COMPENDIUM of Chapter Summaries

Chapter 1 – UK Corporate Governance

The UK adopts a principles-based approach to corporate governance which is enshrined in The UK Corporate Governance Code. The Code is not a statutory instrument. Its application rests upon the principle of 'comply or explain'.

The Code applies to Premium Listed companies on the LSE, which covers the majority, if not all, smaller quoted companies. Under the listing rules, smaller companies are required to disclose how they have complied with the Code's Main Principles and its Provisions where relevant, but the 'comply or explain' principle allows flexibility provided any explanation for non-compliance is sound and acceptable to shareholders.

The Code is a valuable source of guidance on best practice for governing a smaller quoted company. Its value lies particularly in the considered application of its Main Principles. However, applying any code of corporate governance is no guarantee of business success. That depends on so much more, not least entrepreneurial spirit so vital to the smaller company sector. The UK Code is not intended to suppress that vital ingredient to business enterprise.

Chapter 2 – Corporate Law and Governance

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Corporate governance is not wholly prescribed by the law regulating the activities of companies and directors, but corporate law has an important bearing, not least so far as directors' duties are concerned. Corporate governance, therefore, embraces aspects of corporate law, but much more besides.

The Companies Act 2006 wrote into statute the general duties of directors, which hitherto had been provided for at common law and equity. Directors' duties were clarified in statute on the basis of 'enlightened shareholder value', requiring directors to take into account a variety of factors most likely to promote the success of the company for the benefit of the members as a whole. This duty is enshrined in S 172 of the Act and is arguably that duty which directors should pay most attention to. However, until sufficient case law has been accumulated, interpretation of the duty by the courts will remain unclear.

Notwithstanding the enlightened shareholder approach underpinning S172, shareholder primacy continues to hold sway.

Chapter 3 – The Non-executive Director

Non-executive directors fill an important role on the board of a smaller company. Their appointment is mandatory for the Premium Listed Company and they are considered to play a key role in governance. Their effectiveness is, aside from their individual qualities, dependent upon how well a board is led by the chairman, so as to integrate them into board discussion and decision-making, and facilitate constructive relationships with their executive director counterparts. As with the board as a whole, effectiveness is as much down to behaviours as to any prescription of their role.

The balance of monitoring the executive management on the one hand, with contributing to the strategic development of the company on the other, is a challenge for any non-executive director. This is particularly so on the board of a smaller company, especially in its early phases of growth.

Premium Listed smaller companies are required to have a minimum of two independent non-executive directors (excluding the chairman) on the board. This is to satisfy the membership of the audit, remuneration and nomination committees. This does not in any way exclude the appointment of non-executive directors who are deemed not to be independent. This is particularly relevant for smaller companies, especially in the early stages of their development, where the experience and knowledge of the company and its industry built up over many years by an executive can prove invaluable in a non-executive capacity

Chapter 4 – Boards and their effectiveness

The chairman, in his/her capacity of leader of the board, is ultimately responsible for its effectiveness. Effectiveness starts with determining the composition of the board, where the aim should be to pull together the right mix of skills, experience and personal attributes which meet the company's needs, followed by evaluation of the board's performance at annual intervals. The same principles of regular evaluation should also apply to directors individually.

Under the leadership of the chairman, the board has overall responsibility for setting the direction of the company and for its governance.

The company secretary occupies a unique position of being a key support to the chairman on all governance matters.

For smaller companies, the Code requires a minimum of two independent non-executive directors on the board, excluding the chairman, not only to bring objectivity to board decision-making, but also to satisfy the requirement for independence on each of the three committees – audit, remuneration and nomination. However, it is not unusual, particularly in the early phase of Premium Listed status, for the chairman to be counted as one of the independent non-executive directors, and for this to be acceptable to shareholders.

Chapter 5 – Governance and Shareholders

The UK governance model rests upon company boards of directors accountable to shareholders on the one hand, and shareholders themselves holding company boards to account on the other. The model requires that both parties play their part, but it is only in recent times that the role of shareholders has been given the focus it demands. In a world where shareholding is widely dispersed so that ownership (shareholding) and company management are separated, the role of shareholders in evaluating company governance arrangements and practice becomes crucially important.

This role is dependent upon good communication between shareholders and company boards. The vehicles for this communication are company corporate governance reporting and dialogue, i.e. engagement, between the parties. Reporting on corporate governance and compliance or non-compliance with the Code is mandatory for Premium Listing of smaller companies, and guidance on engagement by companies is included in the Code, and for institutional shareholders in the UK Stewardship Code.

There is a danger that company reporting of governance arrangements can be no more than 'box ticking'. Constructive and effective engagement, however, has an important place in building understanding between company boards and shareholders based upon mutual trust and respect and upon an economic purpose to build value. This is important to supporting the growth of smaller companies and their access to capital to fuel that growth.

However, some impediments (not least costs and resourcing) stand in the way of engagement by shareholders which, in all probability, can only be overcome by their taking a long-term investment view and focusing on portfolios limited in number, or a selected number of smaller company investments within larger portfolios. For their part, smaller companies need to focus on their major shareholders, typically around six in number, and be prepared to be constructively challenged by their shareholders on items such as strategy and board composition, etc, which may be issues for engagement.

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