



**CORPORATE GOVERNANCE – NEW GUIDANCE
FOR OWNER-MANAGED, JOINT VENTURE,
SUBSIDIARY AND OTHER UNLISTED COMPANIES**

May 2010

Dean Drew, Partner Shoosmiths

shoosmiths

In April 2010, the IoD published the first edition of the **Corporate Governance Guidance and Principles for Unlisted Companies in Europe**, an initiative of the European Confederation of Directors' Associations, ecoDa¹ of which the IoD is a member.

This new guidance provides an important reference point for **unlisted companies** wanting to develop their corporate governance systems and processes. The guidance brings together **best practice taken from across the EU**, applicable to unlisted companies such as family-owned and owner-managed companies, subsidiaries, joint venture and state-owned companies, start-ups and public sector social profit organisations.

The guidance is divided into two main parts. Part I provides general advice relating to corporate governance. Part II sets out **fourteen principles of good governance**, the first nine of which (the phase 1 principles) relate to all unlisted companies. The remaining five principles (the phase 2 principles) apply to larger and more complex unlisted companies.

Any unlisted company is free to adopt the principles it judges to be applicable and appropriate on an entirely **voluntary basis**.

It is recommended that once started, improving corporate governance within a company should be an ongoing **dynamic process** (hence the principles being split into two phases), developing and refining a company's systems and processes as it grows and changes.

One of the biggest challenges for unlisted companies is simply to begin the process of improving corporate governance as owners are often sceptical and so need to be convinced at the outset of the advantages improving corporate governance can deliver. Good governance will depend, in any given situation, on clear and effective communication and engagement between the key players namely, the **directors, management, stakeholders** (such as customers, suppliers and employees) and **shareholders**, so it is important that the shareholders fully support the process.

Improving corporate governance is not only for long established companies. In early stage, entrepreneur-founded and smaller companies, a single owner may well deal with most matters directly, initially through necessity, and later because "it is easier" and "saves all that red tape". However, in the end this type of arrangement may not be sustainable and exposes a business to the risk of bad decision-making through a lack of objectivity and human weakness. Developing corporate governance in line with the principles identified in the new guidance will help to address these early-stage issues.

¹ ecoDa is a not-for-profit association based in Brussels of 10 European national institutes of directors, including the UK Institute of Directors.

On an equally ambitious note, the guidance also declares that it should serve as a basis for EU member states **to develop or update national corporate governance codes** for unlisted companies.

The guidance can be found on the ecoDa website at www.ecoda.org

Background to the new guidance for unlisted companies

You do not have to go far to find guidance on corporate governance if you are a listed company, or on AIM or if you are one of the UK's larger private equity backed companies. Following the onset of the credit crunch and banking crisis in 2008, if you are a bank or financial institution you will not be short of advice on how to improve your corporate governance arrangements either. If you are an institutional investor then you will be watching with interest to learn how your interaction with portfolio companies might be changed for the better in line with the Stewardship Code being developed by the Financial Reporting Council.

The basis of the new guidelines for unlisted companies can be found in existing corporate governance code, regulation and guidance used in the UK applying to listed and other companies, an indication of which is given below.

Companies on the LSE's Main Market

Over the last twenty years, reporting on corporate governance for companies listed on the **Main Market** of the London Stock Exchange has been characterised by a “**comply or explain**” approach by reference to **The UK Corporate Governance Code** (formerly known as the Combined Code)², which contains detailed provisions covering a comprehensive range of corporate governance standards and practices. From 6 April 2010, reporting on corporate governance changed for listed companies with the introduction of a system categorising equity shares of commercial companies into two groups, those entitled to a **primary listing** and those with a **standard listing**. Those with a primary listing are subject to more stringent regulation than those with a standard listing and this extends to the manner and time frame within which a company is required to disclose its corporate governance arrangements. The Main Official List shows which category applies to each listed security. Commercial companies with a primary listing are still required under the **Listing Rules** to report the extent to which they comply with the UK Corporate Governance Code or explain any non-compliance in their annual reports and accounts. For commercial companies with a standard listing,

² The new edition of the Combined Code to be known as The UK Corporate Governance Code will apply to financial periods commencing on or after 29 June 2010. Further information can be found on the Financial Reporting Council's website at www.frc.org.uk

there is no obligation to comply or explain against the provisions of the UK Corporate Governance Code³. Instead, the position is governed by the FSA's **Disclosure Rules and Transparency Rules** which require that a company with a standard listing includes a statement on corporate governance in its annual Directors' Report⁴.

