Review of the effectiveness of the Combined Code – Progress Report and Second Consultation

Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the FRC's progress report and second consultation on the review of the effectiveness of the Combined Code. The AIC brings a unique perspective to the corporate governance agenda as its members are both institutional investors and issuers. It represents some 350 investment companies with £63 billion of assets under management.

Comments on the guiding principles

The AIC supports the guiding principles proposed by the FRC. However, the overriding consideration should be that the Code should be adjusted if there is evidence that current provisions may have made it more difficult for a board to operate effectively. This is mentioned after the third principle, but should be given more prominence. One particular example of the potential of the Code to hinder the effective operation of boards is the so-called 'nine-year rule' which restricts the pool of potential non-executive directors. This is discussed in more detail below.

The responsibilities of the chairman and the non-executive directors

The AIC agrees that the responsibilities of the senior independent director should be further clarified. This could be achieved by incorporating recommendation 11 of the Walker Review into the Combined Code.

We also suggest that there may be circumstances in which best practice would mean that the chairman should be expected to chair the audit committee. This is particularly relevant to the investment company sector where the day-to-day management and administration of the company is commonly outsourced to a third party manager. The audit committee does not have to deal with issues relating to oversight of the executive but instead focuses on the effectiveness of the manager's internal controls and procedures. As one of the key priorities of the chairman (and the board) of an investment company is to oversee the performance of the manager, some boards believe that the chairman should be expected to lead scrutiny of the manager's internal practices by chairing the audit committee. This could be encouraged in the Combined Code by a specific amendment to highlight unique issues for investment companies.

The Combined Code should not be adjusted to provide further guidance on the time commitment for the various board positions. Recommendation 7 of the Walker Review is too prescriptive to be applied to most companies covered by the Combined Code. The suggestion that the chairman should commit probably not less than two-thirds of his/her time to the company is unlikely to be appropriate for an investment company, except perhaps in exceptional circumstances.

Any changes to the role, key responsibilities and expected behaviours of the chairman, senior independent director or non-executive directors should be included in the Combined Code itself, rather than in any associated non-binding guidance. The Combined Code is itself non-binding. Also, keeping governance best practice in one place will make it easier for boards and investors to follow and reduce potential confusion.

Board balance and composition

The Combined Code should give greater emphasis to the value of collective experience. The Code currently focuses on the independence of individual directors and the evaluation of individual director's performance. The ability of the board as a whole to provide the appropriate mix of expertise and experience should also be recognised. Principle 6 of the AIC Code of Corporate Governance recommends that *"The board should aim to have a balance of skills, experience, ages and length of service"* and recommends that this is linked to succession planning. The Combined Code should reflect a similar recommendation.

The question of a director's independence is an interesting one. Under UK company law, all directors have a duty to *"promote the success of the company for the benefit of its members as a whole"* and to avoid conflicts of interest. Independence is an important consideration in discharging these duties. In this context, it is interesting to consider what additional benefits the detailed provisions on independence included in the Combined Code add for investors. The detailed criteria set out in the Code are also interesting because of the difficulties boards have in trying to explain their assessment of independence when individual directors do not meet the precise criteria set out. This may well have a negative impact on the availability of potential non-executive directors, as directors find external assessments of independence too inflexible and unresponsive to explanation.

The so-called 'nine-year rule' causes particular problems for investment companies, where the inclusion of long-standing directors on the board can be considered beneficial to helping the company achieve its long-term investment objective. Long-serving directors are often seen to add value because they offer experience of the investment cycle. The AIC's view is that length of service is far less important than achieving an appropriate board balance. Furthermore, no convincing argument has been presented to justify why a director becomes non-independent on the day of his/her ninth anniversary of joining the board. The nine-year independence criteria should therefore be removed from the Combined Code. This may help to widen the pool of available non-executive directors.

Frequency of director re-election

The AIC is not in favour of corporate governance guidance which recommends a formal annual election process. It should be for individual companies and their shareholders to decide whether to adopt an annual re-election policy. The AIC addressed this issue in its previous response to the FRC's view of the Combined Code.

