market. At issue, of course, is the degree to which these areas of regulation apply or the thresholds at which they take effect. Our research suggests that companies are failing to meet even the lower standards of due diligence, disclosure and application of the class tests governing the junior market. As requirements rise in the standard and premium segments, a key concern is whether there is a corresponding rise in compliance with these standards.

Many of the breaches of AIM Rules RAID identified in its complaint to AIM Regulation concerned

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[2] David Oakley, 'City watchdog to tighten listing rules', *Financial Times*, 2 October 2012.

[3] RAID, *Questions of Compliance: The Conduct of the Central African Mining & Exploration Company (CAMEC) plc and its Nominated Adviser, Seymour Pierce*, Submission to AIM Regulation, May 2011, available at: <http://raid-uk.org/docs/AIM/AIM_Submission_2011.pdf>.

[4] The ULKA is the FSA acting in its capacity to admit securities to the Official List. A listing is required to trade on the London Stock Exchange's Main Market. Furthermore, the Official List is divided into Premium and Standard Listing categories which govern the rights and obligations of issuers in each category. A Premium listing requires higher standards and imposes additional obligations on issuers.

either a failure to implement existing rules or where rules applicable at admission did not engender continuing obligations. Many of the lessons learned from such failures transfer across to the main market. RAID therefore welcomes FSA proposals to ensure, for example, eligibility criteria attached to a standard or premium listing require on-going compliance.

However, whilst also appreciating the value in adding further specificity to improve the effectiveness of the listing rules, our concern is that the day-to-day implementation of the rules will not necessarily improve without increased oversight by the FSA – either directly, or through the increased scrutiny of sponsors.

RAID has little confidence that the FSA's proposed and recent changes to the listing rules will be rigourously implemented unless both monitoring and disciplinary procedures are also strengthened to deal effectively with non-compliance by sponsors and companies. It has been RAID's overwhelming experience that complaints concerning multiple rule breaches – even when these are public knowledge – are dealt with behind closed doors in an entirely secretive, opaque and unaccountable process to the extent that it is not known whether an investigation has been commenced or is progressing. Most significantly, it would appear the decision of the regulator to take no public action over an alleged breachneither requires justification nor is even communicated to the complainant. This ultimately denies all parties a resolution; allegations hang over companies and their advisers and the public interest remains unsatisfied, leaving only the suspicion that valid complaints have been swept under the carpet or buried by consent orders.

Human rights and market integrity:moving beyond shareholder disclosure to assess suitability

RAID recognises from AIM the trend identified by the FSA in the main market that 'the type of companies that have been causing concern in the area of free float and corporate governance, i.e. companies with an overseas asset base controlled by a majority shareholder, would appear to represent a sizeable proportion of the companies coming to conduct an IPO in London, and we have no reason to believe that this trend will be reversed in the near future.' However, having examined the strategies of archetypal companies on the junior market and participants in the main-market, such as ENRC, we disagree with the FSA's assertion that failure of compliance 'arises largely from a lack of understanding about what good corporate governance behaviour looks like in practice' and its characterisation as 'misaligned behaviour'. Certainly, in our experience of the junior market, there has been a culture of deliberate non-compliance compounded by failures to implement the rules and to bring disciplinary action.

Against this backdrop, the wisdom of the decision to reject a fundamental reappraisal of the FSA's approach must be questioned given the potential harm that threatens London's reputation as a market based on high standards and integrity.

