



**The Quoted  
Companies Alliance**

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9 October 2009

Dear Mr Hodge,

**Financial Reporting Council – Review of the Effectiveness of the Combined Code –  
Progress Report and Second Consultation**

***INTRODUCTION***

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

The QCA Corporate Governance Committee has examined your proposals and advised on this response. A list of Committee members is at Appendix A.

***RESPONSE***

We welcome the opportunity to submit our views on this important consultation. Our general comments are as follows:

**Louder than Words**

We agree with the FRC's consultation paper "Louder than Words" about how regulation should be structured to minimise complexity. We think that this is relevant to the current debate on the Combined Code to ensure that any changes to regulation are appropriately targeted, do not overlap with other regulation and meet a cost/benefit test. To achieve this, we consider that proposals for change should be more outcome orientated and will need to consider whether implementation costs outweigh potential benefits.

As we have argued previously, we consider that the Combined Code needs to be redrafted to clearly identify how the principles and provisions are aligned with the outcomes that are desired. We believe that this will provide the opportunity for a change in the quality of corporate governance reporting.

We view the Combined Code as a principles-based document which is relevant to the majority of quoted companies. We acknowledge that certain types of companies have difficulty with (usually different) parts of the Code and that is why the QCA and other bodies publish guidance on the Code's application for subsets of quoted companies. It may be that specific guidance needs to be developed for BOFIs, in which case consideration should be given as to which is the most appropriate body to develop that sector specific guidance. We do not think that the FRC should be publishing guidance for BOFIs, as this would lead to calls for the FRC to publish guidance for other subsets of the market.

### **Shareholder Regulation**

We also agree with the FRC on the importance of Shareholder Regulation of quoted companies and consider that there are three elements that are necessary for Shareholder Regulation to work. These are:

1. Shareholders need to believe that engagement can lead to better governance and better governance leads to improved investment returns;
2. Companies need to provide Shareholders with sufficient relevant and timely information to enable Shareholders to engage in a meaningful dialogue with boards; and
3. Shareholders need to have appropriate tools to enforce change if they are unhappy with directors' plans or actions.

We consider that more work needs to be done on the first element, which the current consultation does not cover.

We are concerned that the proposals relating to the provision of information to shareholders are too detailed and not sufficiently "outcome orientated". By this we mean that the current Code and the proposals for additional principles and provisions will lead companies to focus on providing yet more information, rather than explaining to shareholders how their corporate governance systems will enhance long term shareholder value. We believe that this information overload will make it even more difficult for shareholders to assess whether corporate governance systems are appropriate, as the key information is likely to be lost the "noise" generated by compliance focused reports.

We have not commented in detail on the appropriate tools that Shareholders might use to enforce change. Instead, we have limited our comments to the practicality of the tools proposed. A more considered debate is needed on the tools that should be available to shareholders who, after engaging in debate with Boards, are still unhappy and wish to enforce changes.

### **Behavioural Aspects**

Many of the issue raised in the consultation are behavioural, and the FRC's challenge is in how to change behaviours. In our opinion, quality leadership and peer pressure are the best ways to change behaviours. The role of the chairman is key. A clear and consistent message about the desired outcome is also very important, and we think that more emphasis is needed in this respect. An ever lengthening set of guidance will only encourage more box-ticking.

Chris Hodge

## **COMMENTS ON SPECIFIC CONSULTATION ISSUES**

### **1. Responsibilities of the Chairman and NEDs**

The Chairman's primary role is to run the Board – his responsibilities therefore revolve around making Corporate Governance work. The NED's purpose is to bring to the Board a greater breadth of skills and experience, which will enhance discussions on strategy, help the Chairman in the oversight of the execution of strategy and perform corporate governance tasks.

