Securing the future of pensions

Corporate Governance Policy and Voting Guidelines for Smaller Companies

November 2012

www.napf.co.uk

Contents

Introduction

We believe that, by encouraging high standards of corporate governance, smaller quoted companies will be better able to manage their growth and attract a greater institutional investor following, thereby enabling them to raise fresh capital more easily and on potentially more advantageous terms.

The starting point for these Guidelines is the UK Corporate Governance Code ("Code") and the NAPF Corporate Governance Policy and Voting Guidelines which are based upon it. It is primarily designed for companies listed on the AIM market however, it is equally appropriate for other smaller quoted companies, including standard listed and ISDX listed companies.

The boards of AIM companies should be familiar with the Main Principles of the Corporate Governance Code and should seek to apply them as appropriate to their individual circumstances.

The Code applies to companies with a premium listing and as such there is no directly applicable Code for AIM companies. However, the principles of the Code are just as relevant to smaller quoted companies as they are to larger ones.

The Guidelines do not cover every provision of the Code. They are intended to provide guidance to companies and shareholders on those issues which we believe are of key importance and where practice may reasonably differ from the Code.

It is appropriate that a company's governance structure reflects its size and the complexity of its business and we therefore expect companies at the top end of the AIM market capitalisation to comply with the provisions of the Code (or to explain non-compliance). However, we accept that there is a broad range and size of companies listed on AIM and some will be very small companies who can best serve their shareholders by concentrating on growing their business and providing good levels of disclosure in their annual report and accounts. We expect all companies to apply the highest standards of corporate governance consistent with the size and complexity of their business. As far as is practicable, we expect that shareholders will apply these guidelines with a degree of flexibility suitable to each company's individual circumstances.

A key focus for smaller quoted companies should be to seek regular and constructive engagement with their shareholders. Such an approach will build trust which will allow them flexibility to operate and the support to grow their business.

We have sought to align our own Policy with that of the Quoted Companies Alliance's , "Corporate Governance Guidelines for Smaller Quoted Companies", which is generally accepted as setting appropriate standards for smaller companies.

It is intended that these Guidelines should be reviewed periodically and updated to reflect developing best practice among AIM companies and their investors.

NAPF Investment Council
November 2012

Disclosure Standards

Directors are elected by shareholders who are the owners of companies and it is therefore important that they report to the owners regularly on the company's performance and the development of its business and that governance structures are in place to ensure that the company is led by an effective board.

Annual reports should demonstrate the link between the company's strategy and performance and its governance in order to enable investors to make informed decisions on the company. High quality disclosure is vital to achieve and maintain trust between a company and its shareholders; as companies evolve, so too will investor expectations.

Companies should seek to apply the disclosure standards set by the Code. However, this may be inappropriate for some smaller companies and therefore as a minimum we expect companies to disclose:

- The Directors' names, any other directorships they undertake, and brief biographical details (including executive or non-executive status) which includes relevant skills and experience they bring to the board.

- The names of the chairmen and members of the nomination, audit and remuneration committees (where these committees exist); including the number of meetings of the board and committees; individual's attendance at them and a summary of the committees' work.

- The names of the non-executive directors whom the board determines to be independent and, where appropriate, the reasons why they are considered as such.

- A description of any board evaluation including the results and action taken or planned as a result.

- A business review which details the firm's strategy and a summary of risk management with an identifiable link between the two.

- An audit committee report which reassures shareholders as to the maintenance of the auditor's independence and a remuneration report which demonstrates alignment between the interests of senior management and shareholders describing the performance hurdles of any incentive schemes.

We encourage companies to include these disclosures in their annual report, but as a minimum they should refer shareholders to the company website.

Shareholders welcome clear and succinct disclosures which demonstrate compliance with both the spirit and letter of the Code. Boards should consider carefully and provide a reasoned explanation for deviations from expected best practice, ideally coupled with proactive engagement with significant shareholders.

Leadership

Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.

Combined roles of Chairman and Chief Executive

The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.

The Code states that companies must provide a clear explanation of the division of responsibilities between the Chairman and Chief Executive. The Main Principle emphasises that no one individual should have unfettered powers of decision, hence the roles of Chairman and CEO should be separated.

