

## Consultation on proposed changes to the Combined Code

### Response by The Association of Investment Companies (AIC)

The AIC welcomes the opportunity to respond to the FRC's invitation for views on possible changes to the Combined Code. The AIC has a keen interest in this debate as its members are both institutional investors and issuers. The investment company sector has approximately £95 billion of assets under management and the AIC represents some 340 investment companies.

The AIC is a strong supporter of effective corporate governance. If appropriately undertaken, scrutiny of the way in which boards operate and the systems they have in place to manage the affairs of the business, can make a positive contribution to shareholder value and wealth creation.

Investment companies have a number of unique features which are relevant to the governance debate. These notably include the fact that the vast majority of companies in the sector have boards comprised entirely of non-executive directors. Most also contract out the majority of the day-to-day management of the company to third party fund managers. This means that the sector has unique governance arrangements and issues.

For this reason the AIC has produced its own corporate governance code, *The AIC Code of Corporate Governance*. The AIC Code is accompanied by a *Corporate Governance Guide for Investment Companies*, which explains how the AIC's Code interacts with the Combined Code. The AIC Code and Guide have been endorsed by the FRC as a means by which investment companies can meet their obligations in relation to the Combined Code. The AIC is grateful to the FRC for its continued support for the AIC Code and Guide.

The special considerations which apply to investment companies reinforce the AIC's view that governance should not be a 'box-ticking' exercise. Instead it should involve a degree of flexibility. Companies should not simply be required to comply with all the aspects of the Combined Code as this may not be appropriate in all cases. This perspective is incorporated into the Combined Code framework as it is a 'comply or explain' mechanism. However, to operate effectively (and to ensure that a focus on governance issues really does deliver value) both sides of the governance equation – issuers and owners – must play their respective role appropriately. Where boards believe that they should not follow practice as set out by the Code, they should explain why. Where investors are presented with an explanation, they should be prepared to evaluate that explanation and take a considered view.

In responding to the FRC's review of the Combined Code last summer, the AIC argued that constructive engagement is all too often absent from the governance process. In particular, it can be difficult for smaller companies to gain access to shareholders to make their explanations, particularly where third party governance agencies are involved. This has increasingly meant that very detailed points referred to in the Code (including some which are not

recommendations) have become *de facto* rules. Unfortunately, the way in which governance is being assessed is all too often failing the Code's own entreaty that,

*"[explanations] should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches."* (Combined Code, Preamble, Para 7.)

The fact that aspects of the Code have, in reality, become calcified into rules helps explain the demand for making changes to the Code. In theory, companies should be able to explain why a particular individual has time to chair more than one FTSE 100 company or why a Chairman should be permitted to be a member of the audit committee. We are also aware of problems where boards have sought to explain why directors with tenure of over 9 years remain independent, but have failed to make progress because of a mechanistic assessment of their compliance with the Code rather than any qualitative consideration being made.

The danger is that companies may feel it not worth seeking to explain preferred departures from the Code and simply comply despite the fact that they feel a better alternative could be available. If so, this argues strongly for the view that there are problems with current governance arrangements.

With this in mind, the AIC would reiterate its general **recommendations** made to the FRC's review of the Combined Code last summer:

- The FRC should consider how the Code could be adapted in the future so that it becomes a more **principles-based** system, which is focussed on outcomes rather than detailed processes.
- Given the special circumstances of investment companies, where a number of detailed practices set out in the Combined Code are not relevant for boards made up exclusively of non-executive directors, the FRC should consider introducing **specific derogations** for companies which have no executive directors. These derogations are implied in the preamble, it is now an appropriate time to specify in more detail what that means.

Other derogations might also be introduced for other types of company which can demonstrate unique characteristics which make aspects of the Combined Code inappropriate.

The AIC is also keen that the FRC should focus on the commitment it made as a result of its review of the Combined Code to try and **increase levels of constructive engagement between different stakeholders in the governance debate.**

As it noted in its findings following the review,

*“While it appears that there is currently a critical mass of institutional investors who devote the necessary time and resource to constructive engagement needed to make ‘comply or explain’ work, it will be necessary to keep the health of the engagement process under review in the light of changes in ownership patterns and increased outsourcing of voting and engagement activities. Action may also be needed to address structural barriers to constructive engagement.”* (Review of the Combined Code: Report on the main findings of the review. November 2007. Page 1)

The FRC suggested that it intended to hold discussions with governance agencies to establish what steps could be taken to increase understanding of their activities. The AIC **recommends** that it should seek to engage in this debate more widely and involve issuers and investors and their representatives. A wider debate of this nature has the greatest potential to make a real contribution and enhance the positive impact of the UK investment and issuer community focussing on governance issues. It would also have the most chance of enhancing the quality of the engagement process.

To date the AIC has had mixed results in its dealings with third party agencies. At the most positive end of the scale this has involved discussions where issues have been resolved to the satisfaction of all involved, which has contributed to achieving better governance outcomes. At the more disappointing end, we have been told that ‘no explanation’ would ever change the view of an agency that a departure from practice as set out in the Combined Code could ever be acceptable.

To change attitudes, and move the governance agenda forward to the benefit of all parties, the FRC should seek to bring parties together and develop a programme of activities to increase understanding and co-operation in effective engagement and resolution of governance issues. The AIC **recommends** that this should be a priority for the FRC.