Companies on AIM

Annual reporting on matters of corporate governance for companies on **AIM** is **voluntary** in line with the greater flexibility given to companies on AIM under the **AIM Rules** (when compared with the Listing Rules applying to equities quoted on the Main Market). However, the commercial value of detailed reporting on corporate governance, for example as a method of attracting and retaining investors, is widely recognised by AIM companies. Typically, an AIM company will tend to adopt corporate governance arrangements reflecting the size, complexity and strategy of the organisation but will plan to improve its corporate governance arrangements at least in line with market expectations for equivalent companies. This can mean adopting the best practice standards of the UK Corporate Governance Code, albeit on a voluntary basis.

Guidance for AIM companies, such as the Corporate Governance Guidance for AIM Companies published by the **Quoted Companies Alliance**, is available⁵.

Private Equity (largest portfolio companies)

For the largest private equity backed portfolio companies, matters of corporate governance are effectively **negotiated** between the players with detailed provisions in equity documents and banking documents setting out the terms of the investment and its objectives, including corporate governance matters. Guidance is available in the form of the Guidelines for Disclosure and Transparency in Private Equity published in November 2007 (known as the **Walker Guidelines**)⁶ resulting from a review of the adequacy of disclosure and transparency in private equity carried out by Sir David

³ In addition to guidance available on the Listing Rules, the following guidelines and information are likely to be relevant to companies on the Main Market in relation to matters of corporate governance: (a) Non-Executive Director Remuneration Guidelines and Policies - published by the International Corporate Governance Networks in March 2010 (b) a revised version of the Corporate Governance Policy and Voting Guidelines for Investment Companies – published by the National Association of Pension Funds in April 2010 (c) the draft form Stewardship Code for institutional investors published by the Financial Reporting Council in January 2010 (consultations on the draft closed on 19 April 2010) and (d) Guidance for Smaller Quoted Companies – The Combined Code on Corporate Governance published by the Quoted Company Alliance.

⁴ Rule 7.2

⁵ Other guidance for AIM companies includes Corporate Governance Policy and Voting Guidelines for AIM Companies published by the National Association of Pension Funds.

⁶ www.walker-gmg.co.uk

Walker. Guidance is also available in the second report by the Private Equity Monitoring Group on Transparency and Disclosure (good practice reporting by portfolio companies) published by the British Venture Capital Associations' **Guidelines Monitoring Group** in December 2009⁷.

In these companies, the governance arrangements relating to the operation of the board (directors), equity investors (shareholders) and other funders (stakeholders) is key. Management of a company's reputation through effective interaction with its stakeholders is also an important feature of these companies.

More generally, private equity houses are concerned to ensure the corporate governance standards they require of portfolio companies reflect market standards and expectation for the size and type of investment.

The Walker Review

Some of the themes and recommendations identified in Sir David Walker's review of corporate governance in UK banks and other financial industry entities published in November 2009 (the **Walker Review**) are reflected in the new guidance for unlisted companies.

One of the key messages from the Walker Review is the importance of **encouraging appropriate behaviour** in delivering good corporate governance. Sir David warns against any slide in emphasis towards a "tick box" approach to compliance, on the basis that this runs the risk of shifting the focus away from careful consideration of actual conduct and decisions taken which are true measures of effective corporate governance. Value may also be added through the way decisions are reached within an organisation and how the players in an organisation interact with each other, with stakeholders and the wider community. That said, a "comply or explain" approach is confirmed as fit for purpose in the context of bank and other financial institutions and is judged as preferable to a more prescriptive regulatory system.