In addition, the AIC does not support the extension of advisory votes. If a shareholder is concerned about a particular issue relating to the company, then company law provides a mechanism for a resolution to be tabled which shareholders can vote against. This process enables a shareholder to have a direct impact on the board. It also improves accountability and reduces the likelihood that shareholders will vote without proper consideration of the issues involved.

Board evaluation

Annual evaluation of the board could be a worthwhile process and external facilitation of this may be useful. However, it should not be expected. Recommendation 12 of the Walker Review states that external facilitation should be used every two to three years. This frequency may be inappropriate for certain types of entities, such as investment companies, and we do not support its inclusion in the Combined Code.

The recommendation relating to annual committee evaluation should be treated with caution. Most companies may find little value in undertaking a formal evaluation process for each of its committees every year. A rolling cycle of committee reviews might be more appropriate in certain circumstances, whereby the effectiveness of each committee is evaluated at most every, say, three years, or at the same time as the board evaluation.

The concept of an assurance statement is unconvincing. It is likely to result in longer corporate governance reports which fail to provide shareholders with additional useful information. It is currently unclear what information might be included in an assurance statement which should not already be provided under the disclosure requirements of the Combined Code.

Risk management and internal control

<u>Strategic risks</u>

The board's responsibility for 'strategic risks and setting risk appetite' could be made more explicit in the Combined Code. However, this change should recognise that risk disclosure is already covered by specific regulatory obligations.

UK companies must produce a business review in the annual report which includes a description of the principal risks and uncertainties facing the company. In addition, companies listed on the London Stock Exchange must produce two interim management statements (IMS) each year to update shareholders on material issues relating to the company. Both the business review and the IMS are signed off by the board prior to publication. Therefore, there are already established mechanisms to ensure that the board is reporting to shareholders on the work that it is doing in relation to the company's strategy and associated risks. Furthermore, the Combined Code already contains a recommendation that the chairman discusses strategy with major shareholders. There is no identified 'gap' in this area which needs to be addressed in the Combined Code. Extending the Code for no real reason should be resisted.

Investment companies also have an additional, sector-specific, mechanism for disclosing strategic risks. One of the key functions of an investment company board is to manage the company in accordance with its investment objective. Under the Listing Rules, investment companies must disclose their investment policy, which sets out how the board intends to achieve the investment objective, in other words, its strategy. This provides shareholders with information on the board's attitude to risk.

Walker recommendations

The majority of the Walker recommendations in relation to the governance of risk are not suitable for inclusion in the Combined Code. The AIC has provided a more detailed explanation of its position in its response to the Walker Review which is attached in Annex 1.

Risk reporting

As discussed above, the disclosure of strategic risks is already covered by specific regulatory obligations. If risks are to form part of the corporate governance statement, the quality of reporting would be improved if the Combined Code embraced a more outcome-based approach. This has been covered in detail in the AIC's previous responses on the Combined Code.

The recent problems in the banking sector have demonstrated that critical information about risks can sometimes be buried in standardised information. Relevant risks are more likely to be highlighted to shareholders if boards are required to consider risks as a whole and provide disclosures which meet high-level objectives. A good example is the production of interim management statements by property companies. The content of the report is only subject to high-level requirements set out in the Disclosure and Transparency Rules. In the current economic crisis, where property companies are suffering from a significant devaluation in asset values, boards are providing a key focus on banking covenants in their IMS. Were this disclosure required as a matter of course, it is less likely that sufficient emphasis on this area would be provided when it is most critical. High-level objectives in relation to risk reporting in the Combined Code would encourage boards to provide more tailored and informative disclosures in this regard.

Remuneration

The Combined Code should not be revised to incorporate the European Commission's Recommendations, the FSA's proposed code of remuneration practice for financial institutions or the recommendations of the Walker Review[1]. The Combined Code is a broad-based document and incorporation of recommendations written for specific sectors would be confusing to its users.

