The Quoted Companies Alliance

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The Kay Review
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Dear Sirs,

BIS – The Kay Review – Call Evidence

INTRODUCTION

The Quoted Companies Alliance is a not-for-profit membership organisation working for small and mid-cap quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

RESPONSE

We welcome the opportunity to respond to this call for evidence and view the Kay Review as an important element in improving UK equity markets and creating an environment in which companies of all sizes, especially small and mid-cap quoted companies, can grow and create employment.

Over the past ten years, listings on UK equity markets have been falling, especially on the London Stock Exchange's Main Market (Please see Figures 1 and 2 below). There has also been a significant drop in the number of British companies listing in London. While there is no one reason for this drop, we see the fall in itself as reason to explore whether or not UK equity markets are fit for purpose.

Small and mid-cap quoted companies make up a significant share of companies on UK equity markets. There are some 2,000 small and mid-cap quoted companies in the UK, representing 85% of all quoted companies. Any review on equity markets must take into consideration these companies, which need equity markets to access finance and are very different from those companies in the FTSE 100.

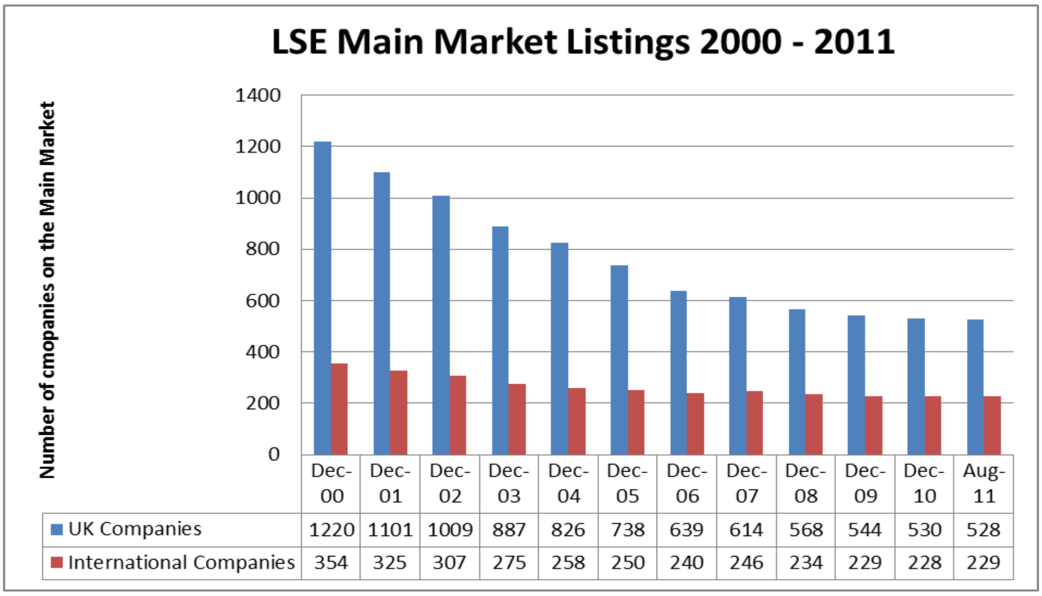
Our research indicates that 60% of small and mid-cap quoted companies believe that equity markets are hindering their company's prospects.[1] Smaller companies feel that equity markets are not fulfilling their intended purpose to help companies raise finance to grow, which inevitably is vital to the UK's economic recovery.[2]

In addition, 75% of companies think that the amount of regulation impacting businesses will grow in the next 12 months and only 4% of companies believe that the Government really cares a great deal about small and mid-cap quoted companies. We believe that action by the UK Government to repair equity markets and

[1] QCA/BDO Small & Mid-Cap Sentiment Index powered by YouGovStone, September 2011; a survey of 100 representative small and mid-cap quoted UK companies. This survey is carried out on a quarterly basis.
[2] QCA/BDO Small & Mid-Cap Sentiment Index powered by YouGovStone, September 2011; a survey of 100 representative small and mid-cap quoted UK companies. This survey is carried out on a quarterly basis.