#### **Walker Review Recommendations:**

3. It is not appropriate to specify number of days, either for BOFIs or for companies more widely, given the range of sizes and natures of companies.
6. This is just a restatement the supporting principles to A1 and the Code should be amended to emphasise this recommendation.
7. Provision A4.3 already covers chairman's time commitment. It is not appropriate to specify number of days, either for BOFIs or for companies more widely, given the range of sizes and natures of companies.
8. There should not be an assumption that a successful chief executive will make a good chairman, as the skills required are different. Whereas industry experience may be useful for a BOFI, this is not necessarily the case for other industries, and should not form part of the Code. As set out out in our introductory comments, the chairman is key to improving corporate governance.
9. This is just a restatement of part of the supporting principles to A2 and the Code should be amended to emphasise this recommendation.
11. This is just a restatement of provisions A1.3 and A3.3 and the Code should be amended to incorporate this recommendation.

#### **Issues for further consideration**

Guidance already exists from the Higgs Report on the role of Chairmen and NEDs. This guidance could do with updating to emphasise the Chairman's responsibility for good governance and the directors' responsibility to act principally for the benefit of shareholders. Guidance on the SID's role is not necessary.

Guidance on the time commitment expected of the Chairman, SID and other NEDs is not appropriate given the range of companies covered by the Code. Engagement letters should state expected time commitments and also an hourly rate of pay for time spent in addition to that expected.

### **2. Board Balance and Composition**

The objective must be to obtain directors with a comprehensive mix of skills and experience, who are able to work together for the benefit of shareholders.

Walker Review Recommendations:

4. This is a FSA regulatory point and is not relevant for the Code.
5. This is a FSA regulatory point and is not relevant for the Code.

Issues for further consideration

Provision A4.2 requires a nomination committee to “evaluate the balance of skills, knowledge and experience on the board, and in the light of this evaluation prepare a description of the role and capabilities required for a particular appointment”. This covers the need for NEDs collectively to have relevant experience, and while we do not consider that any further emphasis is necessary, such an emphasis if desired would be best achieved by change to this provision’s wording..

We are disappointed that the FRC’s consultation is referring to its own guidance as “rules”, even if that is how they are perceived by many. We consider independence to be a state of mind and that the guidance in provision 3.1 is far too often perceived to be a set of rules. We would like this guidance to be removed from the provision and provided separately. We would also like the guidance changed so that if a (proposed) director is, or is related to, a significant shareholder, he/she is likely to be independent if neither he/she (nor any other party related to the shareholder) has any significant business dealings with the company or derives any significant income from the company. We consider the guidance on the length of time that directors can serve useful, as it promotes turnover of directors, bringing in fresh views, and does not prohibit long serving directors from remaining on boards as either independent or non-independent NEDS. The issue arises because of the guidance being interpreted as a rule, and the solution is to clarify that it is not a rule.

The problem with the guidance in provision A3.2 (that independent NEDs should comprise at least 50% of directors (excl. Chairman)) is that this is interpreted as a rule. The solution is for it to be recognised as guidance and for companies and shareholders to be prepared to explain deviations from this.

The need for succession planning is covered in the supporting principles to A4 and in the “Summary of the principal duties of the Nomination Committee” in the “Higgs Suggestions for Good Practice”. There should be no need for it to be included more extensively in the code, however the wording of these supporting principles and in provision A4.2 might be updated to give it more prominence, if desired. We do not consider additional separate guidance to be necessary.

**3. Frequency of director re-election**

We consider the purpose of re-election to be to remind the directors that they are acting on behalf of shareholders, to call them to account if it appears to the shareholders that the director is not acting in their best interest, and also to provide shareholders with a structured opportunity to refresh board membership.

Walker Review Recommendations:

10. We do not agree that the Chairman should stand for re-election annually. The danger is that consistent engagement on an informed basis is replaced by set piece grandstanding and the quality of engagement declines as investors are encouraged to believe that annual voting can replace continuous engagement. Should annual re-

election apply to just the chairman, this may lead to all concerns relating to the Board being focused on one individual vote, which could be destabilising.

36. We believe that a proper debate needs occur on the tools that should be available to shareholders who are unhappy with the actions of some or all directors. We do not consider advisory votes to be sufficiently effective and a delay of 12 months following a significant negative advisory vote is too long. However, in the absence of a more effective tool, we support this proposal.