The ways that **added value** can be achieved identified in the Walker Review include:

- finding the right balance between long-term and short-term objectives - at the board and shareholder levels
- making sufficient allowances generally to enable directors to exercise judgement and appropriate flexibility - to improve the effectiveness of their collaborative decision taking
- using unitary boards with the right **balance of executive and non-executive directors** - bringing a range and appropriate balance of **expertise** and **experience** to bear

⁷ This group monitors and reports on conformity by private equity houses and the largest portfolio companies against the

- engaging an **independent Chairman** with exceptional board leadership skills – able to assert effective inclusive control at board meetings and with sufficient time to give to the role
- encouraging directors to more effectively **challenge proposals** brought to the board by the executive - when determining policy and strategic matters
- requiring the Chief Executive to focus on running the business of the company - distinct from the Chairman’s principal role of running the board
- **regular evaluation** of the board and individual director performance - sometimes with the assistance of external advisers
- engaging with shareholders - to encourage a **sense of ownership** focusing on the long-term interests of the company
- in addition to an executive risk committee, creating appropriate board-level monitoring in relation to **risk oversight** and also establishing a non-executive director with the role of focusing on high level risk - to protect the value in the business for the benefit of shareholders
- more effective use of the remuneration committee – in relation to board level oversight of remuneration policy extended to include senior executives and variable pay arrangements
- effective **engagement with stakeholders** - principally through the Chairman
- management of the company’s **reputation** in the community – for example with a focus on social responsibility

The new Guidance for unlisted companies - is it likely to be widely taken up?

Probably “yes” for a number of good reasons, but not immediately.

Firstly, it is voluntary and designed to be flexible allowing for unlisted companies of different size and complexity. This means companies can make changes in line with the principles **at their own pace**. Usefully, it is suggested that the principles in Part II should be treated as proposals at the outset.

Secondly, most unlisted companies cannot grow beyond a certain size without **effective delegation** beyond a small founding or controlling group. An effective adaptable governance structure is required to provide suitable parameters for decision-taking and change in the structure of the company. For example, Shareholders’ Agreements or Joint Venture Agreements can address these and other

issues relating to corporate governance (including the statutory duties of directors under the Companies Act 2006).

Thirdly, there are real **commercial benefits** to be had in circumstances where the cost of attaining those benefits can be planned and controlled. For example, these might include:

- being better placed to attract external investment and other funding – by being able to demonstrate a level of professionalism
- improving behaviours within the company – with a transparent process, decisions can be shown to have been taken in line with company policies and values, encouraging trust and good behaviours throughout the organisation
- clearer accountability – setting clear roles and objectives carrying responsibility enables decision-taking by the board, individual directors and the executive to be properly evaluated
- planning and developing a strategy for the company – enabling the company to align its efforts and to deal with milestone events such as succession, a change in the role of key players, growth by acquisition, a sale of the company or major fund raising
- broadening and deepening the experience available to the board – by the appointment of a non-executive director (or the formation of an advisory committee to support the board as an initial step in this direction)
- protecting the value in the business for the benefit of shareholders – through identifying and monitoring risks affecting the company
- improving relations with employees and other stakeholders – by engaging with them and with the wider community to explain the company's aims and objectives and how it plans to achieve them thereby generating confidence in others dealing with the company

Fourthly, a **competitive advantage** may be secured – for example where, through better developed corporate governance, new opportunities become available. For example, consider what is behind the phrase “punching above their weight” – generally this means that a company knows how some of its larger competitors act and aligns its business as far as possible along similar lines to compete for new business opportunities that it might not otherwise have access to.

The Guidelines: Part I (guidance on corporate governance for unlisted companies)

The guidelines included in this section provide a useful introduction to the subject of good corporate governance.

Key issues highlighted include:

- the need to have a mechanism in place to **resolve differences** - for example where shareholders have different agendas and require different things from a company
- recognising that exit opportunities for shareholders in unlisted companies are limited – so considering how shareholders might transfer shares at what price and in what circumstances
- that effective corporate governance in unlisted companies is important - as the illiquidity of unlisted company shares means that, in most cases, shareholders will be invested in the company for the long-term
- managing **reputational risk** – by engaging with stakeholders
- defining the power of the board – to be clear what is expected and what it has been entrusted to deliver and the extent to which the work of the board might be supported by relevant committees

The key concepts and widely accepted principles of good governance are also identified in Part I, namely: delegation of authority; checks and balances; professional decision-making; accountability; transparency; conflicts of interest and aligning incentives.

As the information in Part I is of a general nature, intended for use across the EU, local UK law advice will be required where UK based unlisted companies undertake a corporate governance review.