The FSA asserts that it does 'not believe that it is the role of the UKLA [UK Listing Authority] to make judgements about the suitability of issuers'. Yet such a *laissez-faire* approach, based solely on adequate disclosure and the belief that shareholders will use the information at their disposal to make the right decisions as regards suitability, risks sustaining the fallacy that the market is insulated from wider public concerns. It is no longer credible to argue that disclosure to shareholders will alone provide a mechanism whereby market integrity is protected: it is not the case that London's reputation can emerge unscathed when listed or traded companies use the markets to launder conflict-derived assets or raise capital to do business in countries such as the DRC, which have an appalling human rights record and high levels of corruption. The markets and the FSA as their ultimate regulator must recognize not only the moral bankruptcy of this position, but the damage that accrues to a market regime condemned for facilitating the neglect of human rights and the laundering of assets. Competitiveness is enhanced by attractiveness, but whilst London may continue to attract companies

with tainted assets to its markets, this may be at the cost of losing *bona fide* companies that do not wish to be tarred by association.

Our work strongly suggests that current market regulations often neither constrain nor enable respect for human rights; rather, human rights must first impact upon the market before the regulations are called into play. This can lead to an anomalous situation whereby relationships between ruling elites and corporate figures/entities in weak governance zones – relationships condemned by UN bodies concerned with combating exploitation and sanctions violations and with protecting human rights – are the same relationships welcomed by industry analysts, because they provide political capital and risk insurance, thereby enhancing market value.Allied to the question of suitability, the question of adequate safeguards in such circumstances has not been addressed by the FSA in its current proposals: no reference is made to due diligence on human rights issues, either in respect of the background of a company's directors or managerial staff or the provenance of its assets.

It should be recalled that the UN Guiding Principles on Business and Human Rights recognise the heightened risk of gross human rights violations in conflict-affected areas and call upon States to review whether their policies, regulations and enforcement measures effectively address this risk; and also confirm the State's duty to 'enforce laws that are aimed at, or have the effect of, requiring business enterprises to respect human rights, and periodically to assess the adequacy of such laws and address any gaps'; and to '[e]nsure that other laws and policies governing the creation and ongoing operation of business enterprises, such as corporate law, do not constrain but enable business respect for human rights'.[5] It is against this benchmark that the FSA's current proposals on listing reforms should also be judged.

II. Addressing the FSA's proposals in the absence of fundamental reform

Notwithstanding RAID's fundamental position on the need to scrutinise implementation, the need to simultaneously address compliance and standards 'downstream', and the reinstatement of the agenda for wholesale reform that arises from both these needs, RAID has a number of specific comments on the proposals put forward in CP12/25.

Independent business

RAID supports the proposal to reinstate the express provision that a premium listed issuermust be capable of acting independently of a controlling shareholder and its associates, allied to the need to give due consideration of concert party agreements 'given the potential for arrangements to bedeliberately structured to evade these requirements.' However, given the plethora of formal and informal agreements/arrangements for acting in concert that exist and the financial benefits to sponsors accruing from a successful application, we believe that reliance on the sponsor (under the declaration) to make this judgement ought to be supplemented by independent scrutiny by the UKLA.

As recognised in the FSA's proposals, decisions at the eligibility stage cannot easily be undone. It is crucial to correctly identify and verify controlling relationships as this will dictate whether safeguards in the form of relationship agreements and their disclosure will apply at all.

Control of business

[5] United Nations, Human Rights Council, 'Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework', *Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises*, A/HRC/17/31, 21 March 2011. See, I. The State duty to protect human rights, B. Operational principles, respectively, General State regulatory and policy functions, 3 (a) and (b); and Supporting business respect for human rights in conflict-affected areas, 7.

We support the requirement that an applicant to the premium segment must control its business and the requirement that this control should continue beyond the point of entry as a continuing obligation. We share the FSA's unease whereby the lack of control over entities within the track record affects the financial information presented and therefore support the FSA's powers to reject a premium listing in this circumstance.However, 6.1.3EG (7) should be revised to replace 'majority' with 'significant part': 'non-controlled interests have represented a significant part~~the majority~~ of the new applicant's...'

Independence of directors

We prefer Option 1 under paragraph 7.88, i.e., a departure from the 'comply or explain'principleto the requirement of a board comprising a majority of independent directors or independent Chair and independent directors making up at least half the board.

