

# Consultation on the Revised UK Corporate Governance Code

## Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the FRC's consultation on the revised UK Corporate Governance Code (Code).

The AIC is the trade association representing the closed-ended investment company industry. Its membership comprises some 345 investment companies with £68 billion of assets under management. The AIC brings a unique perspective to the corporate governance agenda as its members are both institutional investors and issuers.

### Change of name

The AIC strongly supports proposals to change the name of the 'Combined Code of Corporate Governance' to 'The UK Corporate Governance Code'. As set out in previous submissions, the change in name will not only enhance the Code's status amongst foreign investors, but it will also improve understandability and encourage greater interest by all investors, including retail investors, and by the media.

### Structural changes

#### Section A

The AIC supports the restructuring proposals to create a new 'Leadership' section and a new 'Effectiveness' section. Re-organising the Code in this way will help to consolidate, differentiate and promote two distinct and critical areas, namely the role of the board and its chairman, and the composition and management of the board.

#### Preamble

The structural changes to the preamble help to emphasise the purpose, ethos and context of the Code. This will be particularly useful for overseas companies which will soon be required to report against the Code for the first time under the Listing Rules.

By creating a separate section headed 'Comply or Explain', the reader's attention is better directed towards the reporting regime surrounding the Code. However, we note that the specific reference to the disclosure requirements of the Listing Rules has been removed and replaced by a general statement that *"it is expected that companies will apply the principles and report to shareholders on how they have done so"*. Although there may be a desire to encourage adoption of the Code by companies outside the scope of the Listing Rules (i.e. those that do not have a Premium listing), it would still be useful to note the regulatory disclosure requirements in the preamble. The AIC therefore **recommends** that the section of the pre-ambble

covering 'comply or explain' issues should include a specific reference to the Listing Rules disclosure requirements or a cross-reference to Schedule C.

The AIC is pleased that the FRC has retained the reference in the preamble to the AIC's Code of Corporate Governance as an alternative means for investment companies to meet their obligations under the Code. This flexibility is greatly appreciated by our members and shareholders who continue to believe that this approach provides for more relevant reporting. The AIC will be updating its Code to reflect changes in the Combined Code and ensure it remains up to date. We look forward to taking this forward in discussions with the FRC in due course.

#### List of all Code principles

The new summary section containing all the main principles provides a useful overview of the content of the Code. It will be particularly helpful for those adopting the Code for the first time, particularly overseas companies. However, the AIC **recommends** that the referencing applied to the main principles in the main body of the Code is also reflected in the summary section for ease of use.

#### Section E

The AIC is currently preparing its response to the FRC's consultation on a new Stewardship Code for institutional investors. The AIC believes that there is no benefit from duplicating recommendations for institutional shareholders in both the Stewardship Code and the UK Corporate Governance Code. The purpose of the Stewardship Code is to set standards of governance for institutional investors and therefore this is a more suitable location for the content of Section E. The AIC **agrees** that Section E should be deleted from the UK Corporate Governance Code.

### **Proposed changes to the content of the Code**

#### Main principles

- Upgrading three supporting principles to main principles

The upgrading of three supporting principles to main principles means that Premium listed companies will have to demonstrate to shareholders how they have ensured that:

- the chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role
- non-executive directors constructively challenge and help develop proposals on strategy
- all directors allocate sufficient time to the company to perform their responsibilities effectively

The AIC is cautious about how companies will be able to prove how they have applied the first two new main principles. For example, what sort of evidence would the FRC expect a chairman to provide to demonstrate his/her responsibility for leadership of the board? Furthermore, how might the non-executive directors explain how they have constructively challenged and helped develop proposals on strategy, particularly when decisions are made by the board on a unitary basis?

- Division of main principle A.5

The AIC also supports the division of main principle A.5 into two separate principles. Separating recommendations on the quality and timeliness of board information from those on the development of the directors' knowledge and skills will help clarify the expectations set out by the Code.

- New principle B.1

New principle B.1, which recommends that the board and its committees should consist of directors with *“the appropriate balance of skills, experience, independence and knowledge of the company”*, is sensible. It should help to improve the composition of boards and is more appropriate than the previous A.3 which recommended a balance of executive and non-executive directors.

We are disappointed to see that the revised version of the Code retains the so-called 'nine-year rule'. In the past the AIC has recommended that this is removed as it hinders the effective operation of boards by restricting the pool of potential non-executive directors. There is no evidence that nine years represents a meaningful milestone as other issues (such as willingness to question and to take external advice) are more important indications of independence than length of service. The nine year issue causes particular problems for investment companies where the inclusion of long-standing directors on the board is often beneficial in helping the company understand longer term issues which may affect the company's investment strategy and the impact of the economic cycle. Ideally, the new main principle for the board to consist of directors with an appropriate balance of independence will change perceptions, particularly amongst voting agencies, about retaining the services of long-serving directors on the board. Unfortunately, retaining the nine-year provision will not help in addressing this.

The FRC is also proposing to change the wording of supporting principle B.1 to replace the recommendation that *“the board should include a balance of executive and non-executive directors”* with *“the board should include a strong presence of executive and non-executive directors”*. This balance creates a particular issue for investment companies as the vast majority outsource their day-to-day management and administration and do not have executive directors. This is one of the main reasons for the FRC's endorsement of the AIC Code of Corporate Governance which deals with boards made up entirely of non-executive directors.