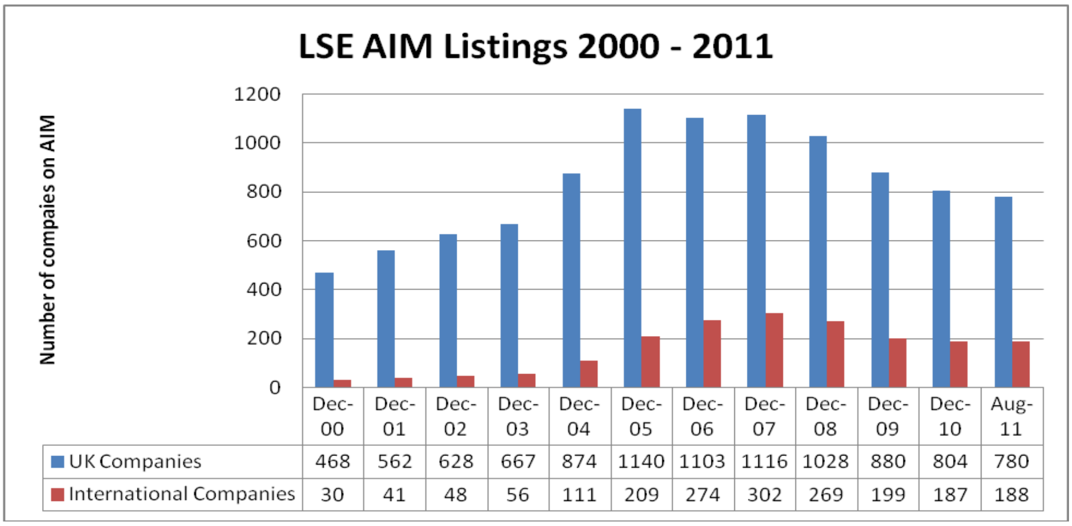
positive steps to drive and encourage investment into the sector would help provide small and mid-cap quoted companies with the positive reassurance necessary to help this sector grow and create employment, which is essential to the UK's economic recovery.

Figure 1 – Main Market Listings 2000 - 2011-11



	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Aug-11
UK Companies	1220	1101	1009	887	826	738	639	614	568	544	530	528
International Companies	354	325	307	275	258	250	240	246	234	229	228	229

Figure 2 – LSE AIM Listings 2000 – 2011



	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Aug-11
UK Companies	468	562	628	667	874	1140	1103	1116	1028	880	804	780
International Companies	30	41	48	56	111	209	274	302	269	199	187	188

Source for both figures: *The London Stock Exchange Statistics – List of all companies, 2000 – August 2011 (available at: http://www.londonstockexchange.com/statistics/historic/company-files/company-files.htm). The following sectors are excluded from both figures: Banks, Company Bonds, Debentures & Loans, Non Equity Instruments, Preferences, Equity Investment Instruments, General Financial, Life Insurance and Non-life Insurance.*

We have responded to those questions which we feel able to answer from a quoted company perspective and for which we can provide evidence.

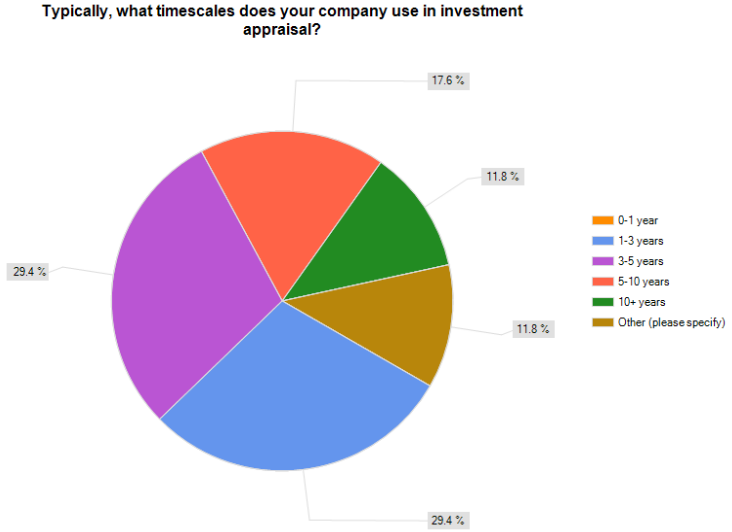
CALL FOR EVIDENCE QUESTIONS

1. **Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries.**

b) **What timescales are used by companies in investment appraisal?**

We conducted a survey of our corporate members in November 2011, which are small and mid-cap quoted companies, asking them directly some of the questions included in the Kay Review. Given the short-timescale we had 17 respondents, which include CEOs, Finance Directors and Company Secretaries of small and mid-cap quoted companies.

