



**The Quoted
Companies Alliance**

**FINANCIAL REPORTING COUNCIL
REVIEW OF THE IMPACT OF THE COMBINED CODE**

**Response to consultation
from the
Quoted Companies Alliance**

20 July 2007

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1. INTRODUCTION

The **Quoted Companies Alliance** (QCA) is a not-for-profit membership organisation dedicated to promoting the cause of **smaller quoted companies** (“SQC”), which we define as those 2,000 quoted companies outside the FTSE 350 (including those on AIM and PLUS) representing 85% of the UK quoted companies by number. Their market capitalisations tend to be below €500m.

We are the only organisation dedicated solely to promoting and pursuing the interests and concerns of SQCs. This sector employs some 2 million people representing 10% of private sector employment.

The authors of this response have the objective of ensuring that the voice of SQCs is heard in debates about the issues which may affect them. This response has been produced by our Corporate Governance Committee. A list of the Committee members is detailed at Appendix A.

Appendix B to this paper gives more detail about the QCA.

2. RESPONSES TO SPECIFIC QUERIES

1. Does the Code support better board performance over time?

The Code’s primary principle is that every company should be headed by an effective board, which is collectively responsible for the success of the company. This necessitates priority emphasis on strategy, performance and Board cohesiveness.

Feedback from company Chairs suggests that the Code has contributed to boards becoming more professional, but that strong and good leadership by the Chair, working with the CEO, is necessary to overcome two challenges. The first is to make the monitoring role of the non-executives effective but compatible with the Board’s cohesiveness. The second is not to let the Board’s real priorities become subordinated by too much attention and time being given to following the letter rather than the spirit of the Code. The majority of Chairs considered that these challenges were being overcome.

QCA Response

- 1.1 We believe that the Code promotes better performance by providing a benchmark against which the governance structures of companies can be measured, however we believe that the plethora of Main and Supporting Principles can be confusing and lead to excessive “boilerplate” in Corporate Governance Reports (CGR).

The Listing Rules requirement that companies should state how they apply the Main and Supporting principles is often interpreted as a requirement to explain how all 60+ elements of the Main and Supporting principles are applied. This can generate excessive “boilerplate” in the CGR. This requirement needs to be clarified and we suggest that that FSA should provide guidance in this

regard which we will be pleased to assist with. We should be focusing reports on why certain processes are in place, not just that they exist.

- 1.2 We believe it would be helpful, in a future review of the Code's content and form (as distinct from its impact), if the Code were to be re-structured to identify the objectives of governance systems in companies, and companies then being asked to explain how they meet those objectives.

This would:

- provide more clarity for investors,
- reduce the amount of boilerplate in the CGR and make the explanations more relevant to the circumstances of the company; and
- attract more input to the wording of the CGR from board members not on the audit committee during the busy year end period.

Any such objectives can be cross-referenced to the Main and Supporting Principles currently in the Code.

- 1.3 The committee has conflicting views about the advantages and disadvantages of preparing the CGR as part of the year end process. Views also differed about whether the CGR should be included in the annual accounts, or made available on the web-site, or both. Limited time at year ends often mean that boards do not focus much attention on the CGR, and how to make it more useful for readers of the accounts. It may be that by separating the CGR from the annual report, it will get more attention from directors and be more meaningful. Boards should be encouraged to review the CGR early in the year end process.
- 1.4 The Code needs to emphasise more that a key outcome from any corporate governance system should be value creation.

There are 3 main parts to the governance structures of companies:

- a) those that encourage creation of shareholder value;
- b) those that protect shareholder value; and
- c) those relating to shareholder communication and engagement.

The Code only covers value creation in the principles and provisions requiring an entrepreneurial board, requiring assessment of the skills of the directors and assessment of the performance of the Board, its committees and the directors. It does not make clear that, especially in smaller companies, the governance structures should give as much, if not more, emphasis to value creation than to value protection.

The thrust of the vast majority of the principles and provisions is on protection of shareholder value and this results in too little emphasis on value creation.

- 1.5 A thorough assessment of the performance of the board, its committees and the directors is a major tool for enhancing future performance. There is a risk

that time pressures result in only perfunctory assessments. Work needs to be done to help Chairmen identify the benefits of thorough performance assessments, so that enough of the board's limited time is allocated to this task.

