Capital Markets and Corporate Governance Standards

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1. Introduction

This chapter deals with the relationship between listing on public markets and corporate governance standards. It focuses primarily on the UK capital markets but occasionally references developments in other jurisdictions so as to place the UK in a global context. While the focus on the UK limits the extent to which the analytical framework and conclusions can be applied more broadly, it also carries some benefits. In the first instance, it allows for a more detailed analysis of a single system as an example of how the objectives and evolution of listing rules and corporate governance have overlapped as the theory and practice of corporate governance has developed. Furthermore, as a major international capital market and a leader in the development of corporate governance codes, UK practice has been influential globally[1], while there are also examples of the UK borrowing and adapting from other systems.

The chapter begins from the observation that corporate governance was not a significant concern for listing rules in the UK for most of the twentieth century. That observation remains true even if account is taken of the fact that the term 'corporate governance' was not widely known in the UK prior to the development of the Cadbury Code in the early 1990s. There were provisions in the Listing Rules of the London Stock Exchange prior to that time which went beyond the prevailing corporate law, but they were less systematic in their treatment of key governance issues than those which followed later. That broad trend, evident also in the US albeit with some timing differences, can be attributed to two factors: the key focus of early securities regulation on disclosure as the primary technique for investor protection; and the phase of so-called 'managerial capitalism' during the post-war years, in which shareholders adopted a largely passive stance towards the running of listed companies.[2] The emergence of 'corporate governance' as a discourse and practice represented a change of focus in which shareholder interest came more directly into focus in terms of its links to the structure, composition and decision-making of the board of directors.

Nevertheless, disclosure remains the primary focus of the listing regime and so some preliminary comments on the relationship between disclosure and corporate governance is appropriate. In principle, disclosure can be viewed as a technique to distribute private

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[1] MacNeil and Esser (2022)
[2] Cheffins (2015). The UK lagged behind the US, where the NYSE Listing Rules required independent directors for boards of listed companies from 1977.

information and thereby improve the capacity of investors to monitor board decision-making.[3] Thus, enhanced disclosure could be expected to mitigate agency costs in both its forms - between shareholders and directors and between controlling shareholders and minority shareholders. As a result, enhanced disclosure could also have the potential to reduce the cost of capital, especially if combined with strong minority shareholder protection in corporate law. Although the empirical evidence for these effects is not conclusive, it seems clear that the general policy of listing rules to expand the requirements of corporate law regarding disclosure has a positive impact on corporate governance. Our approach is to take that as given and to focus on aspects of the listing rules that go beyond disclosure as a regulatory technique. Thus, our main focus is on how listing rules affect the structure, composition and operation of the board and how they adjust the process for making key decisions by comparison with the default arrangements in UK corporate law. In that sense, our analysis represents a broader application of the claim made in connection with cross-listing of overseas companies that the process of listing represents a form of voluntary 'bonding' to higher corporate governance standards.[4]

We approach the relationship between listing rules and corporate governance by focusing on three key interactions. The first is the interaction between listing rules and the UK Corporate Governance Code (UKCGC). The second is the impact of listing rules on the balance of power between shareholders and directors. The third is the impact of listing rules on the role of controlling shareholders and the protection of minority shareholders. Whereas the first interaction implicates the role of soft law codes in the UK and other systems which have followed that approach[5], the second and third interactions run parallel to the corporate law focus on agency costs – as between shareholders and directors and majority and minority shareholders respectively.[6] Our focus is primarily on the 'official list' comprising the premium and standard listing segments, which was linked to the EU 'regulated markets' regime while the UK was still a member of the EU.

We then integrate into that approach a secondary focus on the types of rules through which the listing rules focus specifically on corporate governance. As regards the first interaction (listing rules and the UKCGC), the 'comply or explain' approach that is central to the Code means that disclosure and market discipline are relied on to secure compliance. That reflects also the self-regulatory history of the UKCGC and the investor-led approach to its evolution and enforcement. In the case of the second and third interactions however, there is more diversity in the rule type. In this context we refer to two instances of shareholder approval requirements (significant transactions and related party transactions); one instance of a mandated agreement between shareholders (controlling shareholder agreements); one instance of control over capital structure (dual class shares); and finally, one instance of soft-law controls (pre-emption guidance) operating in tandem with related rules on share issues. Viewed in that light, there is some diversity in the type of listing rules that engage directly with

[3] Coffee (1984); Bueselinck *et al* (2013).
[4] Licht (1998). Implicit in that claim is an expectation that 'bonding' will lead to a higher share price.
[5] MacNeil & Esser (2021).
[6] Kraakman et al (2009) chapter 4.

corporate governance. The association between a UK listing (at least on the premium segment) and the 'comply or explain' approach to corporate governance captures an important element of the interaction but requires to be supplemented by reference to the significant role of these other types of rules.