If a decision is made to include specific recommendations from these other sources in the Combined Code (which the AIC does not support), they should be redrafted in more general terms to ensure they can be applied to the different circumstances faced by entities adopting the Combined Code. For example, a number of the Walker recommendations refer to executive remuneration and are not relevant for investment companies which often outsource their day-to-day management and administrative functions to an investment management company. One solution to difficulties in applying a general Combined Code to all companies could be to produce different versions of the Combined Code for specific sectors or entities. This might reduce confusion and improve application, but would represent a major move away from the current unitary approach.

There may be a case for giving shareholders a more direct role in setting remuneration. However, any changes in this area would be more appropriately dealt with through company law rather than corporate governance.

The quality of disclosure by companies

It is both possible and desirable to rationalise the disclosure requirements set out in the Combined Code. This would encourage companies to move away from making boiler-plate disclosures and ensure that key issues are highlighted to shareholders. The prescriptive nature of the Combined Code encourages a tick-box approach which leads to the production of standardised corporate governance reports and failures of considered engagement. Detailed rules do little to encourage boards to evaluate their processes, and rigid views on "non-compliance" disillusions directors about the value of engagement. Fostering flexibility in disclosures would encourage shareholders and voting agencies to better evaluate the work of the board. As previously stated by the AIC, a move towards a more outcome-based system would achieve this.

It is unlikely to be appropriate for the FRC or the FSA to undertake greater monitoring and enforcement of 'comply or explain' statements. A large number of shareholders read the corporate governance statement and are in a better position to evaluate the board's disclosures. If they are not satisfied with the explanations provided, shareholders have a direct relationship with the board and should be able to encourage enhanced disclosures. They are able to remove directors from the board if they remain unsatisfied. It is difficult to see what role oversight by the FRC/FSA of these matters would add.

[1] A more detailed explanation of the AIC's position in relation to the Walker recommendations on remuneration is set out in its response to the Walker Review in Annex 1.

Engagement between boards and shareholders

The AIC's views on the adoption of the Walker recommendations on shareholder engagement into the Combined Code are set out in Annex 1. In particular, section E should be removed from the Combined Code and presented in a stand-alone document which focuses on the stewardship responsibilities of investors.

The name of the Combined Code should be changed to 'Corporate Governance Code' or 'UK Corporate Governance Code'. This would:

- improve understandability and encourage greater interest by all investors, including retail and overseas shareholders, and by the media

- better reflect the fact that the content of the code addresses the main areas which boards and shareholders should focus on

- more clearly recognise that the code is much more than a compliance checklist and can be a useful tool for boards to improve their governance arrangements.

The FRC should play a greater role in encouraging proxy voting agencies to take a more considered approach to reviewing a company's compliance with the Combined Code. We are aware of a number of examples where a tick-box approach has been applied by a voting agency, which has resulted in a 'vote against' recommendation for the re-election of some, or all, of the directors. Explanations for non-compliance provided in the annual report have not been taken into account. In these examples, the 'comply or explain' approach has failed to operate effectively. The FRC should encourage voting agencies to take a more qualitative approach and be open to entering a dialogue with the board on 'contentious' issues.

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Annex 1

A review of corporate governance in UK banks and other financial industry entities

Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to Sir David Walker's review of corporate governance in UK banks and other financial industry entities.

The AIC is the trade body representing some 350 closed-ended investment companies with £63 billion of assets under management. Investment companies bring a unique perspective to the corporate governance debate as they are both institutional investors with an interest in ensuring that appropriate governance mechanisms are in place and issuers which will potentially be effected by the recommendations set out in the Walker Review if, over time, they become embedded into the Combined Code as best practice for companies generally. Where incorporation into the Combined Code is a possibility, further consideration needs to be given to the desirability of this outcome.

The AIC's comments on the Walker Review are set out below. Our response concentrates on those areas which may, in time, be relevant to the investment company sector.