- 1.6 The protection of value for shareholders and the transfer of value to shareholders depends upon the company having directors who care that this happens. Whereas guidelines have been produced to assist in the forming of judgements about whether directors are independent, there is no substitute for meeting the director, executive or non-executive. Both directors and shareholders should be strongly encouraged to create and take advantage of any opportunities for such meetings.

2. Is the “comply or explain” approach working effectively?

The “comply or explain” mechanism is a cornerstone of the Code’s flexibility. Feedback indicates that while both companies and investors consider that the Code has contributed to more constructive engagement, there are aspects of “non-compliance” which can frustrate the mechanism working properly. Companies do not want to invite adverse publicity or adverse votes arising from a “box-ticking” approach to the Code by investors or those who advise them; and they may be deterred by the time required to “explain”. For their part investors, who may hold equity in many hundreds of companies in the UK and overseas, may simply consider themselves unable to deal adequately with all explanations in detail. They may also consider that some companies do not adequately explain their reasons when not applying the Code. The FRC wants to assess how serious the above frustrations are and, if their effects are material, to consider how best to mitigate them.

QCA Response

- 2.1 The Code is often referred to as being part of a system of **market** regulation. This is inaccurate. The Code is part of a system of **shareholder** regulation. For shareholder regulation to work properly, shareholders must participate through engagement with the companies that they own and whose performance they should be in a position to regulate. If shareholders continue to only occasionally perform their part in a system of shareholder regulation, there is a growing risk that a more inflexible system of regulation will be imposed, to the ultimate detriment of shareholders.

The competence of the board is a key factor in the success or failure of smaller companies. Where there are no indications of impairment of that competence, shareholders are often inclined to leave the board alone to concentrate on creating value. This can appear to be a lack of engagement by shareholders, whereas it is actually a conscious decision not to communicate with the board. This decision may be influenced by a lack of time available to the investors to engage with the boards running all of their investments, and to prioritise their time communicating with companies where they have concerns. The absence of such engagement can leave boards unclear of the level of acceptance of any explanations.

Shareholders should continue to be encouraged to engage with companies in good times as well as bad.

- 2.2 “Explanations” are still regarded by some as “non-compliance” with the provisions of the Code. This remains an area where more education of users of accounts will be helpful.
- 2.3 The comply or explain approach only applies to the provisions of the Code. As explained in 1.1 above there are problems with reporting how the Code’s principles are applied. There should be more flexibility regarding compliance with all the principles, what matters is that the objectives of good corporate governance are being met.
- 2.4 There can be pressure exerted on smaller companies by their advisers to comply with all of the provisions, even in circumstances where it is more appropriate not to comply and where it is right to provide an explanation of the non-compliance. Directors should be encouraged to stand up to such pressure where they believe that it is appropriate. This committee intends to produce a guide for audit committees later in the year, which will cover this point.
- 2.5 We continue to believe that where a chairman is independent on appointment, and his role is clearly defined as managing the board as opposed to the operations of the company, then the chairman can continue to be independent after appointment. We would like to see the Code recognise the possibility that in limited circumstances the chairman may continue to be independent after appointment, and can be counted as an independent director when considering committee membership. This will reduce unnecessary explanations in the CGR about non-compliance with the provisions covering number of independent directors on the board and its committees.

3. What impact has the Code had on smaller companies?

The size range of the quoted companies to which the Code applies is huge. The FRC recognizes that the potential compliance costs are proportionately higher for smaller companies, particularly bearing in mind the possible frustrations of “comply or explain” referred to above. If these are considered to outweigh the benefits associated with the Code, there may be an argument on regulatory impact grounds for some modification to what is required from smaller companies. On the whole, the 2006 consultations with the Chairs of smaller companies were not compelling on the point, but the sample was small and continuing open-mindedness on the FRC’s part is appropriate.

QCA Response

- 3.1 As detailed above, we consider that the focus of the code on value protection detracts from the more important focus that should be given to value creation.
- 3.2 We believe that the same code should apply to companies of all sizes with only limited derogations for smaller companies, if any. A system of

governance should reflect good business practice and an appropriate code will not impose additional burdens.

As set out in 1.2 above, if the code is re-organised to focus on the objectives of corporate governance and how these can be met, then derogations may not be required.

If the code is not re-organised to focus on objectives, then it needs to be made clear that companies are not expected to apply all of the principles of the Code. Also, if the Code is not re-organised then a derogation in respect of independent chairmen should be introduced. No other derogations from the provisions are required.