One question we asked was what timescales they use in investment appraisal. The results are illustrated in the chart below.



The 'Other' responses noted that the timescales vary depending on the size of investment.

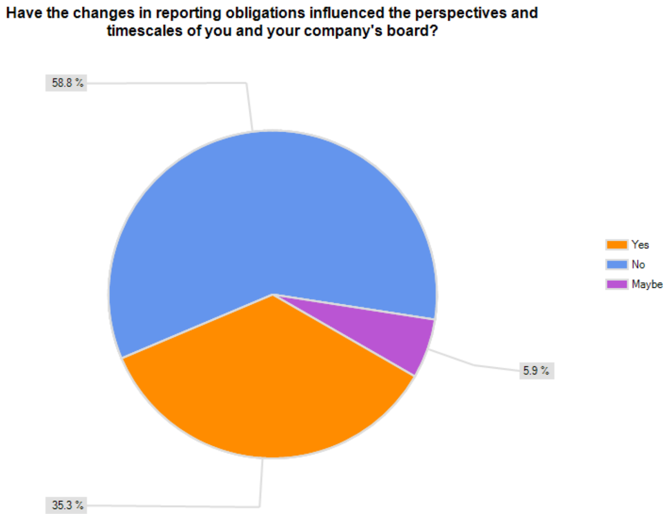
The results indicate that there is not a predominant timescale used by companies and that it very much depends on the sector in which these companies operate.

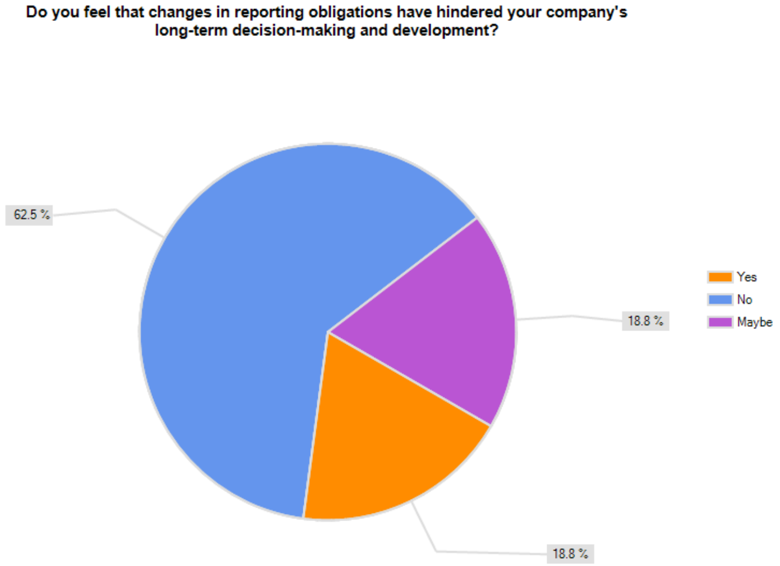
3. **Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business.**

We would particularly welcome evidence on:

a. **whether changes in reporting obligations have influenced the perspectives and timescales of managers and boards, and whether these changes in perspectives and timescales help or hinder long-term decision making;**

Again, we asked our corporate members for their views on this subject and got the following response. Overall respondents did not feel that changes in reporting obligations had a significant effect on their timescales and long-term decision-making and development. However, it was recognised that reporting obligations did have some effect.