Board size, composition and qualification

The AIC is broadly supportive of the recommendations in relation to board size, composition and qualification. However, these recommendations are designed for the special circumstances of banks and complex financial institutions. They are therefore unlikely to be directly transferable in their current form to companies more generally – and this would include investment companies. Clearly, all companies need to give consideration to their board size and structure but this is already adequately covered by the Combined Code where these companies are concerned. Investment companies also have their own issues to consider. For example, the majority of investment company boards are entirely comprised of non-executive directors and therefore the responsibility of the chairman for ensuring effective communication between executive and non-executive directors would not be appropriate. In drawing its conclusions, the review should not include any presumptions of a read across to general corporate governance where these issues are concerned.

Functioning of the board and evaluation of performance

If the Walker recommendations on the functioning of the board and evaluation of the board's performance develop into best practice over time, then the AIC is cautious about particular elements which may not necessarily be appropriate outside the remit of the banking sector.

Recommendation 7

Recommendation 7 says that the chairman should be expected to commit a substantial proportion of his or her time to the business of the entity, probably not less than two-thirds. This time commitment is unlikely to be appropriate for an investment company chairman, except perhaps in exceptional circumstances.

Recommendation 9

Recommendation 9 says that the chairman is responsible for ensuring that *"fully adequate time is available for substantive discussion on strategic issues"*. The AIC agrees with this recommendation but would highlight the increasing burden placed on boards which distracts them from this critical activity.

Recommendation 12

The AIC **agrees** that a formal and rigorous evaluation of the board's performance is important. However, for the process to be carried out with external facilitation every second or third year may be too frequent if the recommendation is extended to non-BOFIs. The wording of recommendation 12 should be made sufficiently flexible so that it can be adapted to the specific circumstances of the company concerned. There should be no presumption that it be generally applied.

The role of institutional shareholders: communication and engagement

The role of institutional shareholders is an important area for the AIC. The AIC has long supported a move towards more qualitative engagement which is focused on outcomes rather than processes. Dialogue should be aimed at improving long-term returns, aligning the interests of shareholders and the company, preventing strategic disasters and resolving problems. Effective dialogue is important for shareholders as it can lead to better functioning companies and increase shareholder value.

If the Walker recommendations relating to shareholder engagement are to be applied to companies more generally, then they should be written in a way which provides sufficient flexibility for the parties involved to adapt them to their particular circumstances. Investment companies have unique issues which can affect the engagement processes. For this reason, the AIC has developed its own Code of Corporate Governance to address the specific issues faced by the investment company sector. (This includes, for example, the prevalence of entirely non-executive boards and considerations which involve the relationship between the company and its external fund manager.) The AIC is also a member of the Institutional Shareholders' Committee and is involved with the ongoing development of its 'Statement of Principles'.

Recommendation 16

The AIC **agrees** that the remit of the FRC should be extended to support the development of best practice in stewardship by institutional investors and fund managers. The AIC also **agrees** that Section 2 should be removed from the Combined Code and presented in a stand-alone document. This area is currently an 'add on' to the Combined Code and it does not really fit within a document primarily focused on the obligations of issuers and not investors. As a result, it arguably does not receive sufficient attention. The material can be given more prominence by promoting it separately in a code aimed specifically at shareholders and governance agencies.

The AIC also **agrees** with the recommendation that the Combined Code should change its name. The current name dates back to the process of creating the content of the Code and does not communicate the nature of the document to people not familiar with its historical development. The 'Corporate Governance Code' or the 'UK Corporate Governance Code' would be a more appropriate title. This would better reflect the content of the Combined Code, improve its profile and impact, and encourage greater interest by all investors, including retail and overseas shareholders, and by the media.

Recommendation 17

The AIC **supports** the ratification of the ISC's 'Statement of Principles' by the FRC. Endorsement by the FRC will give the statement greater prominence. The AIC is currently working with other members of the ISC to update the Statement of Principles into a formal code. Our initial view is that the content of the current statement is broadly correct but there may be issues of emphasis and context which need to be re-examined.