2. Background and Context

We now set out some key aspects of the nature and evolution of capital markets and corporate governance in the UK so as to provide some context within which the linkage between the two has developed more recently. Some of these influences have a relatively long history, dating back to the 19th century, while others, such as the influence exerted by EU harmonisation, are more recent.

Two characteristics of UK company law[7] have been particularly influential. One is the degree of flexibility that results from the widespread use of default rules and the (resulting) limitation in the role of mandatory rules. The best example is the default articles of association, which deal with many issues (such as the powers of the board of directors and its mode of operation) that are often found in statutory corporate law in other systems. Another characteristic is the high degree of shareholder control that is provided for by corporate law: examples include the power to remove directors at any time without cause, to approve the issue of shares and to approve certain transactions between directors or their associates and the company. That approach is reinforced by the 'delegation' model through which the powers of directors are framed in UK company law, meaning that the shareholders are understood to delegate powers to directors rather than having them set by corporate law.[8]

The self-regulatory ethos evident in corporate law is also evident in the development of capital market regulation. If anything, the trend is even stronger as there was no real statutory regulation of much of the infrastructure of capital markets in the UK until the so-called 'Big Bang' reforms introduced by the Financial Services Act 1986. Listing rules were the responsibility of the London Stock Exchange and investor protection remained part of company law, as had been the case since the landmark Joint Stock Companies Act 1844 which provided for registration of companies and separate legal personality. That approach, in tandem with the *de facto* principle of shareholder primacy in corporate law[9], facilitated a self-regulatory approach to corporate governance and was reflected in the emergence of shareholder collaboration via trade bodies such as the Institutional Shareholders Committee (ISC), the Investment Management Association (IMA), the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF).[10] While these trade bodies contributed to investor protection by developing self-regulatory standards covering matters

[7] The Companies Act 2006 applies across the United Kingdom (s1299). Earlier references to 'British' company law reflected a separate company law regime in Northern Ireland.
[8] Davies and Worthington (2012) p384.
[9] Sjåfjell and Taylor (2019).
[10] Jordan (2014) at 6.18.

such as pre-emption rights and directors' remuneration and supporting the principle of one share—one vote in the listing rules, the most significant self-regulatory development was likely the Cadbury Code of Corporate Governance, which eventually became the UKCGC.

Another important influence was the UK's membership of the EU from 1973 to 2020. That influence ran in both directions and while there were many aspects of the UK's approach that were adopted by the EU or by its members (such as 'comply or explain' governance codes), the legacy of the EU is still evident across UK company law and capital markets regulation. Thus, while some reforms are now underway in the context of listing,[11] prospectus requirements[12] and the facilitation of so-called Special Purpose Acquisition Vehicles ('SPACs'),[13] the basic architecture and terminology of UK capital markets owes much to the influence of the EU.

Moreover, so far as listing rules and corporate governance are concerned, so-called 'gold-plating' was an important element of UK implementation of EU law, meaning that in some instances higher standards were imposed than those required by EU law.[14] The rationale for the policy was that higher standards of investor protection (aligned with prior UK practice) promoted investor protection and thereby attracted listing business to London – an important consideration for a market that in its heyday was the pre-eminent destination for foreign listing, albeit that position has long since been lost to competitors. Brexit does of course mean that the EU legacy will likely be diluted over time even if to date there have been only limited moves in that direction. [15]

The UK listing regime falls under the regulatory oversight of the Financial Conduct Authority (FCA), which describes itself as the 'UK's securities regulator'. In the past, the FCA undertook that role under the title 'UK Listing Authority' but since 2017 that terminology has been phased out. The listing regime, viewed as whole, comprises three blocks: the Listing Rules (LR) which govern admission to listing and the obligations of listed companies; the Prospectus Regulation Rules sourcebook (PRR) which governs the prospectus requirements in connection with public offers and admission to trading on a regulated market; and the Disclosure Guidance and Transparency Rules sourcebook (DTR) which governs the disclosure regime for UK financial markets with a view to ensuring transparency in market operation. Our focus is primarily on the first block (LR) but reference is made also to the third block (DTR) where appropriate. In the text that follows we use the term 'listing regime' to refer to the regime as a whole whereas 'listing rules' is used to refer specifically to that block (LR).