Out of those respondents who did believe that reporting obligations have an effect on their timescales and long-term decision-making and development, changes to IFRS were cited as the aspect which most affected their companies. Respondents specifically cited:

- IFRS policies regarding costs associated with acquisitions
- Reporting rules under IFRS on amortisation of intangibles for acquisitions
- The change in fair value accounting for share based payments
- The change in accounting for M&A costs

IFRS is routinely cited by small and mid-cap quoted companies as a key burden on their companies due to the complexity surrounding producing the accounts. IFRS is also argued to not necessarily be portraying the economic reality of their companies. We believe that the evidence collected from our survey shows that the effect of IFRS on companies is one area which must be explored in order to address how companies report their results to the equity markets; whether IFRS produces financial information that investors want; and the cost/benefit of smaller companies using IFRS.

We support the adoption of full IFRS for larger listed companies, but believe it is appropriate to recognise the difference in scale, and of resources available to smaller listed companies and those companies quoted on exchange regulated markets, which may have a capitalisation of just a few million pounds compared to their global listed counterparts capitalised at many tens of billions of pounds. We therefore consider that both small companies listed on regulated markets and companies quoted on exchange regulated markets (such as AIM and PLUS-quoted in the UK) should be able to have the choice to use full IFRS or a proportionate form of IFRS, potentially a version of IFRS for SMEs. We recognise that implementing such a change would require a change in the relevant EU regulation in respect of companies listed on regulated markets, but consider that the "one size fits all" approach to financial reporting by EU listed companies is not appropriate.

Another area which was cited by directors in this survey as having an impact on their long-term decision-making is voluntary quarterly reporting and the EU requirement to produce interim management statements. Interim management statements result in a significant cost to smaller companies in terms of management time spent producing them and are generally felt to not provide any information of significant value, as companies already communicate with their investors frequently and already have reported any price sensitive information to the market under other regulatory requirements.

We note that the European Commission has proposed to abolish the requirement for interim management statements in its recent review of the Transparency Directive[3] and we support this removal as an important step to reduce the burden on small and mid-cap quoted companies and also as a good move to encourage long-termism in equity markets.

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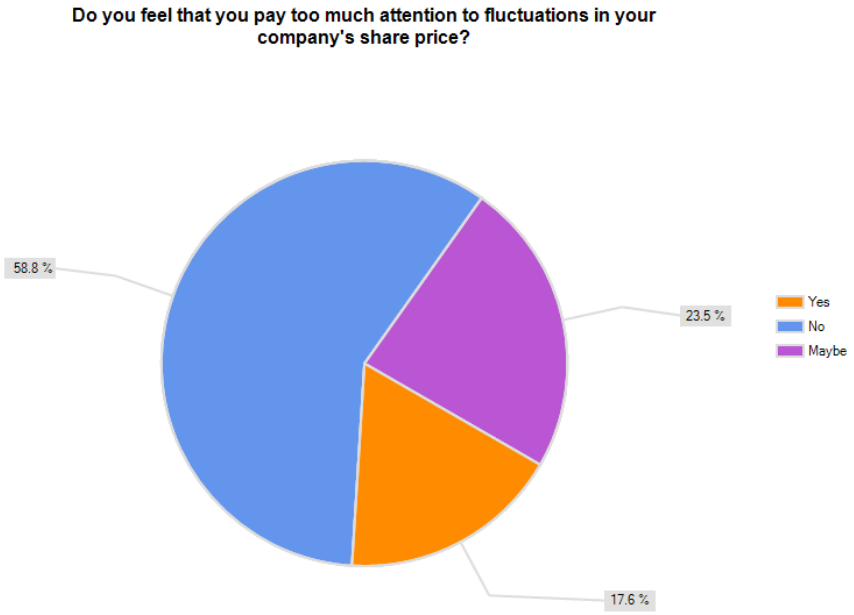
[3] http://ec.europa.eu/internal_market/securities/docs/transparency/modifying-proposal/20111025-provisional-proposal_en.pdf