RAID supports the proposal to ensure the protection of the independence of directors is a continuing obligation.

On the election of independent directors, RAID agrees with the proposed dual voting structure, but disagrees with ultimate determination on a simple majority basis. Whilst recognising that the 90 day cooling-off period should help resolve conflicting opinion between all shareholders (including controlling shareholders) and independent shareholders, the second round should also adopt a dual voting structure. If dialogue between all shareholders and independent shareholders has been successful, the second dual vote should prove unproblematic. However, a final vote on a simple majority basis continues to risk influence of the election by a controlling shareholder.

Application of proposals to mineral companies

RAID supports the proposals outlined in Q22 to subject mineral companies to the requirements to carry on an independent business as well as the requirement to have in place a relationship agreement, majority independent board and procedures for election of independent directors as described in LR 9 where the new applicant mineral company has a controlling shareholder. Moreover, we agree that these requirements should constitute continuing obligations.

Shares in public hands

RAID is concerned that the FSA has taken the position that the free-float requirement should be based solely on liquidity. Whilst recognising that the amount of shares in public hands acts as counter-balance to dominant shareholder and the fact that all buy side respondents argued that it is imperative to turn the free float into an acknowledged tool for ensuring effective corporate governance, the FSA has chosen to listen to the sell-side respondents mindful of damaging London's attractiveness to issuers. The FSA has not given reasons for its decision, which therefore appears as an assertion. No consideration is given to the damage to London's reputation caused by examples of poor governance and how this dissuades potential applicants.

Indeed, the position adopted by the FSA not only precludes significant changes to the existing free-float requirements for premium issuers, but also proposes relaxing free float requirements in the standard segment. RAID does not support the admission of securities with very low free floats to the standard segment (7.111 and Q28). RAID can see merit in ensuring that free-float requirements should be applied on a continuing basis, notwithstanding our concerns over the requirements themselves. RAID does support proposals to notify non-compliance with free-float requirements without delay (Q34) and to tighten cancellation and transfer procedures out of the premium section when free-float requirements and broader listing obligations are no longer met (Q35). RAID also supports the

tightening of voting rules in the premium segment (7.119 and Q32) with the caveat that such revisions should also apply to the standard segment. Proposals to include all disclosure items in a dedicated section in the annual report and to better capture the disclosure of smaller related party transactions are welcomed.

The Listing Principles

RAID welcomes the application of Listing Principles 2 (systems and controls) and 6 (open and cooperative dealing with the FSA) to the standard segment (Q41). RAID also supports the re-stated Premium Listing Principles, with the caveat that we see no reason why elements of these principles cannot be applied to the standard segment.

III. Concluding observations on the FSA's rejection of meaningful reform

The FSA's inclusion of a final section in the consultation on other amendments considered brings us full circle and back to the fundamental lessons to reform market regulation that RAID advocates.

RAID remains deeply concerned that certain wholesale amendments have been rejected by the FSA, including the probation period for a move from the standard to premium segment and a UKLA quality committee. The reasons given – that the FSA does not believe its role is to make subjective, qualitative judgements on suitability, thereby removing transparency and certainty – leaves open both the possibility that applicants will be admitted who will subsequently harm London's reputation and makes it more likely that moves to block unacceptable applicants will continue to occur behind closed doors. Our experience of examining AIM admissions shows, for example, that a company dealing in conflict diamonds was blocked from admission through pressure from the UK authorities to persuade its nomad to withdraw. This process, totally lacking in transparency, was also devoid of accountability and consistency. Other AIM applicants with precisely the same provenance in conflict assets were later allowed to trade and thrive on AIM.

The FSA has missed the opportunity to establish an open and accountable mechanism to block inherently unsuitable applicants, a mechanism which is entirely consistent with the UKLA's overarching power to refuse admission based on potential investor detriment and its objective to maintain market integrity.