[11] See the discussion below in sections 4 and 5.
[12] See FCA (2021b).
[13] The FCA Listing Rules no longer contain a presumption that listing is suspended upon announcement of a potential acquisition target by SPACs that meet certain criteria. See FCA 2021a. See further Payne and Perreira, chapter ? 'The future of the UK IPO'.
[14] This was despite a more general UK policy of 'copyout' from 2010 onwards whereby EU Directives were to be implemented by direct copying of provisions where possible to avoid going beyond EU minimum standards.
[15] An 'on-shoring' mechanism applies to EU legislation taking effect before the end of the Brexit transitional period (31 December 2020) under section 3 of the European Union (Withdrawal) Act 2018.

3. The interaction of the Listing Regime with the UK Corporate Governance Code

We now move on to examine how the UK listing regime links with the UK Corporate Governance Code (UKCGC). The UKCGC has its origins in a self-regulatory initiative that was closely linked to the London Stock Exchange but it remained separate from the listing regime and other forms of 'hard law' for some time.[16] We consider how the link to hard law developed and the manner in which it operates in the context of UK capital markets. In developing that perspective, we view the listing regime as a potential 'third tier' of (formal) regulation of corporate governance in which the first tier is represented by the general provisions of UK company law and the second tier by the provisions of UK company law applicable to public companies (only). The linkage of the listing regime to the UKCGC extends the historical pattern of self-regulatory influence by investors and opens up the potential for some flexibility in corporate governance in the light of the relatively limited regulation of key governance issues such as board structure and operation in UK company law.

The first version of the UKCGC was published in 1992 by the Cadbury Committee. It defined corporate governance as 'the system by which companies are directed and controlled.' Over the years the Code has been updated, revised and expanded and the current one is the 2018 version. The initial codes were drafted in response to various scandals and events and the focus of the codes, and the definition of corporate governance, have also changed over the years with the initial focus on accounting and financial issues evolving into a broader focus now encompassing diversity, stakeholders, and the accountability of the board.[17]

Having begun as a unitary set of provisions, the Code now comprises a set of principles and more detailed provisions. There are five principles dealing with: board leadership and company purpose; division of responsibilities; composition, succession and evaluation; audit, risk and internal control; and remuneration. Examples of provisions include the requirement to establish board committees to deal with: nominations for appointment to the board; audit risk and internal control; and remuneration.[18] Other than in the case of nominations (where a majority of members should be independent non-executives) these committees should comprise only independent directors. The emphasis on the role of independent non-executive directors can be traced back to the original Cadbury Code whereas more recent developments (such as diversity and stakeholder interests) mark a move away from the earlier shareholder-centric focus.

The Code's approach to compliance and reporting reflects its self-regulatory origins, as well as its focus on flexibility in corporate governance. It provides that the principles are to be implemented on an 'apply and explain' basis. In the case of the provisions, the more flexible

[16] See further MacNeil and Esser (2021).
[17] Ibid.
[18] See Provisions 17, 24 and 32 respectively. The requirement to have an audit committee is also found in the listing regime: see generally Rule 7.1.1 to Rule 7.1.7 of the Disclosure Guidance and Transparency Rules (DTR). That requirement originated from Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts [2006] L 157/87.

'comply or explain' approach is followed, meaning that a company has to comply with the relevant provision, and in case of non-compliance it has to be explained.[19]

Over time, however, the purely self-regulatory character of the Code has lessened as conformance with the Code has been required by the UK Listing Regime. Premium listed companies (including overseas companies) are required to include in their annual report a statement of how they have conformed with the code.[20] Conformance in this sense distinguishes between obligations attached to the principles of the code and its provisions. In the former case, premium listed companies are required to provide a statement explaining how the principles have been applied (so called 'apply and explain'). In the latter case, the 'comply or explain' principle is followed, with the result that conformance can take the form of non-compliance with the provision accompanied by an explanation of the reasons for non-compliance. There are no stipulations as to the nature of the explanations for non-compliance and the policy has been that this is a matter for shareholders rather than regulators, in line with the self-regulatory origins of the code. The overall effect for premium listed companies has been to require higher standards of corporate governance by comparison with the minimal requirements of UK company law. But it seems clear also that the objective of providing flexibility in governance through the Code has been frustrated by a tendency towards simple compliance, which has constrained the use of the 'explain' option in connection with alternative governance arrangements. Meanwhile, accountability to investors has suffered due to poor quality 'non-compliance' explanations, as valid reasons are not provided when alternative arrangements are adopted.[21]