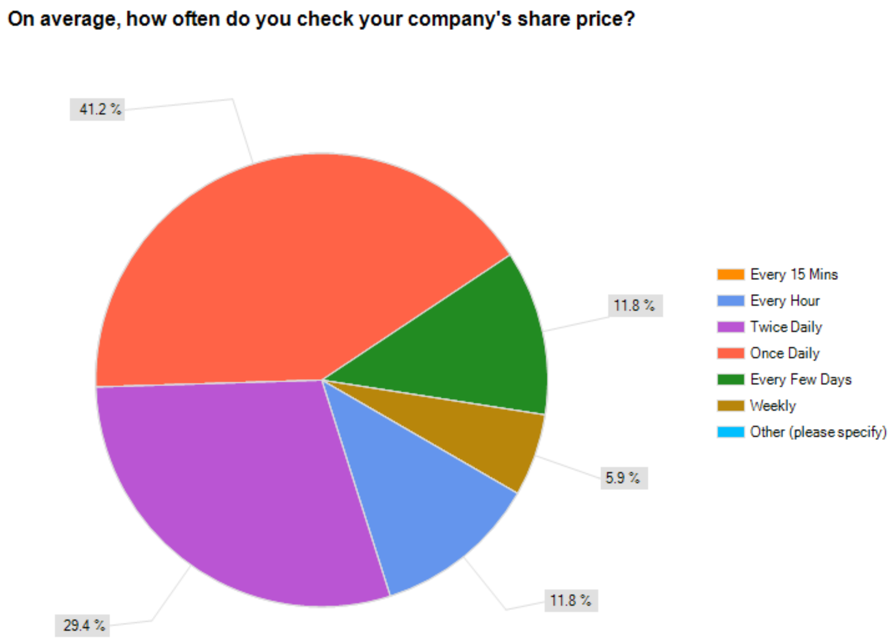
b. how the perspectives of managers and boards vary between listed companies, companies whose equities are traded on AIM and PLUS

This is a difficult question to evaluate as one would have to observe both the boards of listed companies and quoted companies in order to sufficiently answer the question. We note that advisors to companies (e.g. lawyer and accountants) would be best placed to provide evidence on this question.

c. whether publicly traded companies pay too much attention (or feel obliged to pay too much attention) to short-term fluctuations in their share prices;

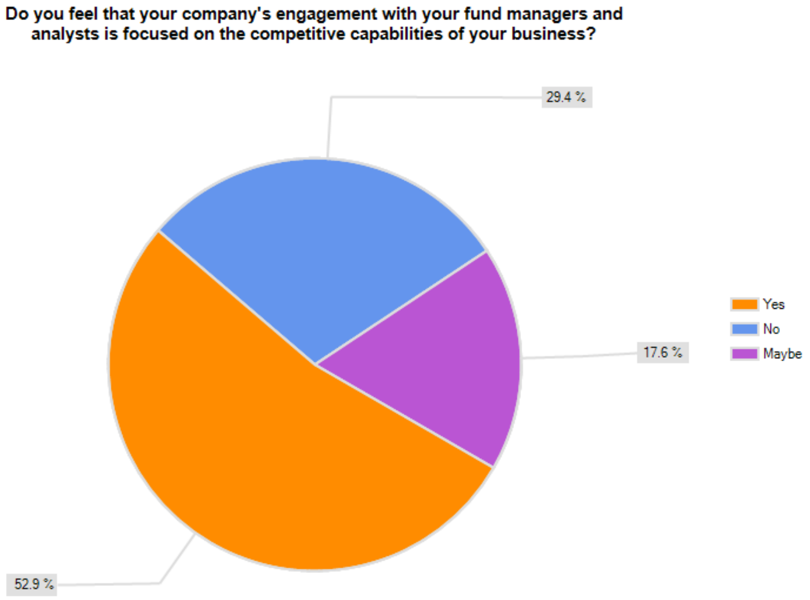
We asked our corporate members this question in our survey on the Kay Review in November 2011 and also asked how frequently they checked their share price. 59% of company directors who responded felt that did not pay too much attention to their share prices, while 41% checked their share price once daily.





d. whether companies feel that their engagement with fund managers and analysts is properly focused on the competitive capabilities of the business.

We asked our corporate members this question in our survey on the Kay Review in November 2011. 53% of respondents felt that their engagement with fund managers and analysts is properly focused on the competitive capabilities of the business.



4. Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their businesses.

We would particularly welcome evidence on:

b. whether government policies aimed at facilitating long-term investment by companies have been effective and whether there are other ways Government could support long-term business growth.

