

## **Review of the impact of the Combined Code**

### **Association of Investment Companies submission**

The Association of Investment Companies (AIC) has taken a keen interest in the development of the Combined Code and market responses to it. We have a unique perspective on this as our interests encompass both issuer and investor viewpoints:

- The AIC represents some 320 investment companies, almost all of which are listed on the London Stock Exchange (four are AIM traded). As listed companies, they have to comply or explain against the Combined Code as required by the Listing Rules.
- Investment companies are collective investment vehicles which offer investors access to a diversified portfolio of assets. A substantial proportion of our members invest in UK listed equities, whose issuers are required to comply or explain against the Combined Code.

The AIC supports high standards of corporate governance and the comply or explain principle. We believe flexibility in corporate governance is essential to allow listed companies to implement arrangements which suit their own circumstances. The need for such flexibility is exemplified by the issues that face investment companies.

A substantial majority of investment companies outsource all of their day-to-day management and operational functions. Under these arrangements, the board of the investment company sets the strategy to achieve its investment objectives and provides oversight of externally employed service providers – the most critical being the fund manager who administers and invests the portfolio on a day-to-day basis.

Given these arrangements, many investment companies have no employees or executive directors. This makes a number of the provisions in the Combined Code relating to, for example, board composition (such as balance of executives and non-executives) and senior management (such as succession planning) irrelevant.

Although some aspects of the Combined Code may not be relevant for externally managed investment companies, there are other important areas of governance specific to investment companies (such as how the board manages its relationship with the manager) which are not covered by the Combined Code but which are of fundamental importance to investors. For this reason, the AIC has developed a complementary corporate governance code and corporate governance guide. These explain how investment companies can develop best practice in corporate governance most suitable to their unique characteristics. We are pleased that the FRC has recognised the importance of investment companies' unique governance

issues and endorsed the AIC Code and Guide. The FRC has stated that investment companies following the AIC Corporate Governance Guide should be able to fully meet their obligations in relation to the Combined Code and relevant Listing Rules.

### **Key recommendations**

The AIC has four key **recommendations**: The FRC should:

- consider how, in the medium term (2-3 years), it can adapt the character of the Combined Code to embrace a more principles based approach. Such an approach would be designed to maintain its rigour but enable flexibility in compliance and minimise unnecessary compliance burdens.
- take steps to ensure the 'comply or explain' mechanism is properly observed. In particular the FRC should undertake market research into the role of governance agencies and develop a code of best practice to ensure that where the specific provisions of the Combined Code are not implemented, alternative approaches and their explanations are properly considered. If they are not, "comply or explain" quickly becomes "comply or else."
- Consider where it might provide derogations for externally managed investment companies where applying the full provisions of the Combined Code is unnecessary. (See Annex A for a full list of areas that should be addressed through derogations.)
- review the inclusion of section 2 of the Combined Code, which applies to institutional shareholders. The AIC agrees that the issues covered in section 2 are important but is concerned that they do not receive sufficient attention as an 'add on' to the Combined Code, which is primarily focussed on issuers. It should consider if these provisions could be presented as a stand-alone document and how they can be promoted separately from the Code.

### **Issues for comment**

**Does the Code support better board performance over time?:** The AIC has mixed views on the impact of the Combined Code on board performance.

It is generally accepted that the calibre and work of investment company boards has been enhanced markedly in the last 5-10 years. This has been driven by a number of changes but the Combined Code has certainly been an important part of this process.

Overall the Code has provided a valuable stimulus for boards to consider their role and how they should conduct their business. This has helped clarify best practice on the operation of boards and their committees and ensured appropriate focus on important issues related to investment companies' ongoing operation (such as shareholder engagement, internal controls, board effectiveness etc). A culture has developed where governance, and the likely views of shareholders on governance arrangements, is considered important and boards have reacted to this. The cumulative impact of this is that boards are clearer in their focus and better equipped to engage with shareholders and to deal with challenges facing the company. This is a positive outcome.

However, while the Combined Code has contributed to better governance practices 'in the round', we are concerned that the ongoing burden of dealing with the detailed provisions of the Code is an increasing problem. A significant number of investment company directors are concerned that dealing with the minutiae of compliance and reporting to shareholders is a distraction from the main task of the board – which is to oversee the management of the portfolio to create real value for shareholders.