The Guidelines: Part II (principles of corporate governance for unlisted companies)

The phase 1 principles numbered 1 to 9 are applicable to all unlisted companies. Recognising that larger more complex unlisted companies are likely to be able to take on a more sophisticated level of corporate governance, the phase 2 principles, numbered 10 to 14, apply to them; to unlisted companies with significant external financing and to unlisted companies aspiring to a public listing.

The Principles are as follows:

Phase 1

Principle 1: Shareholders should establish an appropriate constitutional and governance framework for the company

Principle 2: Every company should strive to establish an effective board, which is collectively responsible for the long-term success of the company, including the definition of the corporate strategy. However, an interim step on the road

to an effective (and independent) board may be the creation of an advisory board

- Principle 3: The size and composition of the board should reflect the scale and complexity of the company's activities
- Principle 4: The board should meet sufficiently regularly to discharge its duties, and be supplied in a timely manner with appropriate information
- Principle 5: Levels of remuneration should be sufficient to attract, retain, and motivate executives and non-executives of the quality required to run the company successfully
- Principle 6: The board is responsible for risk oversight and should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets
- Principle 7: There should be a dialogue between the board and the shareholders based on a mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should not forget that all shareholders have to be treated equally
- Principle 8: All directors should receive induction in joining the board and should regularly update and refresh their skills and knowledge
- Principle 9: Family-controlled companies should establish family governance mechanisms that promote coordination and mutual understanding amongst family members, as well as organise the relationships between family governance and corporate governance

Phase 2

- Principle 10: There should be a clear division of responsibilities at the head of the company between the running of the board and the running of the company's business. No one individual should have unfettered powers of decision
- Principle 11: Board structures vary according to national regulatory requirements and business norms. However, all boards should contain directors with a sufficient mix of competencies and experiences. No single person (or small group of individuals) should dominate the board's decision-making

- Principle 12: The board should establish appropriate board committees in order to allow a more effective discharge of its duties
- Principle 13: The board should undertake a periodic appraisal of its own performance and that of each individual director
- Principle 14: The board should present a balanced and understandable assessment of the company's position and prospects for external stakeholders, and establish a suitable programme of stakeholder engagement

With each Principle comes a list of **key points** and **practical considerations for unlisted companies** to assist in implementing the principles.

Next Steps – what should unlisted companies do next?

Unlisted companies should consider adopting this three step process:

- Step 1: Learn the ways in which better corporate governance can improve performance in unlisted companies
- Step 2: Identify the changes that are needed and develop a process of change implementation as a dynamic rolling programme with distinct phases and milestone objectives
- Step 3: Identify where behaviours need to change to get the best out of the new arrangements supporting the shareholders, directors, management and other stakeholders as necessary to achieve it

Details of how an unlisted company should execute this three step process will of course depend on the particular circumstances affecting the company.

In conclusion

Because of the nature of unlisted companies and, outside of any addition regulatory environment that might apply, it will be difficult to identify whether improvements in corporate governance in unlimited companies has or will become a developing trend. Nevertheless, there are things we do know. The banking crisis has moved corporate governance up the agenda. The IoD and its fellow members of ecoDa considers it important. In many cases, commercial advantage might be achieved over competitors resulting from demonstrable good corporate governance (consider the measures and efficiencies private equity houses typically introduce through improved corporate governance on

acquiring a new portfolio company, to improve competitiveness). Further, when new employees, customers and suppliers are considering working with a company, a level of reassurance can be achieved through demonstrable good governance. This could be in the form of interaction with the wider community. For example, consider how social responsibility programmes can evidence good governance, specifically the values and standards of behaviour a company sets for itself. It might involve employees in effecting changes to corporate governance, thus establishing a good reputation both within the company itself and externally.

Good governance is a key component to the continuing success and stability of listed companies in the UK (for example, for successful fund-raising in capital markets) and therefore it is likely to be beneficial in the unlisted company sector too but perhaps in different ways.

Accordingly, if you are an unlisted company and have not really considered the issues raised in this article before then make a note to put a review of corporate governance on your “to do” list, ideally towards the top. Better still; seek out some initial advice on developing an action plan and make a start.

As the Chinese proverb goes “a journey of a thousand miles begins with a single step”.

Dean Drew
Partner, Shoosmiths

DD 03700 86 8912
E dean.drew@shoosmiths.co.uk