#### Issues for further consideration

We believe that there needs to be a full debate on the tools that should be available to shareholders if they are unhappy with the performance of some or all directors, and are unable to initiate change through engagement. Annual re-election is a blunt tool that we do not consider to be particularly effective, and which could potentially discourage quality engagement.

We believe that shareholders should continue to present resolutions requiring the Board to undertake a specific course of action (binding votes), but consider that shareholders would be better served by replacing board members who they perceive to be not acting in line with the shareholders' best interests.

We believe that Board members should take responsibility for their actions and that instead of advisory votes, shareholders should be encouraged to vote against the re-election of specific directors whose actions they disapprove of.

The chairman has responsibility for corporate governance. Rather than a vote on a corporate governance statement, we believe that shareholders should vote against re-appointment of the chairman if they consider there are ongoing failings in corporate governance.

#### **4. Board information, development and support**

We consider the objective to be that all directors have sufficient background knowledge, information and time to actively engage in discussions and participate in decision making.

#### Walker Review Recommendations:

1. This recommendation is already covered by the second paragraph of the supporting principles to A5; however it could be updated to more specifically cover the points raised in the Walker Review.
2. This recommendation is already covered by the second sentence of the first paragraph of the supporting principles to A5; however it could be updated to more specifically cover the points raised in the Walker Review.
9. This recommendation is already covered by the second sentence of the supporting principle to A2.

#### Issues for further consideration

At present the supporting principles to A5 gives the Chairman responsibility for providing information to directors and also for induction and development. But, they then go on to

clarify that the Company Secretary will normally perform these tasks under the supervision of the Chairman.

Responsibility shared is often responsibility ducked, so we would like it to be made clearer that the provision of information and training is an important part of the Chairman's responsibilities, perhaps through the re-issue of the Higgs "Guidance for the Chairman", updated as necessary.

The Company Secretary is an obvious resource that the Chairman can use to fulfill his responsibilities, however we do not believe that it is possible (in most companies) for a Company Secretary to properly fulfil this role, while simultaneously being an executive director. For example, Finance Directors have extensive responsibilities as a result of that role, and there is a significant risk, particularly in smaller companies where resources are limited, that company secretarial responsibilities receive lower priority. We would therefore like to see an additional provision requiring that the Company Secretary not be an executive director.

We believe that the Chairman should have overall responsibility for the running of the Board and should not be dependent on executive directors for advice in these matters. Where the Chairman has limited experience of managing the boards of publicly quoted companies, we strongly recommend that he has available the services of a full or part time company secretary with relevant public company experience (or some other corporate governance advisor) to assist him in fulfilling these responsibilities.

## **5. Board Evaluation**

The objective is to ensure that strengths and weaknesses are identified and that weaknesses are addressed either through change in personnel or procedures or through additional training.

### **Walker Review Recommendations:**

12. This recommendation is similar to principle A6, but goes further in recommending the use of external facilitator every 2 or 3 years. We consider that there should be an ongoing process of review to identify in real time, as well as with the benefit of history, the improvements that can be made in board performance. Those improvements can then be implemented promptly, rather than waiting for an annual or less frequent review. The challenge lies in improving the reporting to communicate how this is being done.
13. This recommendation is similar to provision A6.1, which could be redrafted in line with these recommendations. However, the final sentence implies that there may be additional information provided to major shareholders in advance of other shareholders. We do not believe that major shareholders should get information before other shareholders unless they have undertaken not to trade until such information is available to all shareholders.

### **Issues for further consideration**

Part of this issue with gaining acceptance for Board Evaluations are the negative connotations associated with the word "evaluation". This needs to be renamed in a more positive fashion, taking into account our point above (12) about this being an ongoing activity, perhaps as a "Board Continuous Improvement Process".

We do not think that board committees should have their performance evaluated less frequently than the main board, since much valuable work is performed at committee level.

It is difficult for boards to be open about the results of their reviews. It is understandable that if the quality of reporting is poor, shareholders will wish to see external facilitation or assurance. Companies need to be reminded of this threat and encouraged to improve their shareholder communications on this topic.

