QUOTED COMPANIES ALLIANCE

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The Business, Innovation and Skills Committee
House of Commons
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26 October 2016

Dear Sirs,

The Business, Innovation and Skills Committee Inquiry on Corporate Governance

Introduction

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size 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.

The Quoted Companies Alliance Corporate Governance Expert Group has examined the Committee's questions and advised on this response. A list of the Expert Group members is in Appendix A.

Response

We welcome the opportunity to submit written evidence to the Business, Innovation and Skills Committee's inquiry on corporate governance.

As an overarching comment, we believe that effective corporate governance encourages sustainable long-term value creation and value protection for shareholders. It is important to identify and share effective practices and areas where good progress has been made, while noting gaps and areas of weakness, given the overall importance and cross-sectoral impact of corporate governance practices.

We note that corporate governance is an area where much that is already on the record still holds true and the Business, Innovation and Skills Committee is encouraged to assess all of the work in the area that has been carried out by the wide range of stakeholders, including the Department for Business, Energy and Industrial Strategy (BEIS), Parliament, the Financial Reporting Council (FRC) and the Quoted Companies Alliance.

In particular, we encourage the Business, Innovation and Skills Committee to review the relevant provisions of the current law, the UK Corporate Governance Code and the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies (the QCA Code).

We believe that it is the responsibility of Parliament and the courts to define the legal framework of directors' duties. We note the successful codification of directors' duties into the Companies Act 2006; this

was a positive change in the legislation which, in our view, achieved its purpose at the time and continues to do so. It is now simple for directors to identify their duties and the wider stakeholder factors by checking the clearly stated law, written in plain English.

Nonetheless, the challenge remains, as this legislation is not read and well understood by all company directors. We believe that the Government should sufficiently resource BEIS to both enforce the existing laws in place and promote good governance practices. We believe that the introduction of new legislation is not necessary, although we note that there is a powerful case for better enforcement and promotion by a properly funded government department. We believe that there is little evidence to suggest that more legislation would equate to improved behaviour from directors.

It is the responsibility of companies to follow legal requirements in the most appropriate manner for their business and put good governance into practice. To this end, corporate governance codes play a vital role.

Corporate governance codes created by persons independent of government can then act as the basis upon which companies comply with the requirements in a way most appropriate to their individual circumstance. Governments are encouraged by the OECD to ensure that the appropriate framework exists for corporate governance codes to be put in place.

We believe that companies should be more aware that good governance arrangements suitable for growing companies exist and that the Government has a leading role to play in supporting this. Enabling and empowering companies to act in a more ethical way will allow smaller companies to both inspire trust from shareholders, as well as grow and thrive in this uncertain economic climate.

The QCA Code has become a valuable reference for smaller companies wishing to follow good governance examples. It serves as a practical, outcome-oriented approach to corporate governance for those quoted companies in the UK not obliged to apply the FRC's UK Corporate Governance Code on a mandatory comply or explain basis.

We also publish two guides that accompany the QCA Code that provide further assistance to Remuneration and Audit Committees:

- our Remuneration Committee Guide for Smaller Quoted Companies supports members of remuneration committees, and those who support them, to develop effective remuneration packages for executive directors and senior management in a fair and reasonable manner. We specifically refer to the Directors' Remuneration Reporting Regulations even though it only applies to listed companies, as we encourage small and mid-size quoted companies to be aware and adopt some or all of the requirements;

- our Audit Committee Guide for Small and Mid-Size Quoted Companies assists audit committee chairmen and members in being more effective in their roles, so that they are able to meet the expectations of investors and comply with regulatory best practice for small and mid-size quoted companies.

The publications mentioned above greatly contribute to the ability of small and mid-size quoted companies to revise the ethical environment in which they operate. To the extent necessary, these can also be used by private companies of any size who wish to put good governance into practice and grow responsibly. We have enclosed copies of all three publications with our response.