We believe that there is much more that the Government can do to support and encourage long-term investment in companies and especially the small and mid-cap quoted company sector.

Tax incentives for investment in small and mid-cap quoted companies

The first QCA/BDO Small and Mid-Cap Sentiment Index showed that 49% of small and mid-cap quoted companies believe that the most helpful action that the UK Government could undertake in the next 12 months would be to introduce tax incentives for investors in small and mid-cap quoted companies.[4] We believe that UK Government should seek to encourage long-term investment through tax incentives that are specifically designed to achieve this aim. We believe the following tax reform would result in more long-term investment and more investment directed at smaller, growing companies:

- **Capital Gains Tax Reform of Entrepreneurs' Relief**

The Quoted Companies Alliance believes that well targeted and cost effective capital gains tax reliefs to encourage equity investment in private and public companies will demonstrate that the Government is prepared to act quickly and decisively to promote entrepreneurial activity). It is generally accepted that the alignment of employee and shareholder interests promote long-term growth in corporate profitability and therefore a higher tax yield for the Exchequer.

[4] QCA/BDO Small & Mid-Cap Sentiment Index powered by YouGovStone, September 2011; a survey of 100 representative small and mid-cap quoted UK companies. This survey is carried out on a quarterly basis.

Now is the time for the Government to address, for the long-term, this vitally important area of personal taxation. Removing restrictions to Entrepreneurs' Relief will help small and medium-sized companies to attract the necessary talent and investment to grow and create more employment, which will boost the struggling economy and essential to the UK's economic recovery. Our proposals to remove this relief include:

Short-term proposals:

- Remove the personal company definition, as currently outlined in Entrepreneurs' Relief, that someone must have 5% of the voting rights and 5% of ordinary the share capital in the company in order to qualify for the relief.

- Have the relief applied from the date the option is granted (rather than exercised) for HMRC "approved" schemes, including Enterprise Management Incentive Schemes.

- To fund the above relaxations and to promote long-term thinking, extend the current holding period from 12 months to 36 months.

Long-term proposals:

- Rebrand Entrepreneurs' Relief as 'Stakeholders' Relief' to identify those parties that make a meaningful contribution to the success of a business and more clearly align employee and shareholder interests to promote long-term growth and employment.

- In addition to employees and officers, target this relief for long-term investors:

    - Remove the qualifying condition for Entrepreneurs' Relief, where only an officer and employee can attain.

    - Remove the personal company definition.

    - Introduce a five year holding period for shares.

    - Consider targeting this relief to the SME sector.

- **Re-instate the Dividend Tax Credit for Pension Funds**

The abolition of the dividend tax credit for pension funds in 1997 has resulted in the value of pensions being more uncertain and reliant on the contributions of an employee and employer only. At a time when Government is focused encouraging people to save for their retirement and faced with a pensions crisis, reinstating the dividend tax credit would be a welcomed action.

We note that the Conservative Party has already indicated its intention to explore reinstating this relief in the Conservative Manifesto 2010 and also its document, 'A New Economic Model – Eight Benchmarks for Britain'.

We understand that there will be a cost to the Exchequer in reinstating this credit. In order to target this credit and encourage investment in the SME sector, we would propose that the Government could initially reinstate the tax credit for investments by pensions in small and mid-cap quoted companies. This would have the dual effect of increasing pension certainty and increasing long-term investment in the small and mid-cap quoted company sector.

- **Inclusion of investments on exchange regulated markets in ISAs**

The tax status of AIM and PLUS quoted companies has changed radically following the abolition of Business Asset Taper Relief. Consequently, companies quoted on an exchange regulated markets do not qualify for certain reliefs that are available to listed companies.

Currently shares in AIM and PLUS quoted companies do not qualify to be included as ISA investments. With the loss in the CGT relief, any aid for small and mid-cap quoted companies is essential. The economy is relying on this sector to rebuild and create growth and employment. This cannot be understated.

We view this measure as redirecting investment into a much-needed area, and hence we believe it can be implemented without significant cost to the Treasury.

We have explained in more detail the above proposals for taxation reform in our 2011 Budget Representations[5] and will soon have published our 2012 Budget Representations.