Beyond premium listed companies, the regulatory regime requires a corporate governance statement from issuers of securities admitted to trading, thereby encompassing most standard listed companies.[22] That statement must include, inter alia, the corporate governance code to which the company is subject or has adopted, as well as all relevant information about the corporate governance practices applied over and above the requirements of national law. For a UK company, the corporate governance statement will usually also include disclosures made in compliance with requirements in the UKCGC. But for overseas companies, and in contrast to the premium listed segment, there is no obligation to conform to the UKCGC, nor even the code to which the company is subject (in its home jurisdiction). Thus, beyond the premium segment, the listing regime adopts a 'light touch' approach to corporate governance standards – in effect extending the longstanding policy of granting concessions to overseas listed companies and thereby limiting the extent of 'bonding' to higher corporate governance standards.[23]

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[19] Explanations should set out the background, provide a clear rationale for the action the company is taking, and explain the impact that the action has had.
[20] See FCA Handbook, LR 9.8.6(R)6 for the current requirements for premium listed companies.
[21] See FCA, Corporate Governance Disclosures by Listed Issuers (Nov 2020), referring to 'boilerplate disclosures' (p4).
[22] See DTR 7.2 and DTR 1B.1.5 for details of the corporate governance statement. These provisions are largely replicated in the London Stock Exchange's Admission and Disclosure Standards, rules B7 and B8.
[23] See generally MacNeil (2001).

4. The impact of the Listing Regime on the balance of power between shareholders and directors

We now consider how governance provisions in the UK listing regime alter the balance of power between shareholders and directors. In common with some other countries, the UK is generally characterised as adopting a shareholder primacy stance in this context.[24] This is evident in UK company law in the form of strong powers of dismissal and the reservation of a range of decisions to shareholders which have the effect of diluting the broad default powers of directors in the standard articles of association.[25] The UKCGC represents another step in that process through its control of the structure and composition of the board of directors. The principal techniques are the requirements relating to independent non-executive directors (INEDs) and their role on three key sub-committees of the board. These requirements amplify the influence of shareholders relative to executive directors by implementing the 'monitoring' model that has long been associated with INEDs and allocating key decisions to sub-committees with a majority of INEDs.[26]

The UKCGC deals with division of responsibilities under Chapter 2. Principle G deals with INEDs and states that the board should comprise of a combination of executive and non-executive directors. Principle H states that INEDs should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account. More details are provided in the provisions. At least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent (Provision 11). The board should identify in the annual report each non-executive director it considers to be independent (Provision 10). Circumstances which could have an impact on the independence are also listed and include, *inter alia*, being an employee of the company or group within the last five years; certain business relations, close family ties and so on. Non-executive directors have a prime role in appointing and removing executive directors (Provision 13). Open advertising and/or an external search consultancy should generally be used for the appointment of the chair and non-executive directors (Provision 20). It is clear that the INEDs are there to support the board, appraise their performance and to fulfil a supervisory and monitoring role.

We argued before[27] that board independence has been a central theme from the outset and has influenced the Code provisions on board structure and composition. This approach has always been based on the presumption that independent boards – those with a high proportion of members who are independent of the company – make better decisions. Evidence supporting that proposition, especially in the US where the tradition of independent directors was longer established, was already available in the 1990s and has generally remained influential, even if not conclusive.[28] Questions therefore remain as to the effectiveness of

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[24] Cabrelli and Esser (2018) Ch 12. They did however indicate that countries like France, Germany and the Netherlands lean more towards a stakeholder model, i.e. not focussed on shareholder or director primacy.
[25] See generally Davies and Worthington (2012) chapters 14 and 15.
[26] See Moore and Petrin (2017) chapter 7. This approach was evident in the Cadbury Code from the outset.
[27] See MacNeil and Esser (2021).
[28] Ibid.

NEDs, especially with regards to their independence[29] and the monitoring functions they provide.[30] Recent scandals have reinforced the impression that the presence of INEDS may be a necessary but not sufficient condition for good corporate governance.[31]

Independence on its own is therefore not sufficient, it has to be linked to the composition and diversity of the board more generally as well as the role of shareholders and stewardship more broadly. Research indicates that there is an 'expectations gap' between what INEDs think their role entails and how institutional shareholders view it, especially with regards to monitoring.[32] A report on what makes an exceptional INED was produced in 2012 listing the core characteristics of an INED as 'independence, courage and integrity, challenging but supportive, thoughtful communication and breadth of experience'.[33] The report concludes by stating that the ever-growing demands of responsible governance have resulted in a change in the role of INEDs, who need to be more engaged, technically competent and numerate. Independence can potentially prevent group think, protect stakeholders, prevent fraud and ensure risks are properly analysed, and the same arguments are also often made in the context of gender diverse boards. It is often argued that diverse boards will ensure better governance, but diversity is not just about gender diversity, it relates to diversity in skillsets, background and experience.