Furthermore we refer the Business, Innovation and Skills Committee to the recent Financial Reporting Council's report of observations on corporate culture and the role of boards[1], which examines the connection between a company's corporate culture and its ability to deliver long-term success.

We believe that these tools, alongside the UK Corporate Governance Code, provide adequate corporate governance guidance for companies of all sizes; it should be the role of the legislature and the executive and, most particularly, your committee and BEIS to promote these tools and support directors in dealing with corporate governance issues that affect them, including support with training and evaluation of performances.

We have responded to the specific questions from the point of view of our members, small and mid-size quoted companies.

Responses to specific questions

Directors' Duties

Q1 Is company law sufficiently clear on the roles of directors and non-executive directors, and are those duties the right ones? If not, how should it be amended?

We believe that the law is very clear on the duties of directors. There is no distinction between the duties of directors and non-executive directors; they apply equally to both categories of directors. We do not believe that, in light of the unitary board model specified under English law, any distinction should be made between the duties of directors and non-executive directors. We note that the UK Parliament, through Chapter 2 of Part 10A of the Companies Act 2006, has successfully and clearly codified a director's duties, and therefore no changes to the legislation are required.

We note that the role of non-executive directors is stated clearly in the code provisions set out in Section A.4 in the UK Corporate Governance Code, maintained and published by the FRC. It specifies that non-executive directors should constructively challenge and scrutinise the performance of management in meeting the agreed goals and objectives, monitor the reporting of that performance and assist in the development of the company's strategy. Furthermore, the evolving framework in relation to narrative reporting demonstrates the different functions of a non-executive director to the executive management.

We refer the Business, Innovation and Skills Committee to guidance from ICSA: The Governance Institute, The Non-Executive Directors' Handbook, which highlights that non-executive directors have responsibility for strategy, performance, risk and personnel within a company.

We believe that there has been no change in the environment since the law on duties of directors was partially codified following in 2006 that requires any amendment to the law or best practice guidelines. However, we do believe that the Government would be well served to sufficiently resource BEIS to enforce the laws that are in force. Equally, we believe that BEIS could commit more effort and resource to encouraging directors to learn how to deal with challenging company law issues.

[1] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Corporate-Culture-and-the-Role-of-Boards-Repor-(1).pdf

Q2 Is the duty to promote the long-term success of the company clear and enforceable?

We believe that this question is predicated on an erroneous reading of Section 172 (1) of the Companies Act 2006. We note that, rather than promote "the long-term consequence of the company", Section 172 (1) of the Companies Act 2006 refers to a duty "to promote the success of the company for the benefit of its members as a whole". To be clear: the long-term consequence of a decision is only one of the (a) to (f) subsidiary factors to have regard to.

Notwithstanding, we note that the duty to "promote the success of the company" prescribes that decisions, as well as being taken with regard to long term consequences, should also be taken with regard to a range of other "stakeholders", such as employees, suppliers, the environment, the general community, and creditors.

Furthermore, we note that it is particularly difficult to litigate against, since it is only a duty for a director to do what (s)he "considers, in good faith, would be most likely to promote the success of the company". Specifically, proving subjective absence of good faith toward any group is extremely difficult. The result has been that directors have the discretion to balance all competing interests, even if to the short term detriment of shareholders in a particular instance.

The duty to promote long term success is not law, but a recent requirement of the UK Corporate Governance Code. We note its Section A: Leadership highlights the board's duty to promote long term success. This means that companies must report to their shareholders if they have followed the code or explain why not. We note that it is too early to say whether this Code change has been effective, although it is important to emphasise that the UK Corporate Governance Code is aimed at large companies, which are likely to be run with a business plan focussed on permanent existence rather than a limited lifespan of the main PLC.

Q3 How are the interests of shareholders, current and former employees best balanced?

There are many stakeholders who have an interest in the success of a company. Employees should not be singled out as having preference over any other stakeholder group. We note that different stakeholders will have different and often competing interests; we believe that the role of directors will be impossible if they have to formally weight those competing interests.

