



**The Quoted
Companies Alliance**

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2 June 2009

Dear Chris,

Review of the Effectiveness of the Combined Code – Call for Evidence

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 individual market capitalisations tend to be below £500m.

Below is the response of the Quoted Companies Alliance. This has been produced by our Corporate Governance Committee. A list of Committee members is detailed at Appendix A.

RESPONSE

Introduction

This response approaches Corporate Governance from first principles and does not confine itself to lessons to be learnt from recent corporate failures in the financial sector. Whereas corporate governance shortcomings undoubtedly had their part to play in these failures, responsibility cannot solely be placed on Boards, but must be spread more widely. As the Turner Review notes, many apparently unrelated and inconsequential actions can result in systemic failures.

The financial world has changed significantly since the Higgs Review and **we believe that the time is now right for a considered review of the Code from first principles.** We are opposed to any “knee jerk” reactions and believe that we should not rush into any changes without considering the full implications. We are concerned that the Walker Review may identify changes required to the governance of financial institutions, and that those may be applied across all listed companies without proper consideration.

This response focuses on the overall structure that we would like to see in an updated Code, and does not go into much detail, because **we think that the next step should be a detailed consultation on the purpose of the Code and how the code can best be structured to achieve that purpose**. We believe that the bulk of the content of the Code is fit for purpose, but that it needs to be put into a contextual framework. The re-drafting of the Preamble in 2008 has gone some way to providing this context, but there is a major disconnection between the Preamble and the main part of the Code that needs to be bridged.

The fundamental tenets underpinning this response are:

- Companies should be managed by a unitary Board exercising a stewardship role on behalf of shareholders.
- Corporate Governance means the processes by which Boards operate in order to perform their stewardship role
- Shareholders are concerned about corporate governance

Building on these we can determine an appropriate approach to achieve good Corporate Governance:

The Purpose of Corporate Governance

The Preamble to the Combined Code as revised in 2008 states that the purpose of corporate governance is to “facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term”.

The definition of the purpose of corporate governance in the preamble to the combined code was not part of the public consultation leading to the 2008 update of the Code and in our opinion is not widely known. **We consider that the consultation should include questions designed to draw peoples’ attention to the purpose of corporate governance as set out in the preamble with the objective of arriving at a widely known statement of the purpose of corporate governance.**

Companies will then be able to explain how the corporate governance processes they adopt achieves this view of the purpose of corporate governance, or alternatively explain why they think this view is not applicable in their situation, what they think is an applicable purpose and how the processes they adopt achieve that purpose.

It is not necessary to develop a consensus view, just a widely known statement of the purpose of corporate governance which will provide a common starting point for any debate about whether a different purpose is appropriate for a particular company and whether corporate governance processes are appropriate and sufficient to achieve the required purpose.

How can this purpose be achieved?

The key drivers for appropriate outcomes are behavioural. Processes can only support good behaviours and in the absence of good behaviours, processes become a meaningless box ticking exercise. We believe that the structure of the existing Code focuses attention on processes and not on outcomes, resulting in defensive reporting about how the “principles” have been applied rather than informative reporting about how outcomes are being achieved.

The challenge is to devise a system that encourages and supports good behaviours. Our view is that any such system must be principles based as a rules based approach is likely to focus attention on processes to the detriment of encouraging good behaviours.

We recommend that the FRC should include in its consultation questions on how good behaviours can be best encouraged.

Rules v Principles. One size fits all?

Companies are diverse in nature and therefore we cannot define a set of common processes that will be appropriate for all companies. We can however clarify a set of outcomes that is more likely to enhance shareholder value.

As we cannot define a single set of appropriate Corporate Governance processes, we either need to define a number of different sets of processes for different sorts of companies, or we need to have a flexible approach.

If we have a number of different sets of processes for different categories of companies, then we also need to determine the characteristics of those categories, and who should be responsible for deciding which set of processes to use when a company does not clearly fit into one of the categories.

The complexities of a rules based approach can be avoided by adopting an outcomes focussed, principles based, flexible approach, which is our recommendation.

Guidance on Corporate Governance Structures and Processes

There are three parts to any Corporate Governance system covering:

- Value creation,
- Value protection, and
- Engagement between Boards and Shareholders

As explained above we consider that any guidance should be principles based, and needs to reflect the wide variety of companies which will be attempting to apply the guidance.

We also think that guidance should be outcome orientated and should focus on commonly accepted structures and processes by which various elements of the consensus view of the purpose of corporate governance can be achieved.

For maximum utility, the guidance should specify the element(s) of the purpose of corporate governance that any structure or process is targeted to achieve.

We consider that the principles and provisions of the existing code should be re-sorted so that they can be related directly to the purpose of corporate governance and that there should be an appropriate balance of principles and provisions between the three elements of corporate governance (value creation, value protection and engagement).

We enclose for information a copy of the QCA's Corporate Governance Guidelines for AIM Companies in which we have tried to adopt a similar approach. This is also similar in format to the FRC's Plan 2009/10.

Enforcement?

The next question is who should monitor the corporate governance structures and processes that have been adopted and how can they encourage improvements by companies?

If we adopt a rules based approach then this can be enforced by a regulatory body since the judgements that need to be made relate to the interpretation of the rules.

