

The City Group for
Smaller
Companies



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FINAL DRAFT

The Secretary
Committee on the Financial Aspects
of Corporate Governance
c/o The London Stock Exchange
London EC2N 1HP

Dear Madam

The City Group for Smaller Companies (CISCO) has over 100 members drawn from a range of City professions including stockbrokers, accountants, solicitors, institutional investors, merchant bankers and corporate financiers.

The members of CISCO believe that the concept of corporate governance described in the Report of the Committee On The Financial Aspects Of Corporate Governance (the committee) should apply to all public companies whose share capital is listed on The Stock Exchange or traded on the Unlisted Securities Market. Indeed, in the case of smaller companies which are sometimes dominated by a founder or entrepreneur, the need for compliance is often greater. There are, however, a number of areas where consideration should be given to refining the recommendations when applied to smaller quoted companies.

We understand the committee are monitoring the implementation of the Code of Best Practice (the Code), and have established a procedure for updating the Code whenever necessary. We therefore wish to bring to your attention a number of recommendations for further refinement of the Code which we believe will assist in its implementation by smaller quoted companies.

The recommendations that we are placing before the committee reflect two objectives.

First, the committee itself highlighted the fact that smaller quoted companies may experience some difficulty complying with aspects of the Code. We have attempted to identify those areas and, wherever possible, suggest alternative recommendations which we believe are feasible for all smaller quoted companies. We consider this preferable to allowing companies the option of doing nothing and excusing themselves from complying with standards they might justifiably claim to be too exacting.

Second, one of the main reasons for establishing the committee was to produce formal guidance on corporate governance, thereby strengthening the existing system. Where effective corporate governance is lacking this usually reflects a lack of discipline rather than devious intent. We are therefore proposing a number of refinements to the report which should provide further guidance to smaller quoted companies.

CISCO normally defines 'smaller quoted companies' as those which are not

included in the FTSE 100, FTSE 250, and FTSE 350 indices. The definition of 'smaller companies' therefore includes companies with a market value roughly below £150m. We recognise that many companies falling within the CISCO definition should not face any difficulties complying with the code as it currently stands. We would suggest that it is the responsibility of shareholders to determine whether or not a company may comply with the CISCO recommendations as opposed to the full Code and that they should direct the company accordingly.

All the recommendations being made by CISCO are intended to be wholly supportive of the spirit of corporate governance as defined by the committee. Wherever possible references to the relevant paragraphs in the Code of Best Practice (COBP) and the report Financial Aspects of Corporate Governance (FACG) are provided.

If you would find it useful representatives of CISCO would be happy to attend a meeting to discuss these issues further.

Richard Balarkas

The Report of the Committee on the
Financial Aspects of Corporate Governance

Refinements for smaller companies

1. Number of non-executive directors - COBP 1.3/FACG 4.11

The requirement for three non-executive directors is possibly excessive and in some cases could impose an unnecessary financial burden. We recommend that smaller companies should have at least two independent non-executive directors as this enables the non-executives to liaise and not be isolated or dominated. To be counted as a non-executive director the individual must be truly independent as defined in paragraph 2.2 of the Code. ✓

2. Division of responsibilities - COBP 1.2/FACG 4.9

The Cadbury requirement for a division of roles between the Chairman and the chief executive officer is viewed to be difficult for smaller companies to implement. Much of the concern caused by a combination of these two roles can be offset by the presence of the board of two independent non-executives. It is also considered good practice for one of the non-executive directors to be appointed as a non-executive chairman.)))

3. Board procedure - COBP 1.1/FACG 4.23

Board meetings should take place regularly, and as required to deal with the matters reserved for its specific decisions, with the board normally meeting monthly. Boards should not meet less than six times a year. ✓

The agenda of regular board meetings should always include a report of management accounts from the finance director.

4. Board procedure - COBP 1.4/FACG 4.23/24

The quality of information available to directors can present difficulties, as often board decisions are not taken in a formal or consultative manner. Decision making is often an ad hoc process covering the full range of a company's activities. It is accepted that any system of corporate governance should not fetter entrepreneurial talent. Systems can nevertheless be established where, in relation to certain areas of management (e.g. substantial purchases/disposals of assets, management changes etc), the entrepreneur must always consult the board as a whole before implementing a decision taken in principle, without compromising commercial effectiveness.

Matters that should always be addressed by the board before a decision is enacted are included in note 1.