The listing regime takes forward the investor empowerment agenda by requiring shareholder approval in circumstances not required by company law. We focus on two key areas in which the listing regime alters the balance of power in favour of shareholders: significant transactions and the role of pre-emption rights in share issues. We adopt as our baseline for comparison the default articles of association for public companies, albeit that in some instances they may have been altered.

4.1 Shareholder Approval Rights – Significant Transactions

The default articles of association for a public company provide broad powers to the directors as they are authorised 'to exercise all the powers of the company'.[34] Company law requires shareholder approval for some transactions with directors[35] but, in line with the shareholder primacy ethos evident in UK capital markets, the listing rules go further in providing for shareholder oversight of significant transactions. The so-called 'class rules' operate by reference to the economic significance of transactions and require disclosure at the lower level

[29] See Moore and Petrin (2017) for a discussion of the US and UK approaches to independence.
[30] See FCA (2020) p4: 'we found it difficult to understand from the statement how issuers had applied Principle H (formerly Principle A.4) relating to non-executive directors providing constructive challenge'.
[31] Mayo (2022).
[32] Liu and Andersson (2014).
[33] Korn/Ferry Institute (2012).
[34] Companies (Registration) Regulations 2008, SI 2008/3014, Schedule 3, Model Articles for Public Companies, Article 3, 'Directors' general authority'.
[35] See CA 2006 Part 10, Chapter 4 and 4A. Approval is required *inter alia* for directors' long-term service agreements, substantial property transactions with directors and loans to directors.

(class 2) and approval at the higher level (class 1).[36] The rules do not apply to transactions in the ordinary course of business, nor to issues of securities or the raising of finance.[37]

Disclosure for class 2 transactions serves the purpose of informing the market of new developments outside the ordinary course of business. The required disclosure should permit the market to evaluate the effects of the transaction and thereby facilitate efficient price formation. In that sense market discipline is relied on to control directors' discretion through adjustment to the cost of capital. For class 1 transactions, in addition to the class 2 disclosure just mentioned, a circular (approved by the FCA) must also be issued to shareholders and their approval obtained in general meeting. The scale of class 1 transactions is such that they represent a material change to the nature of the business of a listed company, hence the perceived need for shareholder approval rather than just disclosure. The result is that directors' discretion to engage in strategic transactions (such as acquisitions and disposals) is curtailed by comparison with the position in UK company law.

4.2 Pre-emption rights – the role of directors and shareholders in share issues

UK company law generally provides directors with wide-ranging powers but they are limited in the case of new share issues. While a more liberal regime applies to private companies, directors of public companies can only issue shares if authorised to do so by the articles or by (ordinary) resolution.[38] Moreover, the issue of shares is further controlled by the principle of pre-emption and those controls take three forms: statutory provisions; listing rules; and self-regulatory controls.

The adoption of the Second EC Directive on Company Law in 1976 resulted in pre-emption rights becoming part of UK company law.[39] The effect is that new share issues of the same class must be offered first to existing shareholders, other than in the case of an issue for cash where the rule does not apply. The result is that shareholders are able to maintain their proportionate shareholding in the company and don't face the risk of dilution from new offers made to 'outsiders'. While the listing rules appear at first sight to remove the statutory exception for cash offers, they do so only subject to the control of shareholders over pre-emption rights. Thus, where shareholders disapply pre-emption rights through the statutory procedure, a listed company is exempt both from statutory pre-emption rights and the additional listing rule with respect to cash offers.[40]

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[36] See LR 10.2 (Classifying Transactions) for further details on the class tests, which operate by reference to percentage ratios of the value of the transaction in comparison with the listed company entering the transaction. A class 2 transaction is where any percentage ratio is more than 5% but less than 25%; and a class 1 transaction is where any percentage ratio is 25% or more.

[37] See LR 10.1.3 (Meaning of Transaction) for further details.

[38] CA 2006, s549 and s551.

[39] See further MacNeil (2002), noting that pre-emption rights are generally not recognised by the default rules of corporate law in the US.

[40] See LR 9.3.11-12R, referencing the relevant provisions of the CA 2006. Note also, LR 6.9.2, requiring a premium listed company incorporated outside the UK (an overseas company) to ensure that its constitution provides rights equivalent to these listing rules.