### **Specific issues**

**Chairing more than one FTSE 100 company:** The AIC agrees with the view that it is too restrictive for the Code to state that an individual should not chair more than one FTSE 100 Company.

The key issue is that the Chairman should have sufficient time to undertake his or her duties. As long as they do have sufficient time, what they do when they are not undertaking their role (assuming that no conflicts of interest are created) should not be of concern from a governance perspective.

The provision in the Code is flawed in its construction because it focuses on a narrow issue (chairing another FTSE 100 company) rather than the outcome (ensuring the Chairman has sufficient time to perform his/her role). This problem is common across the Code as it is currently drafted. The reality is

that any number of other activities could take up the same amount of time as being a FTSE 100 Chairman. Why should chairing another FTSE 100 company be uniquely mentioned?

The AIC agrees with the proposed change in wording to the Combined Code, which is particularly attractive as it moves the provision a little way towards a principles-based approach. The AIC therefore **recommends** the Code be amended as proposed.

**Company Chairman sitting on audit committee for smaller companies:**  
The AIC represents a number of small listed companies, which have small boards. The current provision is too restrictive for smaller companies in particular and the AIC would support amending the Code to allow the Chairman to sit, but not chair, the audit committee and **recommends** that changes be made to this effect.

It should be possible to achieve this without any disadvantage to shareholders. After all, if the Chairman is not deemed to be suitable to sit on the audit committee of a smaller company this creates broader problems from a governance perspective. If there was a problem with a Chairman (perhaps because they were able to inappropriately dominate the board) such a figure would doubtless be able to attend the audit committee and influence its operation and also dominate the decision-making of the full board. The audit committee is an advisory committee to the board and limiting the ability of the Chairman to serve on it provides no innate protection for shareholders. Other mechanisms, such as the independent majority, are far more significant.

On the other hand preventing the Chairman of a smaller company serving on an audit committee is overly restrictive and could be unhelpful where the board felt the Chairman could play a valuable role. This might particularly be the case where the number of independent directors with the specialist skills to populate an effective audit committee may be more limited. The FRC should therefore change the Code to allow smaller companies to appoint the Chairman to the audit committee (but not to chair it).

The AIC believes the proposed drafting changes for the Combined Code to accommodate this outcome are satisfactory, but not ideal. The AIC's preference is to move the Code towards a principles-based, outcome-focussed approach. With this in mind, it should not go into detail on the number of independent directors sitting on the audit committee. One possible wording could be, for example:

*“The board should establish an audit committee of independent non-executive directors. The board should satisfy itself that the committee has sufficient relevant financial experience to review the report and accounts effectively in accordance with up-to-date practice. The Chairman of a smaller company may (if they were considered independent on appointment) sit on, but not chair the audit committee, as long as it retains a clear majority of independent directors.”*

This suggested wording arguably brings out more clearly the key points that the committee should be 1) independent and 2) competent. The AIC **recommend** that the FRC consider a revised drafting along these lines.

If the FRC does decide to make the change as proposed, it does beg the question, why smaller companies are in a different position from larger ones with respect to this question. The AIC **recommends** that in considering the proposed amendment the FRC should also examine whether or not this flexibility should be extended to all companies affected by the Combined Code, not just smaller ones.

The debate over the place of the Chairman on the audit committee also brings out a further critical issue about the treatment and categorisation of the Chairman under the Combined Code. The AIC has serious reservations with the notion that a previously independent director of a company becomes non-independent simply by virtue of taking on the Chairman's role. According to the Code, they should be independent the day before they take the job but lose their essential characteristics of asking challenging questions, seeking out relevant facts etc the day afterwards. This is very difficult to accept – it also goes to the centre of the proposition that in some respects the Code takes, or encourages, a mechanistic rather than qualitative approach.

This also highlights the fact that the position of the Chairman vis-à-vis the independent majority is not immediately obvious or clear. The AIC **recommends** that this point should be clarified in a further iteration of the Code.

**Revised preamble:** The AIC agrees that good governance should support wealth creation and that the implications of 'comply or explain' is not adequately reflected across the drafting of the Code. The AIC therefore supports redrafting the preamble to reinforce these important messages. The AIC **recommends** that the status of 'comply or explain' should be given a more formal status within the context of the Code overall.

**Overlap with FSA corporate governance rules:** It would be useful to highlight where specific regulatory requirements overlap with areas covered by the Code. However, the AIC is not inclined to add detailed footnotes or update Schedule C as proposed in the consultation. Instead, the AIC **recommends** that the Code should include a general statement in the updated 'preamble' (see recommendation on 'revised preamble' above). This statement would make clear that:

- there are areas where the Code supplements minimum requirements established by regulatory rules; and that,
- these minimum requirements are compulsory and not subject to 'comply and explain'; it would also,
- direct readers to a separate document (available on the FRC website) which explains in detail where these overlaps are.

This will ensure the relationship between the Code and regulatory obligations is clear. It has the advantage that the separate paper can be updated as and when required, without raising any questions about having to amend the Code itself (whether the footnotes or the schedules) or hold a consultation on this exercise. It will also ensure that the 'comply or explain' nature of the Code remains distinct and removes any scope for confusion over regulatory obligations.

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