SME Asset Class

We believe that the European Commission could encourage more investment into small and mid-cap quoted companies by creating a SME asset class. This would also allow for the Commission and UK Government to easily adopt a proportionate approach for regulating small and mid-cap quoted companies, as the asset class would be clearly defined and visible for investors. Pension funds could be required to disclose their policy for investment in this asset class. European Governments could apply specific fiscal measures.

5. **Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement.**

We would particularly welcome evidence on:

b. **whether the broader regulation of equity markets has an impact on the investment timescales of market participants;**

While not purely regulation, we believe that there are two areas of equity markets that should be considered in terms of promoting more long-term investment in equity markets:

Indices

The impact of indices on long-term investment should be considered in this review.

The main indices used in the UK for benchmarking and investment, the FTSE All-Share and the FTSE100 (which makes up the vast proportion of the All-Share index), are not focused on facilitating long-term investment. Re-calculated at every chance and whenever there is a change to a bid or offer price, the UK series of indices are by definition short-term and can result in increased reaction to short-term price fluctuations, which can have a significant effect on the UK markets as whole. It would be useful to explore how the UK series of indices could be designed to be more investable, rather than just tradable.

The UK indices are also not representative of the UK economy. There are many examples of companies within the FTSE 100 which are global companies which happen to be headquartered in the UK rather than companies which are wholly or mainly UK related. Many pension funds and retail investment vehicles use the FTSE All-Share as a benchmark for the UK economy. As a result investors who think they are electing to invest in UK-centric companies may be unaware that they are exposed to international volatility and economic changes through the weightings and constituents of the FTSE All-Share index.

We suggest that a new series of indices be considered which reflect companies' contribution to local economies, initially for the UK and Europe. Companies could be allocated to more than one country by virtue of their relative contribution to different countries. Alternatively global companies which have a wide reach could be excluded altogether. This would enable investors and pension funds to ensure that their investment was directed more accurately and would be more transparent in terms of which companies are contributing to the UK and European economies.

Liquidity and effect on long-term investment

It is worth noting that liquidity in small and mid-cap quoted companies is inevitably much less than that of shares in the FTSE100. Almost by definition, small and mid-cap quoted companies are illiquid stocks. At many events organised by the Quoted Companies Alliance where fund managers speak they stress the point that they have to be long-term investors, by virtue of the nature of the sector of the market in which they invest.

As a general example a fund manager may set out to buy a 15% stake in a company. As he starts purchasing he may pay £1 for his first purchases and end up paying perhaps £1.50 as he accumulates his required stake. He does this on a three year view based on the assumption that he has selected a growth

[5] http://www.theqca.com/about-us/responses/39201/qca-2011-budget-representations.thtml

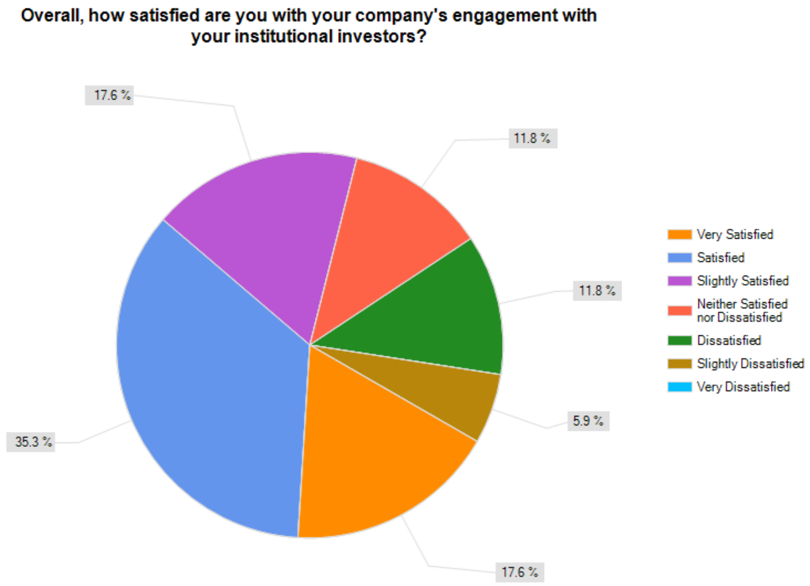
stock which he believes will be worth £10 at the end of that time. These fund managers already take a long-term view. The market does not permit them to make a turn on a share in a short time in the same way that dealing in the FTSE100 does.