We believe that a requirement to promote the success of the company, over the longer term, where relevant, is the best way to balance the competing interests of different stakeholder groups. Any business focussed on the longer term will seek to look after the interests of other stakeholders, including current and former employees, customers, suppliers and the local community.

Q4 How best should the decisions of Boards be scrutinised and open to challenge?

We believe that the individual decisions of board directors should not be open to wide scrutiny. Scrutiny should be provided by rights of liquidators to challenge transactions and for BEIS to take the necessary action to enforce breaches of company law.

The duties of directors are to promote the success of the company for the benefit of its members as a whole. Shareholders are therefore the most appropriate group to challenge the decisions of directors. In

order to do this effectively, shareholders need good quality, timely information, and a venue or format (such as an AGM or investor meetings) in which that challenge can take place.

We note that many of the corporate governance issues that have arisen in quoted companies are due to a lack of challenge by those people that the companies' boards listen to. This includes not only shareholders, but also, to a certain extent, sponsors, Nominated Advisers and brokers.

Q5 Should there be greater alignment between the rules governing public and private companies? What would be the consequences of this?

We note that different rules have evolved over time for public and private companies due to the differing nature of their stakeholders. We believe that a one-size-fits-all set of regulation covering companies from the FTSE 100 down to the sole trader would not be appropriate. We believe that the current distinctions are appropriate and should remain unchanged.

Q6 Should additional duties be placed on companies to promote greater transparency, e.g. around the roles of advisors. If so, what should be published and why? What would the impact of this be on business behaviour and costs to business?

We do not believe that additional duties should be placed on companies in this regard. We do not believe that this would be an appropriate method of promoting greater transparency. We believe that measures from both law and good practice are already having an effect.

Q7 How effectively have the provisions of the 1992 Cadbury report been embedded? How best can shareholders have confidence that Executives are subject to independent challenge?

We note that, in recent years since the 2007/08 financial crisis, there have been a number of high-profile cases among large companies that have shown executive directors not being subject to rigorous independent challenge. We note that in almost all cases, the shareholders have suffered. We believe that shareholders, as the group with the most interest in providing independent challenge, should be providing such challenge and not outsourcing that responsibility to other parties. We note that one potential solution might be for a shareholder committee (perhaps consisting of the top five willing shareholders plus a representative of individual shareholders) to provide a framework for discussions and challenge.

We believe that the provisions of the 1992 Cadbury Report remain relevant today. We note that the UK Corporate Governance Code's focus on structures and processes detracts from the more important aspects of governance, which are having people with the right mix of skills and experience working together in a culture of constructive challenge and continuous improvement. We believe that it is the right outcomes that are important not the different ways that outcomes can be achieved.

We encourage the Business, Innovation and Skills Committee to review the QCA Code, which serves as a practical, outcome-oriented approach to corporate governance for those quoted companies in the UK not obliged to apply the FRC's UK Corporate Governance Code on a mandatory comply or explain basis.

Q8 Should Government regulate or rely on guidance and professional bodies to ensure that Directors fulfil their duties effectively?

We find it difficult to envisage how the Government can regulate to ensure that directors fulfil their duties (as set out already in regulation) effectively.

We note that although guidance – from professional bodies or others – can help directors fulfil their duties effectively, it cannot and should not replace individual judgement. One difficulty with guidance is that it can be interpreted as rules and followed to inappropriate conclusions. We believe that a focus on outcomes, rather than methods, should be the priority. As already mentioned, we believe that the QCA Code's practical outcome-oriented approach serves as a good model.

We believe that the Government should devote greater resources to enforcing the existing frameworks in place.

Equally, we believe that more frequent and higher quality, feedback from investors is the best way to promote improvement in performance.

Executive Pay

Q9 What factors have influenced the steep rise in executive pay over the past 30 years relative to salaries of more junior employees?

We have seen no evidence of a steep rise in the pay of executive directors of small and mid-size quoted companies.

Q10 How should executive pay take account of companies' long-term performance?