Our view is that the Combined Code has achieved the attitudinal shift towards governance that was the major prize. However, now that the relevance of higher governance standards has been established in the market, the AIC believes that the detailed nature of the Code could, in some ways, be detracting from the governance process. This is particularly the case where it (even inadvertently or under pressure from activist shareholders) encourages focus on (sometimes very discrete) issues that assume the same importance as other more significant considerations.

For example, the AIC believes that the main principles set out in the Code are all valid and identify the critical issues that boards should be taking into account when monitoring and implementing their governance arrangements. More questionable is the value of all the detailed supporting material. For example, the Code establishes that the board should be made up of a majority of independent directors. The AIC supports this as an important aspect of good governance. However, it then sets out in detail a range of criteria that might be relevant to independence. These detailed provisions are unnecessary once the headline principle has been established and boards are required to explain their reasoning for their views.

The critical problem with detailed provisions on independence is that the criteria are mechanistic. They identify things that might be relevant to a board's deliberations. However, fundamentally, independence cannot be pinned down by mechanistic means. Independence is, not only the absence or management of potential conflict of interests, but a state of mind and of character which determines an individual director's approach to questioning and challenging views presented to the board as well as offering an alternative viewpoint on strategic and other issues

of importance. Unfortunately, the detailed provisions of the Code all too often simply become a checklist which is monitored by governance teams who do not seek to make a qualitative assessment or listen seriously to alternative explanations of why a particular director might be independent despite not satisfying all the factors listed. (This is a particular risk where external governance agencies have inflexible processes to assess governance practice.)

This problem has been starkly illustrated in relation to the reference to directors serving for more than 9 years since the date of their first election. Although the Code recognises that length of tenure 'may' be relevant to determining independence, our members have all too often found that any director serving over 9 years is automatically identified as non-independent by governance agencies. This goes directly against the views of many boards who value both the independent attitude and experience of the director in question. The problem with overly mechanistic assessments based on the detailed criteria set out in the Combined Code is compounded as the comply or explain mechanism often does not operate satisfactorily.

The AIC **recommends** that the FRC should overhaul the overall structure of the Combined Code and move it towards a principles based approach.

Principles based regulation is becoming increasingly significant. It can maintain high requirements, move away from mechanistic compliance systems, ensure senior involvement in qualitative assessments of relevant issues and allow commercial flexibility. This should be completely in tune with the objectives of the Combined Code and the comply or explain approach.

The AIC has prepared a separate annex (attached to this submission as Annex B) that analyses the existing Code and suggests areas where extraneous detail could be removed. We have sought to put forward a balanced position (rather than simply cut the Code down to just the main principles). We would **recommend** that the FRC considers these proposals as a possible basis for moving the Combined Code to a principles based approach in the medium term.

In preparing our thoughts on how a principles based regime might look (see Annex B for details) we have also identified a number of areas where the Code has no relevance to externally managed investment companies, as discussed in the introduction above. The AIC, therefore, **recommends** that the FRC should also consider introducing explicit derogations. The FRC has already considered the issues where the Code may be irrelevant for externally managed investment companies as part of its assessment of whether or not to endorse the AIC Code of Corporate Governance and AIC Corporate Governance Guide, so we do not anticipate that this proposal presents a problem in principle.

With this in mind, the AIC **recommends** that specific derogations for investment companies with external managers should be introduced in the near future. These would cover, for example, all references to executive directors, the chief executive and senior management. (A full list of areas where derogations might be created is set out in Annex A and explained in more the attached matrix.)

The FRC should consider introducing these (alongside derogations for other classes of company, such as smaller listed companies) in the near future even if such measures might become less significant in the medium term if the Combined Code moves to a principles based approach.

In preparing our thoughts on a more principled based Combined Code we have identified one area that could be acted on very quickly to move compliance in the desired direction. The AIC **recommends** that in the near future the FRC should remove all the schedules attached to the Code. These are far too detailed for a governance framework that envisages flexibility in compliance. We would envisage that these materials would still inform both the way that boards consider their compliance obligations and the perspectives of shareholders. Indeed we can envisage various organisations putting them forward, in part or as a whole, as their views of best practice. However, we do not think it necessary for such detailed provisions to be part of the formal Code itself.