However, self-regulation in the form of guidelines developed by institutional investors[41] limits the extent to which premium listed companies can make share issues for cash other than on a pre-emptive basis. As a general rule, approval for such issues in the form of a general disapplication sought at the annual general meeting will be limited to 5% of the issued ordinary share capital. There are also controls over the price at which an issue can be made.[42]

The overall impact of these rules is firstly to protect shareholders from dilution in their proportionate shareholding and voting power. Linked to that is the risk of financial dilution from a share issue made to outsiders at a discount to the prevailing market price. But the three forms of regulation mentioned above also combine to limit the power of directors to issue shares to 'outsiders' to raise cash. That represents a form of control over opportunistic deal-making, which might well otherwise be funded by such issues. Whether that outcome represents the best balance between the facilitation of entrepreneurial deal-making by directors and oversight by shareholders is debatable but the nature and structure of the controls certainly align with the shareholder primacy tendency of UK company law and capital markets.[43]

5. The impact of the Listing Regime on the role of controlling shareholders and the protection of minority shareholders

In this section we evaluate the implications of three aspects of the listing regime that are linked to concerns over the potential abuse of the powers of controlling shareholders, and the protection of minority shareholders. While equality between shareholders of the same class has been a longstanding principle of the listing rules, minority shareholder protection has not been a major concern. Two reasons largely explain that outcome. The first is that UK company law has relatively strong minority protection provisions.[44] The second is that share ownership in the UK market has tended to be relatively dispersed and therefore the potential concerns that might arise from the presence of controlling shareholders in listed companies were generally not present in the UK.

As regards the UKCGC, its provisions on the composition of the board and the appointment of the chair insulate the operation of the board to some extent from the influence of a controlling shareholder.[45] At least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent.[46] The chair should be independent on appointment and the roles of chair and chief executive should not be exercised by the same

[41] Pre-Emption Group (2015).
[42] LR 9.5.10.
[43] See further the Hill Review (2021) at p46 noting that the pre-emption rights were relaxed during the pandemic but that institutional investors were unwilling to do so on a permanent basis.
[44] Lele and Siems (2007).
[45] See generally Reddy (2018).
[46] UKCGC Provision 11.

individual.[47] Moreover, independence in this context encompasses, inter alia, representing a significant shareholder (a lower threshold than a controlling shareholder).

So far as the listing rules are concerned, regulation of related party transactions did address concerns over abuse of power, but minority protection became a more prominent concern as companies with controlling shareholders (particularly in the mining sector) were attracted to list in London and attention focused on the potential abuse of majority voting power. Changes were made to the listing rules in 2014 to address this issue. More recently, minority protection concerns were triggered by the global rise of so-called 'dual class' share structures, which provide for enhanced voting rights for different classes of shares, often with the objective of preserving the control of founders following a public offer. Ultimately, the UK policy of resisting dual class shares was relaxed on the basis that it was necessary to protect the global competitive position of the UK capital market.

5.1 Related Party Transactions

Related party transactions ('RPTs') open the potential for abuse of power by controlling shareholders who may use their influence to divert assets and opportunities to related parties.[48] The Companies Act 2006 and the common law focus on controlling RPTs with directors, although shareholders can fall within the category of 'shadow directors', which was included in 2015.[49] Beyond that, company law did not address RPTs with shareholders.

The listing rules, however, do regulate RPTs with shareholders. The main technique is disclosure and only large RPTs are subject to approval.[50] We focus on approval here as a technique that implicates governance more instrumentally than disclosure, which is more directly linked to market efficiency in the pricing of securities. The relevant listing rules apply to companies with a premium listing while parallel provisions in the DTR Handbook expand the regime in line with the Shareholder Rights Directive to include standard listing and admission to trading on a regulated market.[51] The purpose is stated to be that 'The safeguards are intended to prevent a related party from taking advantage of its position and also to prevent any perception that it may have done so.' The definition of a related party focuses on 'substantial shareholders' with a shareholding of 10% or more, as well as directors, persons exercising significant influence and associates of any of these.[52] An important exclusion from the RPT regime is transactions 'in the ordinary course of business',[53] which are presumed to be subject to the normalisation tendency of market discipline with regard to pricing and terms. In the case of RPTs requiring approval, a circular must be sent to shareholders and their

[47] UKCGC Provision 9.
[48] See generally Reddy (2018).
[49] CA 2006 s177 and s170(5).
[50] See LR 11.1.7 and 11.1.10. Disclosure is triggered at the threshold of 0.25% of economic value and approval at 5%. Disclosure must be accompanied by a fairness opinion provided by the sponsor. But the value of that opinion has been questioned: see further Davies (2022).
[51] See generally FCA Handbook, LR 11. See also DTR 7.2, implementing the provisions of the Shareholders Rights Directive, Directive 2007/26/ EC L184/17, as amended by EU Directive 2017/828 (SRD II) L 132/1. The EU regime bears a strong resemblance to the UK model.
[52] See LR 11.1.4 for further details.
[53] LR 11.1.5.

approval secured without voting by the related party - in that sense, it is the approval of the ‘independent’ shareholders that is required.