We note that remuneration arrangements for executive directors are an important factor in ensuring that they are motivated to create value for shareholders. Companies of all sizes face many choices in tackling issues of remuneration; this is particularly true for small and mid-size quoted companies.

We encourage the Business, Innovation and Skills Committee to read our approach to remuneration in our Remuneration Committee Guide, in particular to the approach we take as to the application of the 2013 remuneration reporting regime into this part of the market. We believe that companies should approach matters of remuneration in a way that is proportionate, rational and measured. Equally, companies should be clear and transparent when setting executive pay, in order to nurture the development of trust between companies and shareholders. Models of remuneration should support the sustained alignment of interests between directors and shareholders which should help to deliver long-term growth in shareholder value.

We believe that a significant proportion of an executive director's remuneration should be performance based. This can be done by linking pay to strategic milestones, key performance indicators (KPIs) and value drivers that incorporate challenging and transparent targets related to corporate and individual performance.

Our Remuneration Committee Guide is specifically targeted at small and mid-size quoted companies to serve a practical guide as to how remuneration committees can develop effective executive remuneration packages.

Q11 Should executive pay reflect the value added by executives to companies relative to more junior employees? If so, how?

We note that the success of a company is likely to derive from the activities of a team of people who should all share in the rewards of success. We believe that how such rewards are apportioned should be a matter

for boards taking into account the particular circumstances of the company. This should be set out in the remuneration policy, and reported on by the Remuneration Committee.

Q12 What evidence is there that executive pay is too high? How, if at all, should Government seek to influence or control executive pay?

We have not been provided with any evidence of systemic high executive pay within the small and mid-size quoted company sector.

Q13 Do recent high-profile shareholder actions demonstrate that the current framework for controlling executive pay is bedding in effectively? Should shareholders have a greater role?

We note that the current voting and disclosure regime has now been in place for two years. We believe that, to a certain extent, it has had a positive influence on executive pay. In particular, we note that the new regime has resulted in companies taking into account the broader economic climate when considering executive remuneration, so that the pay awarded is more commensurate with the company's performance.

We believe that shareholders should be encouraged to take an active interest in the company they have shares in. Through their involvement they can encourage the company to improve its corporate governance measures which is likely to lead to better performance of the company. While we note that there is a risk that too close involvement may lead to some shareholders having price-sensitive information depriving them of the legal right to trade shares, we believe that this is manageable.

We believe that shareholders should trust directors to do what is right and that good directors deserve such trust. Shareholders should not be taking responsibility for making decisions that ought to be taken by directors. However, there should be appropriate feedback mechanisms, so that shareholders can inform directors how well they think directors are performing and where they believe there is room for improvement.

Composition of Boards

Q14 What evidence is there that more diverse company boards perform better?

We believe that company board diversity is integral to enhancing the effectiveness of boards and provides companies with a broader skill-set, thus ensuring that they are better prepared to respond to an ever-changing and uncertain economic environment. We note that this issue is of particular relevance to the small and mid-cap quoted company sector – this constituency tends to have a low proportion of women and ethnic minorities on their boards and in senior management roles.

We believe that it is important that companies recruit the best people regardless of their background. An absence of diversity on boards calls into question the effectiveness of a company's recruitment process, and should therefore result in nomination committees being challenged by shareholders. Public companies should give serious consideration to promoting greater diversity in all its forms, including gender diversity amongst applicants for board and other positions.

Q15 How should greater diversity of board membership be achieved? What should diversity include, e.g. gender, ethnicity, age, sexuality, disability, experience, socio-economic background?

We believe that diversity on boards leads to more effective decision-making, better utilisation of the talent pool, and to an improvement in corporate reputation and investor relations. Greater diversity of board membership can be achieved through regulatory measures such as imposing quotas and enhancing disclosures using a comply or explain approach or, alternatively, by trying to change the corporate culture of the business.

