

# Review of the effectiveness of the Combined Code

## Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the FRC's call for evidence on the effectiveness of the Combined Code. The AIC brings a unique perspective to this review as its members are both institutional investors and issuers. It represents some 345 investment companies with £58 billion of assets under management.

The AIC takes a keen interest in the corporate governance agenda. High standards of corporate governance, coupled with an effective 'comply or explain' regime, can lead to better functioning companies and increase shareholder value.

The Combined Code continues to play an important role in this regard and is a key reference for investment company boards in reviewing their governance arrangements. However, due to the general nature of the Combined Code, the AIC has produced its own corporate governance code which is tailored to the specific circumstances of the investment company industry. The AIC Code of Corporate Governance has been endorsed by the FRC as an alternative means for investment companies to meet their obligations in relation to the Combined Code.

The AIC believes that the profile and impact of the Combined Code could be improved if the FRC changed its title. 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 AIC **recommends** that the title should be changed to 'The UK Corporate Governance Code'. This would better reflect the content of the Code and encourage greater interest by all investors, including retail shareholders, and by the media.

There are a number of other ways in which the Combined Code could be improved to strengthen the governance practices of companies and to enhance the application of the 'comply or explain' regime. Our **key recommendations** are for changes to the Combined Code which:

- embrace a more outcome-based system which is focused on delivering results
- incorporate specific derogations for companies or sectors with unique characteristics which make certain aspects of the Code inappropriate
- enhance the impact on shareholder engagement by requiring the chairman to inform the board of shareholder concerns
- improve remuneration disclosures and oversight by requiring companies to provide a statement of the risks associated with the remuneration policy and a description of the remuneration policy for highly paid employees, as well as requiring the company chairman and the chairman of the remuneration committee to stand for re-election at

the next annual meeting in the event that the remuneration report is rejected by shareholders

- expand the terms of reference of the audit committee for large complex financial companies (e.g. banks) to include oversight of risk, or for a separate risk oversight committee to be established
- give greater encouragement to directors to take independent professional advice if required
- place greater emphasis on the importance of succession planning and reporting progress.

Our focus has been on making positive recommendations to enhance the Combined Code. However, the AIC is aware of representations from some parties for the Combined Code to recommend the annual re-election of directors. The AIC does not support this approach.

It should be for individual companies and their shareholders to decide whether to adopt an annual re-election policy. If a blanket requirement is introduced, there is a risk that the election of directors becomes a routine process, with little or no consideration given to the skills and contribution made by the director concerned. Where shareholders do have serious concerns about the continuing appointment of a director, they have the option of tabling a resolution for a vote on his/her re-election.

For shareholders to demonstrate the seriousness of their intent by pro-actively laying motions to remove a director would be a far more powerful mechanism for shareholders to highlight their concerns than the mechanistic routine of annual votes for all directors. This would be the product of an effective engagement process – annual re-election for all directors risks prioritising form over substance i.e. the appearance of a strong mechanism which, in reality, delivers no substantive change.

### **Consultation questions**

#### **Q1: Which parts of the Code have worked well? Do any of them need further reinforcement?**

The AIC believes that the Combined Code, as a whole, has encouraged both investors and issuers to give more consideration to governance, and to what constitutes good governance, than before the Code was introduced. However, there are examples where the Combined Code places governance obligations on boards which are inappropriate to the structure and specific characteristics of the company. Where the ‘comply or explain’ mechanism does not operate properly, and justifications for non-compliance are given insufficient consideration by investors, implementation of the Code becomes ineffective. This issue is covered in more detail under question 4 below.

The AIC has identified the following areas where the Combined Code needs reinforcing to improve governance practices and to enhance the relationship between the board and the company’s shareholders:

- **Shareholder concerns:** One area of the Combined Code which should be strengthened is in relation to the chairman's responsibility to communicate the views of shareholders to the board as a whole (D.1.1). The AIC **recommends** that this is extended to ensure that the chairman is explicitly responsible for informing the board of any specific concerns which have been raised by shareholders. This recommendation should also encompass the senior independent director, particularly where he/she has been approached by shareholders raising concerns which have not been resolved through contact with the chairman (or, where applicable, the chief executive or finance director) or where the normal channel of communication through the chairman is inappropriate. This will ensure that the board as a whole will be in a position to discuss, and decide on, the most appropriate form of action. The directors can also consider together whether a formal response to the shareholder concerned on behalf of the board is appropriate and, if so, the nature of that response.
- **Remuneration:** The AIC **recommends** that the remuneration report should include a description of the general remuneration policy for highly paid employees. This would provide shareholders with more complete information about the remuneration practices of the company, and allow them to make a more informed decision about whether or not to approve the remuneration report.

The AIC also **recommends** that, in the event that the remuneration report is rejected by shareholders, the company chairman and the chairman of the remuneration committee should stand for re-election at the next opportunity. This would allow shareholders to demonstrate their support, or otherwise, for the key individuals responsible for the remuneration policy of the company.

The AIC also **recommends** that the Business Review contains a statement of the risks to the company arising from the remuneration policy. Where no statement is given, an explanation should be provided in the annual report as to why the risks are not disclosed. This might highlight to shareholders, for example, the introduction of short-term incentives which are to the detriment of the longer-term interests of the business. Disclosure would provide useful information to shareholders when considering the risk:reward profile of their holding.