## Provisions

- Personalised training and development

New provision B.4.2 recommends that the chairman should agree and regularly review a personalised approach to training and development with each director. The AIC does not support this suggestion. Whilst it may have some merit for large complex organisations such as banks, it may be excessive for many other companies, including investment companies. There is already an obligation to ensure adequate skills and development. This should be sufficient for most companies. There is also a concern that this provision could be taken to mean that directors should undertake regular formal training courses. Although formal training may be appropriate in some cases, many issues are addressed by the ongoing work of the board. For example, directors considering changes to regulatory or governance requirements will be updating their skills as part of this process. We therefore **recommend** that the wording of B.4.2 is amended to say the chairman and board members should review their competencies and agree if any training and development may be required in order that each director maintains an appropriate set of skills to perform his/her role effectively.

- Board evaluation

New provision B.6.2 says that board evaluation should be externally facilitated at least every three years. This concept has been adopted from Sir David Walker's recommendations on the governance of the banking sector. As stated in our previous response on the Combined Code, the AIC does not believe that it is appropriate to give this recommendation broader application. Formal and rigorous evaluation of the board's performance is important. However, for certain types of entities, including investment companies, regular external facilitation is unlikely to be required. We are unconvinced that the additional costs and resourcing requirements needed for an external valuation process would be offset by any real benefits to shareholders. Ultimately, shareholders which are not satisfied with the effectiveness of the board have, through their voting entitlements, the ability to replace directors. Also, other provisions, for example on skills and experience, will focus the board's attention on the key issues required for evaluation, making external facilitation unnecessary in most cases.

Nevertheless, there may be circumstances in which an external evaluation is warranted or where shareholders demand the greater objectivity that an external evaluation can provide. The AIC therefore **recommends** that B.6.2 should say that boards should consider if external facilitation would be helpful.

The AIC supports the FRC's decision not to introduce any recommendations relating to external evaluation of board committees.

- Risks

The AIC notes the proposed changes on risk in C.2 and C.2.1. The management of risk is a central issue for any board. One of an investment companies' key risk disclosures is its investment policy which it is required to publish under the Listing Rules and which covers asset allocation, risk diversification and gearing. Significant changes to this investment policy are subject to shareholder approval. Therefore, for an investment company it is the shareholders who are responsible for agreeing the investment policy, which is different to other companies where the risk policy is set by the board. The requirement for an investment company to publish an investment policy will be reflected in the updated version of the AIC Code.

- Disclosure of business model

New provision C.1.2 recommends that the annual report includes disclosure of the company's business model (which is defined in provision C.1.2 as "*the basis on which the company generates revenue and makes a profit from its operations*") as well as its overall financial strategy. The AIC notes the FRC's comment in its '2009 Review of the Combined Code: Final Report' that preparation of such a statement may also serve to prompt discussion in the boardroom as to the long-term robustness of the company's business model. For an investment company, its business model and financial strategy would be akin to its investment policy. An investment company is already required by the Listing Rules to disclose "*the full text of its current published investment policy*" in its annual report. Furthermore, this new disclosure is unlikely to generate additional discussion amongst investment company boards as the investment policy already forms the core part of the board agenda.

- Re-election of directors

The FRC is asking for views on its proposal that there should be annual re-election of the chairman or annual re-election of all directors. As stated in our previous responses on the Combined Code, the AIC does not support the inclusion of either approach in the Code.

The annual re-election of all directors will create many more resolutions for shareholders to vote upon in a general meeting. This comes at a time when action is being taken to focus shareholders' attention on key governance issues. Distracting shareholders in this way is not helpful and discourages proper consideration of critical areas. Director re-election will become little more than a routine process or a 'tick-box' exercise, with shareholders giving little or no consideration to the skills and contribution made by the director concerned.

Where shareholders do have serious concerns about the continuing appointment of a director, there is already a structure in place to table a resolution for a vote on his/her re-election. In any event, under the existing framework, shareholders have the ability to vote on a directors' reappointment

every three years. Subjecting directorship beyond one year to shareholder approval may also encourage directors to take a short-term view of the company rather than focussing on its longer-term development. It is therefore unclear what positive benefits an annual re-election process will bring.

The annual re-appointment of the chairman and the so-called 'nine year rule' as discussed above are also inappropriate. The arguments against the annual re-election of the chairman are no different to those against the annual re-election of all directors. The nine-year provision is particularly unsuitable because there are many other factors which could influence a director's independence. Indeed these may be more significant than length of service but are not subject to annual re-election.

Therefore, for the majority of companies it is inappropriate to introduce a policy of annual re-election of the chairman or of all the directors. The AIC **recommends** that the three-year rolling re-election approach is retained.

- Communication

The FRC is proposing that E.1.1 is amended to insert the word 'existing' into "*Non-executive directors should be offered the opportunity to attend existing meetings with major shareholders...*". We are not clear what this insertion adds. The principle is clear that non-executive directors should be given the opportunity to attend meetings with shareholders. The word 'existing' creates more confusion. For example, it may be taken to mean meetings that have already been scheduled with major shareholders, rather than meetings that might be held in the future. The AIC therefore **recommends** that the word 'existing' is removed.

### **Disclosure requirements**

The AIC agrees that companies should be given the option of disclosing their full corporate governance statement on a website with an edited version containing the most important information in the annual report. The AIC **recommends** that companies are required to include a reference from the annual report to where the full information can be found. If this approach is adopted, the FRC may want to consider publishing guidance on the type of information which would be deemed 'important' for inclusion in the annual report.

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