The QCA Guidelines state the roles of chairman and chief executive should not be exercised by the same individual.

Separation of the roles of Chairman and CEO is a cornerstone of good governance in the UK, enshrined in the Code and propounded for many years by the NAPF. The NAPF considers that the functions of Chairman and CEO are different. They should be clearly distinguished and not confused or compromised by being combined. However, where this is not the case the Company should provide details of the exceptional circumstances which caused the roles to become combined as well as a forward looking statement explaining its intentions to separate the roles, including an anticipated timeline.

NAPF AIM Policy

The **NAPF AIM Policy** supports the separation of the role of chairman and chief executive. However, a pragmatic approach is justified if a vote against the director combining these roles might be considered detrimental to the company.

CEO becoming Chairman

The Code states that a CEO should not go on to become Chairman of the same company.

The QCA Guidelines do not address this point.

The NAPF supports the Code principle that the CEO should not become Chairman. However, should this happen, the Company must disclose in the annual report its reasons for the appointment, describe the selection process and ideally consult major shareholders in advance.

NAPF AIM Policy

The **NAPF AIM Policy** is that succession of the CEO to chairman is a significant issue, acceptable only on rare occasions and boards should ensure that they consult in advance with their major outside shareholders before making such a decision and explain in its annual report how the board will ensure that it is not dominated by the individual so appointed.

Founder Chairman or CEO

It is not uncommon for a founder of a smaller company to be Chairman or CEO and/or a very substantial shareholder, in such circumstances independence can be difficult to maintain.

NAPF AIM Policy

There is no voting recommendation in the **NAPF AIM Policy.** However**,** where the Chairman and/or CEO is a founder and/or substantial shareholder, and/or a founder continues to have a large shareholding, the company should explain how the board ensures that decision making is not concentrated and that board oversight, and protection of all shareholders, is maintained, most appropriately in the form of a disclosed shareholder agreement.

Appointment of a Senior Independent Director

The Code states that companies should appoint a recognised senior independent non-executive director, other than the board Chairman.

The QCA Guidelines do not address this point.

The NAPF supports the Code principle.

NAPF AIM Policy

The **NAPF AIM Policy** requires the appointment of a Senior Independent Director where a company has a combined Chairman and CEO, to ensure an independent voice on the board which can provide a communication channel for the Company's shareholders if needed.

Balance of the Board

The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.

In addition, the board should satisfy itself, and communicate to shareholders, that succession plans are in place for the board and senior management, so as to maintain an appropriate balance of skills and experience.

The Code states that a smaller company should have at least two independent non-executive directors on its board.

The Code provisions for board balance, along with committee composition, are the areas where smaller companies have most problems in complying. The make-up of smaller company boards varies considerably. AIM comprises a broad spectrum of companies, some of which are more mature and have an advanced corporate governance framework that includes larger boards and established board committees, whilst other less mature companies may have as few as three directors - a Chairman, CEO and a non-executive director.

In addition to the size of a board, the Code definition of independence presents a further hindrance towards compliance, since some of the criteria may be unachievable for smaller companies.

The QCA Guidelines state that a company should have at least two independent non-executive directors and should not be dominated by one person or a group of people.

The NAPF supports the Code principle and encourages companies to provide a detailed explanation in the event of non-compliance.

NAPF AIM Policy

For larger boards the **NAPF AIM Policy** does not deviate from the Code, which requires at least two independent directors, excluding the Chairman.

For smaller boards the **NAPF AIM Policy** requires that boards have at least two independent non-executive directors to comprise not less than one third of the board, one of whom may be the Chairman.

This less stringent requirement is appropriate for AIM companies who have boards comprising of no more than four directors. Such boards might consist of the Chairman, the CEO and, at most, two non-executive directors, of which one should be independent. These provisions safeguard independent representation on the board whilst providing sufficient flexibility for those companies with smaller boards.

Composition of the Audit, Remuneration and Nomination Committees

The Code requires that the Nomination Committee should be made up of a majority of independent non-executive directors.

The QCA Guidelines state that the Nomination, Audit and Remuneration Committees should have the necessary character, skills and knowledge to discharge their duties and responsibilities effectively.