It may seem odd for such a fundamental governance process to have been overlooked by UK company law in the light of its relatively strong stance on minority protection. Even so, the UK listing regime has a record of ‘gold plating’ governance requirements in UK company law (for example via the UKCGC) and listing requirements drawn from the EU (for example via the premium listing segment). Against that background the more relevant question may be whether the RPT regime provides meaningful oversight of potential abuse of power by substantial shareholders. On the one hand, the RPT approval regime applies to relatively few transactions, especially in the case of larger companies.[54] On the other hand, the approval process, and in particular its expansion of disclosure in the shareholder circular, offers the potential for more informed control of RPTs by independent shareholders. The solution might therefore be to expand the RPT approval regime by lowering the 5% threshold of economic value or introducing a threshold linked to the cash value of the transaction.[55] That stance would provide increased oversight of RPTs and align with the stance on ‘controlling shareholder agreements’ as well as recognising that, while the UK is still typically characterised as a dispersed shareholding system, the majority of premium listed companies have at least one substantial shareholder.[56]

5.2 Controlling shareholder agreements

A controlling shareholder for the purposes of the relevant provisions of the listing rules (applicable only to the premium segment) is defined by reference to control of 30% or more of the votes at a meeting of the company.[57] The purpose of the relevant provisions is stated to be to ensure that the protections provided by the listing rules are effective, and that, despite having a controlling shareholder, the company is able to carry on an independent business. Examples are provided by the listing rules of instances where these objectives may not be met, such as where a controlling shareholder appears to be able to exercise improper influence over the applicant for listing.

An applicant for premium listing must have in place a controlling shareholder agreement and must maintain that agreement in place.[58] The objective of the agreement is to ensure that transactions with the controlling shareholder will be conducted at arm’s length and on normal commercial terms and that the controlling shareholder will not frustrate compliance with the listing rules. In addition to the agreement, the election of independent directors must be approved by the independent shareholders.[59] Disclosure of compliance with the agreement is

[54] Davies (2022) p14, noting that other approval requirements (e.g. non pre-emptive share issues) may operate in tandem with the RPT regime.
[55] See Davies (2022) p15, noting that a 2% threshold was proposed by the London Stock Exchange prior to the current rule taking effect in 1993.
[56] See Davies (2022) p6 Table 3 for data on substantial shareholdings.
[57] LR 11.1.4A.
[58] LR 6.5.4 and LR 9.2.2AD. The requirement largely reinstates a provision that was withdrawn in 2005.
[59] LR 9.2.2E. See also LR 9.2.2F for the procedure where the independent shareholders do not approve the appointment. See further Reddy (2018) for discussion of Sports Direct International PLC in this context.

required in the annual report[60], thereby enabling shareholders to monitor the situation. In principle the FCA could sanction the company for any breach, but that option would not available for shareholders and therefore sanctions might be counterproductive in the event of breach by the controlling shareholder.

5.3 Dual Class Shares

Dual class share structures ('DCSS') exist when different classes of shares[61] carry different voting rights, with the result that there are differences between the economic interests and voting rights of investors according to the shares they own. These structures have grown in significance in recent years, in particular as a technique to entrench the control of founders when innovative companies (especially in the 'tech' sector) list on public markets.[62] While UK company law is permissive in its approach to DCSS, institutional investors in the UK were in the past generally supportive of the principle of 'one share one vote' and therefore opposed to DCSS as a matter of principle. While the basis for that policy was never clearly articulated, it was reflected in the listing principles[63] for premium listed companies, which limited companies with DCSS to a standard listing in London.

However, the increasing acceptance of DCSS in other important capital markets and the perception that the UK stance was discouraging listing in London prompted a review of the UK position. The Hill Review proposed that DCSS be permitted in the premium listed segment subject to conditions and that approach was given effect by changes to the listing rules which took effect in December 2021.[64] However, there are strict conditions attached to the type of DCSS that is permitted. In particular: the high vote shares must be unlisted and held only by directors; the DCSS can last for only five years; high vote shares are limited to 20 votes per share; and weighted voting applies only in the case of resolutions to remove a director or a shareholder resolution required by the listing rules after a change of control. The limitations on weighted voting both entrench the directors and deter takeovers during the period that the DCSS operates.