We would note that removing these schedules from the Code (and even removing detailed provisions from the main body of the Code) does not give boards an easy way out. In some ways it makes meeting accepted governance standards more challenging as it requires boards to consider carefully what arrangements they require to meet the high-level provisions of the Code. They can no longer fall-back automatically on a checklist.

Of course, we envisage that many commentators on governance issues, particularly those with interests in providing commercial services, are likely to oppose a change such as this precisely because it will drive the governance system away from a checklist approach towards a qualitative assessment. We understand that their current business model (which often relies on relatively junior practitioners taking a view on levels of compliance) will be unsuited to such a change. However, the formulation of the Combined Code should not be driven by the narrow needs of governance agencies but the need to deliver high quality and flexible governance standards for companies listed in the UK with a view to improving UK corporate performance in line with the FRC's philosophical approach.

The AIC is confident that now the Combined Code has achieved the objective of successfully focussing attention on the role of governance it should be reframed to ensure that going forward the compliance burden remains proportionate. A principles based approach will offer the best prospect of balancing compliance burdens with high standards. It will also mean that boards can strike a better

balance between considering legitimate governance concerns and focussing on the strategy and operation of the business for which they are responsible.

**Is the 'comply or explain' approach working effectively?:** The AIC does not believe that the comply or explain approach is working effectively. However, this is not the fault of the Combined Code itself. As discussed above, particularly where governance agencies are involved, investment company boards have not been able to secure proper consideration of explanations they try to provide.

Problems arise in various areas. Most straightforward is that any deviation from the Combined Code can automatically attract a negative assessment of the company's governance approach (either by a shareholder's internal governance team or an external agency).

This creates a number of potential problems for the issuer. In the worst-case scenario, such a recommendation might cause shareholders to vote against, say, the election of a director or not approve the annual report and accounts. Even if such a resolution is not defeated, negative and uniformed governance assessments and the disquiet they can unnecessarily stimulate amongst investors, is likely to attract unhelpful media attention. This is in turn problematic as it may raise unfounded fears among shareholders and potential investors about the company's governance. Arguably, even more critically, it can distract the board and reduce its ability to communicate key messages about business-critical issues. Of course, if there are serious failings in company governance then scenarios of this nature are bound to arise. However, they should not be allowed to emerge simply because a board – with good reason – has not followed the precise line set out in the Combined Code. The comply or explain approach is supposed to allow for this, but it does not always function effectively.

The problems created by a negative assessment are compounded where there is no mechanism for the board to provide an explanation of their approach. This is particularly the case where investors have outsourced their governance assessments to an agency. Such agencies can have a reach across the market and their views are extremely influential. However, we understand that these agencies often do not contact the board if they intend to make a negative assessment. Our members have experienced circumstances where they only find out shortly before a company meeting that an agency has made a negative assessment because their shareholders have told them that this is the case. When an approach is made to the agency to explain the company's position there is often no point of contact, or not one sufficiently senior to receive and act on an explanation. The company therefore has no realistic chance of making effective representations to the agency to seek a changed assessment based on the explanation. They will have even less chance of effectively communicating with all their shareholders. This is highly unfortunate and is a critical failure of the current comply or explain mechanism.

The AIC strongly **recommends** that the FRC acts to develop the comply or explain regime. This could involve various activities. In the first instance the AIC **recommends** that the FRC undertakes some market research (probably also including site visits) to understand how governance agencies operate, the assessment processes they have in place and the way they deal with explanations/appeals from issuers. We also **recommend** that it should develop a code of practice for governance agencies and other investors. This would cover assessment processes, making contact with issuers in advance of taking a negative view to enable them to make representations, and procedures for making representations within a reasonable timeframe and at a sufficiently senior level.

The AIC also **recommends** that Section 2 of the Combined Code, which refers to the responsibilities of institutional shareholders be removed from the Code. The AIC believes that the issues covered by Section 2 are very important. However, their importance is not properly recognised at the moment and their relevance is reduced by placing them at the end of the main Code that is itself focussed on issuers. With this in mind, the AIC believes they should be split off from the Combined Code and promoted separately as part of the code of practice for governance agencies and shareholders proposed above.

The AIC believes that enhancing the framework within which agencies and shareholders approach their obligations in relation to comply or explain will complement our proposal to refocus the Code on a principles based approach.