5. Attendance of non-executive directors

Non-executive directors should attend board meetings as a matter of course and it should be considered good practice for them always to attend annual and other general meetings.

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6. Audit committees - COBP 4.3/FACG 4.35

It is fundamental that an audit committee is established and that all non-executive directors are members of it, but membership need not be restricted to non-executive directors. A non-executive director should be appointed as chairman of the audit committee. As part of the arrangements, non-executive directors should have meetings (at which the executive are not present) with the company's auditors.

Where a company has a small board (that is to say less than five members) the audit committee may also assume the duties of the remuneration committee and nomination committee.

7. Fees COBP 2.2/FACG 4.13

Non-executive directors should not have share options or any compensation on the termination of their appointment.

8. Terms of appointment of non-executive directors - COBP 2.3/
FACG 4.16

In a small company the desire to maintain the vitality of the board through the rotation of non-executive directors has to be balanced against the considerable time and effort expended in finding a suitable replacement for a smaller company, and the loss of accumulated knowledge. The recommendation that non-executive directors should be appointed for fixed terms and never for indefinite periods will benefit all companies, but in the case of smaller companies the length of the appointment might reflect the greater difficulties experienced in finding suitable replacements, and the benefits of having a working relationship with a non-executive director that has developed over a number of years.

For smaller companies we recommend that the term of the appointment should normally be for five years and not exceed ten years. Companies should ensure that the appointment of non-executive directors is staggered, and that the non-executive directors do not retire at the same time.

9. Resignation of non-executive directors

Any non-executive who resigns from any quoted company should be entitled to communicate (at the company's expense) with its shareholders giving the reasons for his resignation and any matters he considers should be brought to their attention. This procedure could also apply where there is fundamental disagreement leading the non-executives to vote against resolutions proposed at board meetings.

10. Selection of non executive directors

Companies should seek to define the objectives of the role a non-executive director is expected to fulfil before starting the selection procedure. If necessary advice may be sought from major shareholders to try and identify those areas of the board's

knowledge base and skills that may need strengthening.

(Note: The committee, in addressing the concern that there may not be a large enough pool of suitable candidates from which companies can select non-executive directors, commented that companies should take a more open minded approach to finding suitable non-executives. They should, for instance, not rule out divisional managers of large organisations. It is of some concern to CISCO members that the main body responsible for promoting the function of non-executive director, Pro-ned, perhaps tends to maintain elitism. It has, we understand, some 800 executives on its database who are normally drawn from the boards of blue chip companies. Given that there are over 2000 listed companies, all of whom may be seeking three non executive directors, the Pro-ned list is inadequate.)

We hope the committee finds these points constructive and helpful. Representatives of CISCO are very willing to discuss these recommendations with the committee if required.

Notes

1. Matters which should be presented to the board

Management structure and senior management responsibilities.

Nomination of directors.

Appointment of Chairman.

Appointment of managing director.

Appointment or removal of company secretary.

Senior management appointments.

Remuneration, contracts and grants of options for senior management.

Business strategy.

Operating budgets.

Diversification/retrenchment policy.

Acquisitions and disposals of subsidiaries or other assets or liabilities over, say, 5% of net assets/profits.

Investments and capital projects over a similar level.

Other transactions over a similar level.

Substantial commitments including;

- pension funding
- contracts in excess of one years duration
- giving of security over significant group assets

(including mortgages and charges over the company's property)

Contracts not in the ordinary course of business

Raising new capital and confirmation of major financing facilities.

Treasury policies including foreign currency and interest rate exposure.

Specific risk management policies including insurance, hedging, borrowing limits, corporate security

Agreement of code of ethics and business practise

Establishment of overall framework for proper control e.g. internal audit

Establishment of managerial authority limit for smaller transactions

Actions or transactions where there may be doubt over their legality or propriety

Agreeing membership and terms of reference of board committees and task forces

Matters referred to the board by board committees

Governance of company pension schemes and appointment of company nominees to board of trustees.

Final approval of annual and interim reports and accounts and accounting policies

Appointment/proposal of auditors

Approval of prospectuses, issue documents

Approval and recommendation of dividends

Allotment, calls or forfeiture of shares

Disclosure of director's interests

Avoidance of wrongful or fraudulent trading

Calling of shareholders' meetings

Delegation of the board's powers

Authorising use of company seal

Charitable and political donations