The relaxation of the listing rules to permit DCSS in the premium segment clearly has the effect of facilitating effective control by directors, albeit for a limited period of time. While that represents a reversal of the earlier UK position that DCSS had a negative impact on the quality of corporate governance, both empirical evidence[65] and the toleration of DCSS in other major markets suggest that the earlier UK stance was misguided. Nevertheless, the restrictive nature of the UK regime is indicative of a reluctant adopter, driven by competitive pressures rather than enthusiasm for the ethos of DCSS. In particular, the inability of founders to use high vote shares to maintain control over the board of directors and the limited duration of DCSS have

[60] See LR 9.8.4.
[61] While there continue to be preference shares with limited voting rights, DCSS split ordinary shares into classes with different voting rights.
[62] See Reddy (2021) chapters 6 and 7 for an evaluation of the benefits and detriments of DCSS and evidence on their operation.
[63] LR 7.2.1A, The Premium Listing Principles, 3 and 4.
[64] See LR 6.1.9A and LR 9.2.22A-F.
[65] See comprehensive sources cited in Lidman & Skog (2021).

led to claims that the listing rules have not adopted a true version of DCSS.[66] Thus, it remains to be seen how DCSS will work in the UK context and in particular whether it will succeed in attracting new listing by innovative businesses, as envisaged by the Hill Report.

6. Conclusion

Over time an increasing link can be observed between the UK listing regime and corporate governance standards. While disclosure had been the main focus of the listing regime, the emergence of the UKCGC and its incorporation as a disclosure rule into the listing regime resulted in a more substantial and wide-ranging focus on corporate governance standards. The linkage between hard and soft law represented by that process reflected the self-regulatory origins of the Code and by implication the influence of institutional investors. In principle the 'comply or explain' approach left considerable flexibility in governance to listed companies but experience indicates that little use has been made of that option as simple compliance has become widespread. In that sense, the salience of 'comply or explain' as a concept has been eroded and with it the sense that market discipline would be the primary disciplinary mechanism in demarcating a legitimate space for the operation of governance structures and processes that deviated from the UKCGC.

So far as the impact of the listing regime on the balance of power between shareholders and directors is concerned, we observed that the tendency has been to expand shareholder oversight through approval rights for significant transactions and share issues without pre-emptive rights. These interventions have the effect of cutting back the broad default powers given to directors by corporate law. They limit the capacity of directors to significantly change the nature or scope of the business without shareholder approval.

The impact of the listing regime on the role of controlling shareholders and the protection of minority shareholders is generally to strengthen minority protection beyond the relatively strong protection already evident in corporate law. The approval requirements for related party transactions tackle an obvious gap in corporate law even if they are arguably set at too low a level and are engaged by relatively few transactions. Controlling shareholder agreements and the related disclosure of compliance offer some potential for control over abuse of power, albeit that the overall impact is harder to assess. Further research might well clarify that issue. Meanwhile, the limited adoption of dual class share structures arguably moves the listing regime in a different direction by permitting more effective control by controlling shareholders in the form of founding directors. Nevertheless, since the evidence from other systems does not link those structures clearly with a reduced level of minority protection, it would be premature to claim that this development runs contrary to the general trend towards strong minority protection.

[66] Reddy (2022).

In overall terms, the linkage between the UK listing regime and corporate governance standards is substantial. In that sense the claim that listing (including cross-listing by overseas companies) represents a form of ‘bonding’ to higher corporate governance standards seems correct. It is more difficult to evaluate the drivers for establishing the appropriate balance between disclosure and governance standards in the listing regime. It may be that the increasing engagement by the listing regime with ‘governance’ recognises the decreasing marginal utility of expanding disclosure obligations, which can inform market pricing of securities but do not provide a conduit for shareholders to use their voting power to influence decision-making. The increasing role of stewardship in corporate governance adds another dimension to the respective roles of disclosure and governance as it opens up the potential for informal influence at an earlier stage than voting on formal resolutions. Meanwhile, the relative position of the UK versus other systems is likely influenced by its tendency towards shareholder primacy in corporate law and investor empowerment in corporate governance and capital market practice. Thus, while the UK presents an interesting case-study, its relevance for other systems should be understood with these caveats in mind.

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