Recommendation 18

The AIC **agrees** that the Statement of Principles should be regularly reviewed in conjunction with the FRC in order to ensure that it continues to reflect current circumstances. However, an annual review may be too frequent. This issue should be considered further.

Principle 19

The AIC **agrees** that fund managers and other institutions authorised by the FSA should signify their commitment to the next iteration of the Statement of Principles on their website and describe their policies on engagement. Where a fund manager or institutional investor is not able to make this commitment or disclosure, then an explanation should be given. There may well be legitimate reasons where investors choose not to engage, for example if resources can be better used elsewhere to generate shareholder returns.

Recommendation 20

The AIC **agrees** that the FSA should encourage commitment to the Principles of Stewardship, although it is not clear how this would be achieved in practice. However, ultimately it is for the institutional investors to determine their policies and procedures in terms of stewardship and engagement, and there may be circumstances when they choose not to engage. The FSA's focus should therefore be on ensuring that appropriate disclosures are made where this is the case.

Recommendation 21

The content and implications of recommendation 21 would be clearer if it is split into two separate recommendations, one dealing with the Memorandum of Understanding and the other with major foreign institutional investors. The AIC **agrees** that major foreign institutional investors should be encouraged to commit to the Principles of Stewardship.

The AIC sees less value in introducing a Memorandum of Understanding into best practice procedures. It is unclear how this would work and there are risks that a rigid procedure would reduce flexibility for entities with different circumstances. There may be circumstances when such an approach is suitable but it should be for the investors concerned to establish the best mechanism to suit their particular situations.

Recommendation 22

The AIC **agrees** that voting policies should be disclosed. However, fund managers and other institutional investors should not be required to disclose their voting record in respect of individual stocks.

UK companies are already subject to regulation in relation to disclosing the result of polls. This provides interested parties with information on what goes to a poll and the level of support for competing propositions. It is difficult to see the benefit of requiring disclosure of the votes by all institutional investors. The main effect is likely to be to create an opportunity for third party activism, which may not necessarily result in the best outcome for shareholders. There is also a chain of ownership which creates complications. If funds' beneficial owners are interested in voting practice, they should be allowed to ask for the voting instruction – but no more than this should be required by legislation or governance codes. There may, however, be occasions where investors choose to voluntarily disclose their voting record but this should be a matter for them.

The AIC would **recommend** that, before any decision is taken about incorporating recommendations on disclosing voting records into the Combined Code, further work is done to establish what these disclosures are seeking to achieve and what risks might arise from publishing such information.

Governance of risk

The governance of risk is an important area for banks. The issues covered in recommendations 23 to 27 largely address the governance of risk in the context of BOFIs and are less relevant to other companies, including investment companies. Also, risk oversight is one of the main functions of an investment company board. As the day-to-day management and administration of an investment company is usually outsourced to a third party fund manager, the board's focus is on overseeing the activities and performance of that manager and ensuring that investment returns are in line with the company's stated risk profile.

<u>Recommendation 23</u>

The AIC has no views on whether the establishment of a board risk committee is, or is not, appropriate for a BOFI. However, it is unlikely that a separate committee focussing on risk is relevant to the investment company sector because, as explained above, risk is a key focus of the board's remit. The AIC therefore **<u>recommends</u>** that, if this recommendation were to be applied to non-BOFIs, the requirement should be for the board to consider whether it is appropriate to establish a separate risk committee, and where it concludes that this is not appropriate, it sets out its reasons in the annual report.

Obliging a company (whether through formal compliance or market expectations) to adhere to practice guidelines that are insufficiently flexible can create problems in some circumstances. One current example relates to the Combined Code recommendation which prevents the company chairman from chairing the audit committee. The majority of investment companies outsource their day-to-day management and administration to a third party manager. Therefore, the audit committee of an investment company does not have to deal with issues relating to oversight of the executive. Instead, its main focus is on the effectiveness of the manager's internal controls and procedures.