We believe that nomination committees should be challenged by shareholders when there is no evidence of diversity (in its broadest sense) in the composition of the board and boardroom appointments. We consider that diversity should include age, race, gender, ethnicity, sexuality, disability, educational background and professional qualifications of the directors. We also note that the FRC completed a study of Board Succession Planning last year, where further guidance in this area was provided, particularly in respect of diversity, promoting the development of a pipeline, the importance of board evaluation and the role of the nomination committee.

We note that the use of shareholder committees to approve the process for recruitment of non-executive directors (including chairmen) and the recruitment criteria, as well as the ratification of the process's outcome is a possible improvement on the current system. This will help develop trust between shareholders and directors.

Q16 Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?

We believe that a requirement to have workers on boards who are not directors by reason of their function could lead to many adverse and unintended consequences, even if problems with definitions can be overcome. We note that senior management are as much workers as are clerical or shop floor staff. Companies seeking to be successful over the longer term will strive to keep employees motivated and engaged through a number of mechanisms, which will vary according to the type of company and the stage of its development. We believe that a one size fits all solution will not be appropriate for many of the companies affected.

An alternative solution could be to encourage companies to establish employee councils or forums, where a non-executive director attends and ensures that there is effective two-way communication between the board and employees.

We believe that any change to the current board structure would challenge the test of independence set out in Section B.1.1 of the UK Corporate Governance Code, creating an unusual hybrid where a worker-appointed director is, effectively both a full time employee (in a director role) and a non-executive director. Furthermore, this could result in boards becoming larger, undermining the initiative of the last two decades for boards to be effective, tight units.

Q17 What more should be done to increase the number of women in Executive positions on boards?

Efforts have been made over recent years to improve the number of women on boards. Whereas some progress has been made more needs to be done. We believe that it is important to look at the whole leadership pipeline if we are to benefit from more balanced boards. We should focus on the talent pipeline

of capable and aspiring women to ensure that they can see their way ahead and move into leadership positions. In fact, one of the key drivers for developing female talent below board level is commitment and accountability from senior leaders and managers. Companies leading the way in terms of talent management hardwire diversity targets and achievements to managerial responsibility, performance and reward.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours faithfully,

Tim Ward
Chief Executive

Enc: The Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies

The Quoted Companies Alliance Audit Committee Guide for Small and Mid-Size Quoted Companies

The Quoted Companies Alliance Remuneration Committee Guide for Small and Mid-Size Quoted Companies

APPENDIX A

Quoted Companies Alliance Corporate Governance Expert Group

Edward Craft (Chairman)	**Wedlake Bell LLP**
Colin Jones (Deputy Chairman)	UHY Hacker Young
Nathan Leclercq	Aviva Investors
Jonathan Compton David Isherwood	BDO LLP
Kalina Lazarova	BMO Global Asset Management (EMEA)
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Nicholas Stretch	CMS Cameron McKenna LLP
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Nick Gibbon	DAC Beachcroft LLP
Tracy Gordon	Deloitte LLP
Melanie Wadsworth	Faegre Baker Daniels LLP
Rob Burdett	FIT Remuneration Consultants
Richie Clark	Fox Williams LLP
Michael Brown	Henderson Global Investors
Will Pomroy	Hermes Investment Management Limited
Alexandra Hockenhull	Hockenhull Investor Relations
Julie Stanbrook Bernard Wall	Hogan Lovells International LLP
Darshan Patel Niall Pearson	Hybridan LLP
Peter Swabey	ICSA
Jayne Meacham Carmen Stevens	Jordans Limited
Darius Lewington	LexisNexis
Anthony Carey	Mazars LLP
Peter Fitzwilliam	Mission Marketing Group (The) PLC
Cliff Weight	MM & K Limited
Caroline Newsholme	Nabarro LLP
Julie Keefe	Norton Rose Fulbright LLP
Amanda Cantwell	Practical Law Company Limited
Susan Fadil Philip Patterson	PricewaterhouseCoopers LLP
Marc Marrero	Stifel
Kevin Kissane	Vernalis PLC
Edward Beale	Western Selection Plc