## **6. Risk Management and Internal Control**

All companies are exposed to risks and it is important that major risks are identified and managed in an appropriate manner to enhance shareholder value. Internal controls are part of the process of managing risks.

### Walker Review Recommendations:

23. We do not think that there should be a general requirement for companies to have separate risk committees. Particularly in smaller companies, there is significant overlap between the membership of different committees and a meeting of any separate risk committee may well just be a follow on to an audit committee meeting.
24. There is no general need for a CRO. This role will often be performed by the head of internal audit.
25. We are not certain that an external facilitator would add much reassurance. The best way to provide such reassurance is by better risk reporting.
26. Whilst it is good practice for non-executives to monitor acquisition and disposal programmes, we do not believe that a separate principle or provision is required.
27. If there is a separate risk committee then the type of information called for in the recommendation should be reported, but this should arise as a result of good practice and should not be a specific requirement of the Code.

### Issues for further consideration

The board's responsibility for setting strategy is clearly stated in the Code. Identifying and managing strategic risks is fundamental to setting and monitoring execution of strategy. There may be a case for redrafting of the supporting principles to A1 to be more specific about this.

The principles and provisions in C2 and C3 and the Turnbull Guidance do not need updating. The Turnbull guidance has only recently been reviewed and updated.

We do not think that there should be a general requirement for companies to have separate risk committees. Particularly in smaller companies, there is significant overlap between the membership of different committees.

Risk reporting should be integral to the Business Review in the same way that risk is integral to the setting and execution of strategy. As such, the format and content of risk reporting should be specific to each company, and any guidance is likely either to be at such a high level as to be of little use, or to be too specific to be appropriate, leading to boiler-plate reporting.

## **7. Remuneration**

The objective of remuneration structures should be to encourage management to promote the success of the company, and in particular to avoid encouraging excessive risk-taking and short term profit enhancement to the potential detriment of long term value.

The Code's existing principles and provisions relating to remuneration are extensive and out of proportion with the Code's elements on dealing with value creation. The FRC should not be looking to add to the existing requirements, but needs to draft new requirements that promote desired outcomes. Many of the provisions of B1 could be relegated to guidance.

Many of the Walker Review recommendations on remuneration are also very detailed and should not be incorporated into a revised Code.

The challenge should be to explain to shareholders how remuneration policies support the execution of the company's strategy.

### **Walker Review Recommendations:**

28. This is far too extensive and general a requirement to be appropriate for all listed companies.
- 29 & 30. It is unclear why the median remuneration of executive board members has been chosen and also why reporting should be in bands and not individually. A more general requirement to report individually key employees' remuneration would seem to be more appropriate.
31. This very specific recommendation should be caught by a more general requirement to explain material elements of remuneration packages.
33. This recommendation is too specific and a more general requirement would be to report how incentive schemes promote the long term success of the company.
34. This recommendation is too specific and a more general requirement would be to report how incentive schemes promote the long term success of the company.
35. This recommendation is too specific and a more general requirement would be to report how incentive schemes promote the long term success of the company.
37. This very specific recommendation should be caught by a more general requirement to explain material elements of remuneration packages.
- 38 & 39. This recommendation should be adopted to enhance best practice.

### **Issues for further consideration**

The FRC's objective must be to do what is best for listed companies' shareholders. Where other bodies impose requirements on companies, the FRC must be careful not to introduce complexity by imposing similar, but not identical, requirements. EU recommendations are not binding on countries and so should not be imposed unless they replace similar existing requirements. Most Walker Review recommendations are too specific to be appropriate for all listed companies, and the FSA's proposed code is also likely not to be relevant.



The Code should be isolated from developments in best practice by requiring a principled, outcome orientated approach. Guidance on best practice is useful, but would need to be kept regularly under review. This could usefully be contained in a “Turnbull” or “Smith” type addendum to the Code.