As one of the key priorities of the chairman (and the board) of an investment company is to oversee the performance of the manager, some boards believe that the chairman should be in a position to lead scrutiny of the manager's internal practices by chairing the audit committee. This is contrary to the Combined Code. Therefore, in this example, either a specific derogation for investment companies (and possibly also for smaller companies) would be appropriate or an amendment to the wording of the Code which provides more flexibility in its application. This approach should also be recognised where any of the Walker recommendations might extend beyond the remit of BOFIs.

<u>Recommendation 27</u>

As discussed above, it would usually be more appropriate for the whole board of an investment company to deal with *"the strategy of the entity in a risk management context"*. In such cases, any disclosures in this regard would be covered in a risk report presented by the board. The AIC supports the flexibility provided in the first sentence of recommendation 27 which recognises that the risk report may be presented by the board risk committee or the main board.

Remuneration

Recommendations 28 to 39 mainly relate to the issue of executive remuneration which is not relevant in the context of investment companies as the vast majority of boards are compromised entirely of non-executive directors. The equivalent issue for investment companies is the remuneration of the external fund management company which is responsible for the day-to-day management and administration of the company. There is an ongoing debate around the industry about the use of benchmarks as a performance indicator in the calculation of any performance fee (akin to a bonus payment). A recent survey by Grant Thornton LLP concludes that about half of all investment companies have a performance fee structure in place but that there was no clear evidence that this leads to improved performance. The AIC believes this is a matter for individual boards to determine and that arrangements should ensure that the basis of manager remuneration does not encourage excessive risk taking. (See principle 15 of the AIC Code of Corporate Governance in Annex 2.)

The AIC Code also encourages transparency. Investors should be provided with sufficient information about the remuneration policies of the company to make an informed decision. For example, although there is no expectation that an investment company should have a performance fee in place, the AIC Code of Corporate Governance recommends that the board regularly reviews the performance of, and contractual arrangements with, the manager and discloses its decisions and rationale in the annual report.

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Annex 2

Principle 15 of the AIC Code of Corporate Governance

15. The Principle – The board should regularly review both the performance of, and contractual arrangements with, the manager (or executives of a self-managed company).

Recommendations

It should become best practice for a management engagement committee consisting solely of directors independent of the manager (or executives) to make this review annually with its decisions and rationale described in the annual report.

The company chairman may be a member of, and may chair, the management engagement committee, provided that he or she is independent of the manager.

The long-term nature of the advantages of investment companies suggests that frequent changes in management arrangements would be undesirable. Issues include:

- Monitoring and evaluating the fund manager's investment performance and, if necessary, providing appropriate guidance.

- Considering the merit of obtaining, on a regular basis, an independent appraisal of the manager's services.

- Requiring the manager to provide attribution and volatility analyses and whether it should be published at least annually.

- Putting in place procedures by which the board regularly reviews the continued retention of the manager's services.

- Reviewing the level and method of remuneration, the basis of performance fees and the notice period. The board should give due weight to the competitive position of the company against the peer group.

- Considering whether the initial and annual fee should be based on gross assets, net assets or market capitalisation.

- If there is a performance related element, or the introduction of a performance fee is under consideration, the review should seek to ensure that the basis does not encourage excessive risk and that it rewards demonstrably superior performance by the manager in managing the portfolio against the company's stated objectives when compared to a suitable benchmark or peer group. Key factors to be considered include:

    - The views of shareholders
    - Appropriate benchmarks/hurdle rates

- A reduction in the basic fee when a performance fee is introduced
- A cap on the performance fee
- A high water mark
- A combination of short-term and long-term measurements and incentive

- Ensuring that a sound system of internal control is maintained to safeguard shareholders' investment and the company's assets. A review of the effectiveness of the system of internal control should be made annually by the board. Such a review should be reported to shareholders.

The AIC has produced a paper entitled ''Evaluation of the Manager: A Paper for Non-Executive Directors of Investment Companies on meeting the requirements of the Listing Rules''. This is available on the AIC's website at www.theaic.co.uk/technical.