8. The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.

We would particularly welcome evidence on:

a. whether the measures taken to stimulate engagement by investors with companies have been sufficiently effective;

We asked our corporate members for their views on this subject in our survey on the Kay Review in November 2011, querying overall whether or not they were satisfied with their engagement with their institutional investors. 70.5% of directors of small and mid-cap quoted companies who responded indicated either that they were very satisfied, slightly satisfied or satisfied with their company's engagement with institutional investors.



In addition, we held a roundtable with directors of small and mid-cap quoted companies and the Financial Reporting Council in October 2011 to discuss the effect of recent changes to the UK Corporate Governance Code on their companies and also their views on engagement with shareholders since the introduction of the Stewardship Code.

Overall, directors felt that there had not been much change in their engagement with investors since the Stewardship Code came into effect. Anecdotally, companies felt that their investors still do not attend or vote on a regular basis at AGMs and that offers to shareholders to meet with non-executive directors were often turned down. There was also a general feeling that proxy voting agencies are still issuing voting recommendations without fully understanding a company or engaging with them, nor informing a company directly of their recommendations.

10. Likely trends in international investment and in the international regulatory framework, and their possible long term impact on UK equity markets and UK business.

We would particularly welcome evidence on:

b. whether recent or planned regulatory actions by authorities outside the UK, and particularly regulatory policy developments at EU level, will affect engagement between asset managers and the companies in which they invest, and the ability of companies to respond to that engagement.

We are concerned about potential regulatory developments in Europe surrounding corporate governance and the impact that it will have on the ‘comply or explain’ regime. We do not believe that strict rules that dictate how companies and investors have to engage will result in improved corporate governance and engagement. We fear that this would result in a ‘tick box’ approach to engagement and undermine the premise of ‘comply or explain’ regime – in that shareholders are ultimately responsible for challenging companies on their explanations.

If you would like to discuss this in more detail, we would be pleased to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

APPENDIX A

THE QUOTED COMPANIES ALLIANCE (QCA)

A not-for-profit organisation funded by its membership, the Quoted Companies Alliance represents the interests of small and mid-cap quoted companies, their advisors and investors. It was founded in 1992, originally known as CISCO.

The Quoted Companies Alliance 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
- legislation affecting small and mid-cap quoted companies
- corporate governance
- employee share schemes
- trading, settlement and custody of shares
- structure and regulation of stock markets for small and mid-cap quoted companies;
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from various standard-setters

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents quoted companies in fourteen European countries.

Quoted Companies Alliance's Aims and Objectives

The Quoted Companies Alliance works for small and mid-cap quoted companies in the United Kingdom and Europe to promote and maintain vibrant, healthy and liquid capital markets. Its principal objectives are:

Lobbying the Government, Brussels and other regulators to reduce the costing and time consuming burden of regulation, which falls disproportionately on smaller quoted companies

Promoting the smaller quoted company sector and taking steps to increase investor interest and improve shareholder liquidity for companies in it.

Educating companies in the sector about best practice in areas such as corporate governance and investor relations.

Providing a forum for small and mid-cap quoted company directors to network and discuss solutions to topical issues with their peer group, sector professionals and influential City figures.

Small and mid-cap quoted companies' contribute considerably to the UK economy:

- There are approximately 2,000 small and mid-cap quoted companies
- They represent around 85% of all quoted companies in the UK
- They employ approximately 1 million people, representing around 4% of total private sector employment
- Every 5% growth in the small and mid-cap quoted company sector could reduce UK unemployment by a further 50,000
- They generate:
    - corporation tax payable of £560 million per annum
    - income tax paid of £3 billion per annum
    - social security paid (employers' NIC) of £3 billion per annum
    - employees' national insurance contribution paid of £2 billion per annum

The tax figures <u>exclude</u> business rates, VAT and other indirect taxes.

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