A majority of members of a Committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the Committee, but the chairman should not chair the Nomination Committee when it is dealing with the appointment of a successor to the chairmanship.

The Code requires that:

- Audit and Remuneration Committees comprise at least two non-executive directors, all of whom are considered independent.
- At least one member of the Audit Committee should have ‘recent and relevant’ financial experience.

NAPF AIM Policy

The **NAPF AIM policy** supports the Code Principle. However, it recognises that the lack of independent membership, compounded with the insufficient number of non-executive directors on a board, could make compliance unachievable.

The Audit, Remuneration and Nomination Committees ideally should comprise solely independent non-executive directors. At a minimum there should be a majority of independent directors on all committees.

The Chairman may be a member of the Audit, Remuneration or Nomination Committees provided that, other than his chairmanship, he/she fulfils the test of independence, in which case he/she will be viewed as an independent director.

Board Evaluation

The Code stipulates that a board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

The Code further states that the board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted.

The QCA Guidelines also suggest that a board should periodically review its performance, its committees' performance and that of individual board members.

NAPF AIM Policy

The NAPF views board evaluation as an important tool for all boards. Companies are encouraged to disclose details of the process and as far as possible the outcomes from the evaluation.

Remuneration Arrangements

The **NAPF AIM Policy** does not deviate from the Code. Companies should generally adhere to current best practice guidelines (ABI & NAPF Remuneration Guidelines). A significant component of senior management's remuneration should be linked to performance and there should be disclosure of the performance conditions attaching to any bonuses or long-term incentive plans. Companies are strongly encouraged to engage in constructive dialogue with their shareholders in relation to remuneration arrangements. It may also be appropriate to put their Remuneration Reports to a vote at the AGM.

Director Independence

The NAPF and the QCA Guidelines encourage all companies to be rigorous in the assessment of independence using the criteria of independence defined in the Code.

However, when applied to AIM companies some of the stated criteria (B.1.1. of the Corporate Governance Code) require more flexibility due to the particular circumstances faced by such companies. A significant shareholding, participation in the company's share option scheme and tenure are among the most common problems faced by AIM companies.

For FTSE All-Share companies, NAPF considers personal shareholdings in excess of one percent of a company's issued share capital to be material and consequently considers that such a shareholding may affect independence.

However, we believe that the threshold should be increased for AIM companies, because they have a smaller share capital and they may pay non-executive directors' fees in shares rather than cash, due to cash flow pressures.

NAPF AIM Policy

The **NAPF AIM Policy** is that independence may be compromised if a director has a beneficial or non-beneficial shareholding of more than three percent of the Company's issued share capital.

The NAPF believes that remuneration other than fees paid in cash or shares may compromise independence. This includes participation in the company's share option scheme or a performance-related pay scheme, or membership of a company's pension scheme.

It is most common for smaller AIM companies to have issued options to non-executive directors, either historically upon IPO or as a one-off grant (due to cash flow constraints).

The **NAPF AIM Policy** excludes historical one-off grants prior to or at the time of joining AIM, if the quantum is not considered to be material, from the assessment of independence. However, should this practice become routine or a director actively participates in a share option scheme then the director's independence may be judged to have been compromised. Companies can use fully-paid shares as part of the remuneration for non-executive directors.

The **NAPF AIM Policy** is flexible in cases where tenure is over nine years. Concurrent tenure with the CEO or other Executive Directors over nine years or more is, however, seen as potentially compromising a director's independence. The board evaluation process and succession planning policy are important when reviewing independence and should be disclosed in the Annual Report.

Pre-emption Rights

The **NAPF AIM Policy** is to support the Pre-emption Principles published in 2006 by the Pre-emption Group. Companies should seek annual approval from shareholders for issuance on a non-pre-emptive basis.

However, it is recognised that there may from time to time be good reasons for waiving pre-emption rights among smaller companies; for example, for reasons of cost, shareholder structure or speed. Companies should, in keeping with the spirit of the principles, consult with leading shareholders in advance, provide them with a full justification for a decision to seek authority to issue stock above the 5% annual limit and should account for its usage in the subsequent Annual Report. Notwithstanding this flexibility, any issuances over 10% without pre-emption rights will need particularly cogent justification, unless prior approval has been sought.