- 3.3 The code has been useful in setting expectations and our impression is that it has resulted in changes, particularly the splitting of the roles of Chairman and Chief Executive, and in the number of non-executives on boards.
- 3.4 The Code does not apply to companies with shares traded on AIM or PLUS, and we have produced a widely accepted guide to corporate governance for AIM companies.
- 4. Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?**

If not, in what respects and how do you believe they should be modified?

QCA Response

- 4.1 As explained in 1.1 above, we do not believe that the Code and resulting CGRs clarify the purpose of corporate governance. The code sets out to provide a framework for the explanation of a solution to a problem, but does not identify the problem. As a result CGRs provide lots of potentially worthwhile and well meaning information, but normally they do not address the issue of what the objectives of the governance system are, and how the governance processes relate to those objectives and ensure that the objectives are being met.
- 4.2 Independence of directors is a state of mind and cannot be determined by any guidelines or rules. There is no substitute for shareholders meeting directors and making their own personal judgements. Nevertheless, companies should be encouraged to give fuller explanations of why directors are considered to be independent where there are indications that they might not be.
- 4.3 As noted in 1.3 above, good arguments can be made for putting the CGR on the company website and not in the annual accounts. This idea would benefit from more research. There will be no significant additional costs or savings from either approach.

APPENDIX A

Edward Beale (Chairman)	City Group PLC
Stephen Armstrong	Autobar Group Limited
Nigel Burton	Granby Oil & Gas plc
Anthony Carey	Mazars LLP
Paul Clarke	Fuller, Smith & Turner P.L.C
Louis Cooper	Chiltern plc
Clive Garston	Halliwells LLP
Mark Harwood	Baker Tilly LLP
Paul Lee	Hermes Pension Management Ltd
Elaine New	Seven Arts Pictures plc
Giles Peel	Capita IRG plc
Andrew Viner	BDO Stoy Hayward LLP
Melanie Wadsworth	Faegre & Benson LLP
Nick Wargent	K & L Gates
John Pierce	The Quoted Companies Alliance
Laurence Davis	The Quoted Companies Alliance

APPENDIX B

THE QUOTED COMPANIES ALLIANCE (QCA)

A not-for-profit organisation funded by its membership, the QCA represents the interests of SQCs, their advisers and investors. It was founded in 1992 and originally known as CISCO.

The QCA has nearly 400 members. 75% of these are smaller companies quoted on the stock market, or companies with aspirations to join. 25% are drawn from the full range of professional advisory firms whose business is either wholly or significantly derived from servicing smaller companies.

The QCA is governed by an elected Executive Committee, and undertakes its work through a number of highly focussed, multi-disciplinary committees and working groups of members who concentrate on specific areas of concern, in particular:

- taxation
- introduction of, or changes to, legislation affecting SQCs
- corporate governance
- share schemes for employees
- trading, settlement and custody of shares
- structure and regulation of stock markets for SQCs; Financial Services Authority (FSA) consultation
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from the Accounting Standards Board
- company law reform

The QCA is a founder member of UNIQUE, the Union of Issuers Quoted in Europe, which represents over 3,500 quoted companies in seven European countries.

QCA's AIMS

As the only organisation dedicated solely to the particular interests of the SQC sector, the QCA has three primary goals:

Identification

To create a distinct identity for the SQC sector, and demonstrate its value to the stock markets and the UK economy.

Representation

To pro-actively pursue and represent the interests and requirements of the SQC sector to enable it to increase its contribution and ensure that its specific needs are addressed.

Affiliation

To build a strong and vocal collective body of support from within the SQC sector, among corporate directors and securities industry leaders.

DEFINITION

The Quoted Companies Alliance definition of Smaller Quoted Companies (SQC) is:

- all fully listed companies – excluding the top 350 ie with market cap of £340m+
- plus companies quoted on AIM
- plus companies quoted on PLUS

The QCA also represents companies planning to float.

SQCs contribute to the economy:

- there are approximately 2,000 SQCs
- they represent around 85% of the total of quoted companies by number
- they employ 2 million people
- this figure represents around 10% of total private sector employment
- every 5% growth in the SQC sector could reduce UK unemployment by a further 100,000
- They generate:
 - corporation tax paid of £2.0 billion pa
 - income tax paid of £5.0 billion pa
 - social security paid of £2.0 billion pa

The tax figures exclude business rates, VAT and other indirect taxes.

For more information contact:

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