The position adopted by the FSA sends the message that it will more than tolerate the admission of companies with assets derived from circumstances of weak governance, conflict and human rights abuse, preferring to leave such considerations to shareholders and the market, whose judgement is driven by the extent to which human rights impinge upon market value.

Our detailed analysis of certain AIM companies shows how this strategy is both morally bankrupt and jeopardises the market: in the case of CAMEC, failures to reveal illicit original ownership of its mining assets arising from the DRC conflict resulted in the company at one point losing its mining licences, with a consequent collapse in its share price.

Once admitted to trade however, it would appear that the response of the AIM authorities has been to turn a blind-eye to non-compliance by company or nomad. It is for this reason that RAID, while welcoming FSA proposals to tighten eligibility criteria and extend this to continuing obligations, ultimately views the consultation as flawed:

- concentration on standards in the premium segment neglects conduct in markets 'downstream' and thereby permits and even legitimises lower standards, failures of due diligence and,

ultimately, asset laundering

- even in the standard and premium segments, the failure to introduce any degree of qualitative control leaves London's reputation as market based upon integrity sorely exposed;

- finally, there is little in the proposals to improve the efficacy of implementation; rather measures to reinforce the obligations of sponsors or subject them to closer scrutiny and supervision have been rejected: "Given the nature of the confirmations required from sponsors already and the rules proposed to apply to issuers, we do not see the need to impose a further requirement on the sponsor....Furthermore, we believe that the imposition of further responsibilities here would serve to discourage firms from undertaking sponsor services and therefore risks reducing the choice that issuers currently have.' This stance causes us considerable alarm given that, even in relation to the junior AIM market, our complaint on compliance by CAMEC's nominated adviser has not been publicly dealt with by the authorities.

Summary of answers to the questions posed in CP12/25

Please note that RAID has not answered or commented upon all of the questions posed under the consultation.

FSA question	RAID's response	Qualification/comment
Q2: Do you support our proposal in LR 6.1.4ER(1) to require new applicants where a controlling shareholder is present to enter into a relationship agreement?	Yes	
Q3: Do you support our proposal in LR 6.1.4FR to require that a relationship agreement must cover certain provisions as described above? Do you think that there are any other provisions that should be considered and if so what are they?	Yes	
Q4: Do you agree with our proposal in LR 9.2.2AR(1) that where a company has a controlling shareholder it must have in place a relationship agreement at all times?	Yes	
Q5: Do you support our proposal to subject a listed company to a continuing obligation to comply with a relationship agreement at all times (LR 9.2.2GR)?	Yes	
Q6: Do you support our proposal that a listed company must at all times comply with the content requirements for a relationship agreement as set out in LR 6.1.4FR, where applicable (LR 9.2.2AR(1))?	Yes	
Q9: Do you support our proposal to require a listed company to disclose the current relationship agreement in the annual report (LR 9.8.4R(15))?	Yes	
Q11: Do you agree with our proposals to amend LR 9.8.4R to include an obligation to make a statement on the compliance of the listed company with the relationship agreement (LR 9.8.4R(14)) as described above?	Yes	
Q13: Do you agree with the proposal to amend the requirement for control of assets to control of business (LR 6.1.4AR)?	Yes	
Q14: Do you agree that the proposed guidance (LR 6.1.4BG) regarding control of business? Do you think that there are any other indicators that should be considered and if so what are they?	Yes Qualified	Add to LR 6.1.4BG: 'This list of factors and situations is not exhaustive. Other factors and situations that indicate a lack of unfettered ability to implement business strategy and control may also be considered.'
Q15: Do you agree with our proposal to supplement guidance in LR 6.1.3EG(7) as set out above?	Yes Qualified	6.1.3EG (7) should be revised to replace 'the majority' with 'a significant part': 'non-controlled interests have represented a significant part~~the majority~~ of the new applicant's...'
Q16: Do you agree that control of business should be demonstrated at admission and on continuous basis rather than for the entire period covered by the historical financial information? If not, then please outline your thoughts on the way in which control of business should be demonstrated.	Yes Qualified	See change above to capture control of a significant part cf. majority of the business. Agree that control should be demonstrated on a continuous basis.
Q17: Do you agree with Option 1 or Option 2 above?	Option 1	
Q19: Do you support our proposal to extend the requirement for board composition as set out in LR 6.1.4ER(2) as a continuing obligation (LR 9.2.2AR(1))?	Yes	
Q21: Do you support our proposal for election of independent directors by two rounds of voting as described above (LR 6.1.4ER(3), LR 9.2.2ER and LR 9.2.2FR)?	Yes Qualified	Agree with the dual voting structure, but disagree with ultimate determination on a simple majority basis.