If we have a principles based approach enforced by a regulatory body then, over time, the interpretations of the principles by the regulatory body will create a rules based system, thus negating the advantages and flexibility of a principles based system.

The only practical mechanism for enforcement of a principles based system is through shareholder regulation (i.e. engagement by shareholders to encourage or require improvements in corporate governance), which leads to the question of how shareholders can best monitor corporate governance structures and processes and encourage improvement.

Monitoring will require companies to disclose to shareholders their corporate governance processes in such a manner that shareholders can (i) have an informed debate with the Board and (ii) form a sensible judgement about how appropriate the corporate governance structures and processes are taking into account the nature of the company.

If we accept a principles based approach to corporate governance and shareholder regulation, then there are three areas for further debate:

- What guidance should be given to companies regarding disclosure of corporate governance structures and processes, and
- What mechanisms should be available to shareholders to encourage or enforce improvements in corporate governance?
- How can (should?) shareholders be encouraged to engage in discussions about corporate governance

Disclosure Guidance

The underlying purpose of any disclosure is to provide useful information to users in a useable format. Anything else is useless.

The focus of corporate governance disclosures must be to set out the objectives that the business's corporate governance system has been designed to achieve, to explain if those objectives differ from the consensus view of the purpose of corporate governance, and to explain how the corporate governance structures and processes which have been adopted achieve the objectives that have been set.

The challenge is to provide this guidance in a manner that discourages boilerplate reporting.

It is theoretically possible to identify a party other than the shareholders to monitor the clarity of corporate governance reporting (but not the appropriateness of the corporate governance processes), for example: a body similar to the FRRP (who already monitor the Business Review), or as an expanded role for Sponsors. **We recommend that the**

FRC consults on who (if anyone) should monitor the clarity of corporate governance reporting, and what sanctions should apply for any shortcomings.

Monitoring and Enforcement Mechanisms

Once we have corporate governance reporting that is sufficiently clear as to be a useful basis for informed debate, the next issue to be addressed is whether the stewardship role is being adequately performed by the directors.

In our opinion only direct engagement between shareholders and boards can determine whether the stewardship role is being adequately performed, and if shareholders for whatever reason do not wish to engage in such discussions then it is not possible to force them. We do not believe that there are any workable and enforceable measures to require engagement from all shareholders and we consider that it is not equitable to introduce a system which only targets some shareholders.

We recommend that the FRC consults on ways to encourage shareholders to engage with Boards about corporate governance and mechanisms that should be available to shareholders to encourage improvements in corporate governance.

Cost/Benefit Analysis

We consider that any proposals should be subject to normal cost/benefit analysis taking fully into account the disparate nature of companies that are affected.

Things to avoid

Any revised code should be careful not to duplicate requirements that are already in place as a result of FSA regulations or statute. If necessary, such requirements can be incorporated by reference. (c.f. FRC's Complexity project)

The Turner Review touched on the possibility of having full time "non-executive" directors. We think that this is impossible and any attempt to have full time "independent" directors can only be managed by the introduction of two tier Boards, which we are against as a matter of principle.

Code content

We think that there should be a fundamental review of the structure of the code so that it can best encourage achievement of its desired outcomes and we are against any tinkering with the code without such a fundamental review.

We think that such a review will highlight areas where there are imbalances and inconsistencies between the purpose and content of the code, or where the existing content can be better emphasised. Such areas might include:

- The chairman's responsibility for corporate governance as part of his responsibility for the running of the Board,
- The role of the company secretary in implementing corporate governance processes, reporting to the chairman, in particular in coordination of the executive team to ensure the timeliness and adequacy of board papers
- The importance of risk identification and management,
- Incentive structures that encourage responsible behaviour
- Executive succession and contingency planning
- Benefits of performance evaluations

Chris Hodge
Financial Reporting Council
Combined Code Review
2 June 2009
Page 6.

- The value of an holistic approach to corporate reporting, rather than the piecemeal approach adopted by most companies today
- Clarification of the fiduciary duties of directors as well as of trustees and fund managers

If you wish to discuss these issues with us, we will be pleased to attend a meeting.

Yours sincerely,

A handwritten signature in black ink that reads "John Pierce". The signature is written in a cursive style and is underlined with a single horizontal line.

John Pierce
Chief Executive

THE QUOTED COMPANIES ALLIANCE CORPORATE GOVERNANCE COMMITTEE

Edward Beale (Chairman)*	-	City Group plc
Mirza Baig	-	F & C Asset Management plc
Nigel Burton	-	Advanced power AG
Anthony Carey	-	Mazars LLP
Louis Cooper	-	Horwath Clark Whitehill LLP
Clive Garston	-	Halliwells
Tim Goodman	-	Hermes Equity Ownership Services Ltd
Mark Harwood	-	Baker Tilly LLP
Elaine New	-	Seven Arts Pictures plc
Andrew Viner	-	BDO Stoy Hayward LLP
Melanie Wadsworth	-	Faegre & Benson LLP
Nick Wargent	-	K & L Gates
John Pierce	-	The Quoted Companies Alliance
Kate Jalbert	-	The Quoted Companies Alliance

*Main Author