- **Oversight of risk:** The AIC **recommends** that, for large complex financial companies (e.g. banks), the terms of reference of the audit committee are expanded to include oversight of the risk profile of the company. In some cases, particularly for complex companies, this may place an excessive workload on the audit committee, in which case the Combined Code should recommend that a separate risk oversight committee is established which is dedicated to this function. This approach would highlight the importance for a company of overseeing

risk and allocate specific responsibility for this task to a committee of the board.

- **Independent professional advice:** The Combined Code should be strengthened to give directors greater encouragement to take independent professional advice. Provision A.5.2 states that the board should ensure directors have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. The AIC **recommends** that the chairman should be given specific responsibility for ensuring that independent advice is obtained where the directors consider it necessary to their understanding. This should include obtaining expert opinions or reviews on any area of the business which the directors consider necessary in order to make sound business decisions and to achieve effective governance.
- **Succession planning:** The AIC **recommends** that the Combined Code places a greater emphasis on the importance of succession planning. This could be done through a provision that encourages chairmen to report annually on the process being followed and progress made.

**Q2: Have any parts of the Code inadvertently reduced the effectiveness of the board?**

The AIC **recommends** that the Combined Code should be adapted to embrace a more outcomes-based system which is focussed on delivering results (see question four). This would enable companies to adopt a more flexible approach to compliance and encourage investors to consider the company's corporate governance arrangements in a more qualitative way. One example of where such a change in approach would be beneficial is in relation to the nine year reference regarding independence, which has inadvertently reduced the effectiveness of the board.

One of the considerations identified in the Combined Code when determining a director's independence is length of service. The Combined Code suggests a cut-off date of nine years from the date of first election, after which the board must state its reasons if it considers that the director remains independent. Some market participants interpret this recommendation as being that a director serving over nine years is automatically non-independent. This mechanistic approach is caused by the overly detailed criteria set out in the Combined Code, and is exacerbated where the 'comply or explain' regime does not operate effectively (see question 4). The composition of the board can be adversely effected if an independent director is suddenly classified as non-independent the day after his/her ninth anniversary.

Long-standing directors should not be prevented from forming part of the independent majority and the AIC **recommends** that the nine year reference regarding independence is removed. This should be replaced by a general

statement, in line with an outcome-based approach, about the relationship between independence and length of tenure, which will provide companies with greater flexibility over the composition of the board. This approach would place more emphasis on the desired outcome, in this case a focus on the value of an independent attitude and on the experience that a director can bring to the company.

**Q3: Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?**

See question one.

**Q4: Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved?**

The AIC continues to support the application of a 'comply or explain' mechanism. Investment companies have certain characteristics which mean that many of the recommendations of the Combined Code are not appropriate for the sector.

For example, the majority of investment companies have boards comprised entirely of non-executive directors, meaning that recommendations on executive directors' remuneration are not relevant. In addition, most investment companies outsource their day-to-day management functions to a third party fund manager, so those parts of the Combined Code referring to the chief executive, senior management and internal audit are irrelevant. For this reason, the AIC produced its own Code of Corporate Governance (see above) which reflects the specific arrangements of investment companies. The AIC Code of Corporate Governance is now widely adopted within the investment company industry and is well regarded by shareholders.

The 'comply or explain' approach allows a board to present explanations to shareholders to justify areas of non-compliance with certain aspects of the Combined Code which are inappropriate to the company's structure, and it enables a board to implement specific arrangements which are more suited to its particular circumstances. However, for the 'comply or explain' regime to work effectively, both sides of the governance equation – the issuers and the investors - must play their respective roles appropriately.

Where investors are presented with explanations of non-compliance by companies, they should be prepared to give them due consideration and form a view taking into account all relevant factors. In practice, constructive engagement can be missing from the governance process. Particularly where governance agencies are involved, investment company boards have, at times, not been able to secure proper consideration of explanations they try to provide. As a result, any deviation from the Combined Code can automatically attract a negative assessment of the governance approach adopted by a company.

In the most recent edition of the Combined Code, the FRC made changes to the preamble to strengthen the 'comply or explain' regime. For example, it emphasised the need for companies to provide shareholders with "*a careful and clear explanation*" where specific provisions are not followed "*which shareholders should evaluate on its merits*". Although these revisions were welcomed by the AIC, they do not go far enough to ensure that the 'comply or explain' mechanism is properly observed. The AIC would reiterate its general **recommendations** made to the FRC as part of previous reviews of the Combined Code in March 2008 and July 2007:

- The FRC should consider how the Combined Code could be adapted to embrace a more **outcomes-based** system which is focused on delivering results rather than detailed processes. This would enable companies to adopt a more flexible approach to compliance and remove any propensity to treat governance as a box-ticking exercise. An outcome-based system would also help to reduce boiler-plate disclosures to a minimum and encourage investors to carry out a more qualitative assessment of a company's compliance with the Combined Code.
- The FRC should consider incorporating **specific derogations** into the Combined Code for companies or sectors with unique characteristics which make certain aspects of the Code inappropriate. For example, there should be a specific exemption for externally managed investment companies from the Combined Code recommendations dealing with executive directors and the executive team.

Both of these recommendations would encourage companies to approach their corporate governance reporting in a less mechanistic way, leading to better quality disclosures which focus on the more relevant factors. This in turn should enable shareholders to evaluate explanations of non-compliance provided by boards more fully, and encourage engagement between the parties to address the more qualitative aspects of the issues in hand.

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