Q22: Do you support our proposal to amend LR 6.1.9R to subject mineral companies to the requirement to demonstrate the ability to carry on an independent business together with additional requirements where a controlling shareholder is present? If you do not support this proposal, please outline your reasons for doing so.	Yes	
Q23: Do you support our proposal to subject a mineral company to a continuing obligation to comply with LR 6.1.4CR, and if applicable, LR 6.1.4ER and LR 6.1.4FR at all times (LR 9.2.2AR(2))?	Yes	
Q28: Do you support our approach to companies wishing to list on the standard segment as described above?	No	RAID does not support the admission of securities with very low free floats to the standard segment
Q32: Do you support our proposal in LR 6.1.25R and LR 9.2.22R to require that where a shareholder vote must be taken under the provisions of LR 5.2, LR 5.4A, LR 9.2.2CR, LR 9.4, LR 9.5, LR 10, LR 11, LR 12 or LR 15, such votes must be decided by a resolution of the holders of premium listed shares as discussed above?	Yes Qualified	Caveat that such revisions should also apply to the standard segment.
Q34: Do you support our proposal to delete LR 9.2.16R and replace it with a requirement in LR 9.2.24R for a listed company to notify any non compliance with continuing obligations as set out in LR 9.2 to the FSA without delay?	Yes	
Q35: Do you support our proposal to delete LR 9.2.17G and replace it with guidance in LR 9.2.25G to consider LR 5.2.2G(2) and LR 5.4A.16G in relation to its compliance with the continuing obligations as set out in LR 9.2?	Yes	
Q36: Do you support our proposal to amend LR 9.8.4R to require a listed company to disclose all matters that need to be disclosed under LR 9.8.4R in the annual report and accounts in a single identifiable section?	Yes	
Q37: Do you support our proposal to amend LR 9.8.4R(3) to extend the period of time over which disclosure of smaller related party transactions as required by LR 11.1.10R(2)(c) should be included in the annual report and accounts to include comparative information for the previous 2 financial years?	Yes	
Q38: Do you support our proposal to amend LR 11.1.10R(2)(c) to set out minimum disclosure requirements that need to be set out in the listed company's next published annual accounts as described above? Do you think that there are other factors relating to the smaller related party transaction that should be subject to disclosure requirements in the company's next published annual accounts and if so what are they?	Yes	
Q40: Do you agree with our proposal to amend LR 7.1.1R to make Listing Principles applicable to standard listed issuers?	Yes	
Q41: Do you support our proposal to amend LR 7.2.1R as described above? If not please provide an explanation for objection to each principle.	Yes Qualified	Caveat that we see no reason why elements of other principles cannot also be applied to the standard segment.
Q42: Do you support our proposal to amend the guidance in LR 7.2.2G and 7.2.3G to enable the application of the guidance to the relevant Principles?	Yes Qualified	See qualification to Q41, above.
Q43: Do you support our proposal to amend LR 9.8.6R(5) by including a specific disclosure obligation on the application of Principle B4 of the Code along with the accompanying guidance in LR 9.8.6BG?	Yes Qualified	Should also apply to the standard segment.