Shareholder complaints about corporate governance usually relate to executive compensation, but shareholders then fail to dismiss the executives whose pay they are complaining about or the remuneration committee members who agreed to those executives’ pay demands. As stated in the introduction, a more considered debate needs to be had on the tools that should be available to shareholders who cannot achieve change through engagement.

## **8. Quality of Disclosure by Companies**

Please see our introductory remarks about the relevance and importance of high quality disclosures as the basis for a high quality dialogue between shareholders and Boards. Quality is important, not quantity.

The purpose of corporate governance as set out in the preamble to the Code is to “facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term”.

Disclosures need to be focused on how the company’s corporate governance processes achieve this purpose. Additional disclosure requirements risk being counter-productive, if key disclosures become lost.

### Issues for further consideration

Corporate governance practices usually change little over time, so there is little benefit in cluttering up an annual report with a corporate governance report. An explanation of corporate governance practices does need to be maintained on a company’s website, and this document should identify when it was last updated and have changes since the previous update highlighted. Best practice should be to update this document at least once a year.

Board committee reports should be included in the annual report every year.

We do not believe that any monitoring or enforcement of “comply or explain” statements is required, but if any were to be introduced it should be limited to determining whether explanations were sufficient to enable shareholders to understand the issues and engage in informed debate.

## **9. Engagement between Boards and Shareholders**

There needs to be a mutual understanding between Boards and shareholders of objectives and constraints.

### Walker Review Recommendations:

14. Application of principle D1 – engaging in dialogue requires Boards to understand who their shareholders are. It is good practice to be aware of changes in the share register and to respond, but it is not clear how this could be incorporated into the Code.

16-18. These recommendations should be adopted.

19 & 20. This is an FSA regulatory point and not relevant for the Code.

21. The FRC is not the appropriate body to encourage overseas shareholders to commit to the Principles of Stewardship and MoU.

22. This is an FSA regulatory point and not relevant for the Code.

#### Issues for further consideration

The framework recommended in the Walker Review appears to make sense, but not being an institutional investor we are unable to comment further.

The FRC should endorse and publicise the Principles of Stewardship and MoU, but it should not become involved in the enforcement of corporate governance. Its role must be to continue to encourage from the sidelines. The QCA will be approaching the ISC and major UK institutional shareholders to work with them to ensure that either: the Principles of Stewardship and MOU are relevant for smaller quoted companies, or that separate versions are prepared for smaller quoted companies.

Although provision D1.1 requires the Chairman to discuss governance and strategy with shareholders, this does not happen for many small companies. Results presentations are the normal opportunities for smaller companies to meet Shareholders and far too often these are only attended by the Chief Executive and Finance Director. The Chairman should be encouraged to attend such meetings, so that he has first-hand knowledge of the areas of interest and concern to shareholders. If he does not, then he should explain how he fulfils his responsibility for ensuring effective communication with shareholders and that the board members develop an understanding of the views of major investors.

Shareholders often complain about the “bunching” of AGMs restricting their ability to give sufficient consideration to corporate governance reporting. The FRC should work with others to reduce this.

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

Yours sincerely,



Tim Ward  
Chief Executive

**QCA CORPORATE GOVERNANCE COMMITTEE**

Edward Beale* (Chairman)	-	City Group PLC
Mirza Baig	-	F & C Asset Management
Nigel Burton	-	Advanced Power
Anthony Carey	-	Mazars LLP
Louis Cooper	-	Horwath Clark Whitehill LLP
Clive Garston	-	Davies Arnold Cooper LLP
Tim Goodman	-	Hermes
Mark Harwood	-	Baker Tilly LLP
Andrew Viner	-	BDO LLP
Melanie Wadsworth	-	Faegre & Benson LLP
Nick Wargent	-	K & L Gates
Tim Ward	-	The Quoted Companies Alliance
Kate Jalbert	-	The Quoted Companies Alliance

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## **THE QUOTED COMPANIES ALLIANCE (QCA)**

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

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
- 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; Financial Services Authority (FSA) consultations
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from various standard-setters

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

### **QCA's Aims and Objectives**

The QCA 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 exclude business rates, VAT and other indirect taxes.

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