**What impact has the Code had on smaller companies?:** Again, the picture is mixed. There is a greater focus on appropriate governance, which has had some beneficial effect in changing the culture of issuers. However, there is increasing concern from directors representing smaller investment companies that the burden of detailed compliance and reporting is becoming disproportionate.

The problems of the comply or explain process are also compounded for smaller companies as they are even less likely than those with a larger market cap to be able to communicate effectively with governance agencies. Any mechanisms which are in place are less accessible, it is harder to secure attention from more senior assessors and they are unlikely to be informed if a negative assessment is possible.

Anecdotal evidence supports our view that for smaller companies the detailed nature of the Combined Code is becoming a problem. We have been told by one investment company with investments focused on UK small & medium sized companies that over the last 3 years around one in six of the companies it holds within its portfolio have moved from the main board to AIM. One of the main reasons cited were the direct and indirect costs of corporate governance.

Of course, it is contradictory to the objective of securing better corporate governance standards if the burdens created by the Code for small businesses create incentives to operate in a manner which does not require companies to comply or explain against the Code. It is also undesirable if those who do not seek to avoid these obligations have too high a burden.

The potentially negative impact the Combined Code has on small business would be alleviated by moving to a more principles based regime where governance agencies operate under a code of practice that enables issuers to properly explain and be heard where they do not comply. However, the AIC also **recommends** that alongside the development of a principles based approach the FRC should also consider whether or not derogations for smaller companies would be appropriate. (The extent to which this might be necessary is likely to depend upon how far the Code itself is revised.)

**Do disclosures on the Combined Code in annual reports provide useful information to shareholders at proportionate cost to companies?:** There are a wide number of approaches to corporate governance disclosures. Some reports are much fuller than others and it is therefore difficult to generalise.

However, we do believe that the current formulation of the Code, incorporating very detailed recommendations, does create a higher burden than is necessary and that a move to a principles based regime would be invaluable in ensuring the proportionality of compliance burdens.

We are also clear that the key interest of shareholders is the performance of the company itself. In the case of an investment company this will involve describing the performance of the underlying portfolio and how that performance was achieved, the impact of gearing etc. Despite this we are aware that governance reports are tending to become longer and more time-consuming for boards to prepare. In the context of preparing an annual report it is unfortunate if attention is being taken away from the key reporting tasks.

The FRC should seek to balance the need for effective reporting of governance issues with proportionate costs by moving to a more principles based regime that encourages the report to focus on key issues – not detailed mechanistic points. It should also consider and introduce derogations for certain companies where reporting is irrelevant or likely to be burdensome because of their size (see recommendations made above).

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**For more information on the issues made in this submission please contact:**

**Guy Rainbird, Public Affairs Director,**  
The Association of Investment Companies

**E-mail:**        [guy.rainbird@theaic.co.uk](mailto:guy.rainbird@theaic.co.uk)

**Tel:**            020 7282 5553

## **Annex A: Areas where derogations from the Combined Code should be allowed for externally managed investment companies.**

### **A1 The Board, Supporting Principles**

The requirement for non-executives to determine “appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.”

### **A2 Chairman and chief executive, Supporting Principles**

The requirement for the Chairman to “ensure constructive relations between executive and non-executive directors”.

#### **A2 Chairman and chief executive, Code provision A.2.1**

The requirement for “The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board”.

#### **A2 Chairman and chief executive, Code provision A.2.2**

The requirements for, “A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report. (Compliance or otherwise with this provision need only be reported for the year in which the appointment is made.)”

### **A.3 Board balance and independence, Main Principle**

The requirement for the board to “include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board’s decision taking.”

#### **A.3 Board balance and independence, Supporting Principle**

The requirement for a “strong presence on the board of both executive and non-executive directors”

### **A.4 Appointments to the Board, Main Principle**

The requirement for orderly succession arrangements for “senior management”.

## **B.1 The Level and Make-up of Remuneration Main Principles**

The requirement for “A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.”

### **B.1.3 Remuneration Policy, Code Provisions**

The requirement for “Remuneration for non-executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board.”

## **B. 2 Procedure, Supporting Principle**

The requirement for the remuneration committee to consult the “chief executive about their proposals relating to the remuneration of other executive directors.”

### **B. 2.2 Remuneration Procedure, Code Provisions**

The requirement for the remuneration committee to, “have delegated responsibility for setting remuneration for all executive directors” and “senior management”.