

Guernsey Financial Services Commission Code of Corporate Governance

Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to comment on the Guernsey Financial Services Commission's draft Code of Corporate Governance ('GFSC Code'). The AIC is the trade body representing some 350 closed-ended investment companies with £69 billion of assets under management. Some 55 of the AIC's Members are domiciled in Guernsey and will therefore apply the GFSC Code. Investment companies bring a unique perspective to the corporate governance agenda as they are both issuers and institutional investors with an interest in ensuring that appropriate governance is maintained.

The AIC promotes the maintenance of high standards of corporate governance, which, coupled with an effective 'comply or explain' regime, can lead to better functioning companies and increase shareholder value. The introduction of a corporate governance code for the financial sector in Guernsey is an important contribution to governance standards. It will set high standards for boards of Guernsey companies to measure themselves against and enhance their own governance arrangements and oversight. It will also act as an important tool for overseas parties to understand and evaluate the standards that the sector applies.

The AIC supports the adoption of a code designed to help deliver desirable 'outcomes' rather than processes. This will provide boards with flexibility to attain the standards prescribed within the remit of their own business model. This should allow boards of investment companies to achieve relevant 'Level One outcomes' in a manner which is sympathetic to their unique structural characteristics. The vast majority of investment companies outsource their day-to-day management and administration to a management company and/or administrator and as a result the board is comprised entirely of non-executive directors. The outcome-focussed model will allow this approach to be maintained while also delivering appropriate governance outcomes.

The use of a 'comply or explain' regime will also help deliver suitable accountability in governance matters whilst maintaining appropriate commercial flexibility. It recognises that companies operate in different circumstances and enables boards to adopt alternative approaches while achieving the same desired outcome.

It is also important to ensure that the GFSC Code is suitably integrated with other obligations that affected companies may have to comply with. Where investment companies are concerned, this would include the UK's Combined Code of Corporate Governance ('Combined Code'). We would also be pleased if it could take account of the AIC's own Code of Corporate Governance ('AIC Code'). This is explained below, along with our other comments on the draft GFSC Code.

Governance framework

We **recommend** that consideration be given to the interaction of the GFSC Code with the Combined Code and the AIC Code.

From 6 April 2010, overseas companies listed on the London Stock Exchange will be required, under the Listing Rules, to ‘comply or explain’ against the Combined Code. The Financial Reporting Council (FRC), the body responsible for the Combined Code, allows investment companies to discharge this obligation by reporting against the AIC Code rather than the Combined Code. The AIC Code promotes similar high standards of governance and has been constructed to take account of all relevant issues covered by the Combined Code but also addresses issues relevant to an investment company board such as board independence from the manager and reviewing management and other third party contracts.

If listed companies are required to report against the GFSC Code *and* the Combined Code (or AIC Code as appropriate), there will be an increased compliance burden. Considering two sets of standards is both time-consuming and potentially confusing. It would not be an effective use of the board’s time and would not produce any additional useful information for shareholders.

The GFSC should consider how it could reduce the compliance burden for companies subject to more than one corporate governance regime. As the original objective in preparing the Code was to demonstrate adherence to internationally recognised standards, one option is to allow companies to report against other internationally recognised governance statements. This would deliver proper outcomes whilst maintaining the competitiveness of the jurisdiction. The AIC therefore **recommends** that the GFSC should formally recognise the Combined Code as an appropriate alternative to its own Code for listed companies. They would then only be required to consider one set of standards. If the GFSC has identified areas of good governance not currently covered by the Combined Code, it could require Guernsey-domiciled listed companies to make additional disclosures to cover these issues.

This approach could be extended to other corporate governance codes adopted in other jurisdictions or by other sectors if the alternative arrangement delivers suitable standards and if this were requested by those governed by the GFSC Code.

For example, the AIC **recommends** that, in addition to endorsing the Combined Code as an alternative means of applying the GFSC Code, it also acknowledges that the AIC Code is a suitable alternative for Guernsey-domiciled listed investment companies to apply the Combined Code and any additional obligations included in the GFSC Code. This arrangement would reduce the workload for the board and enable directors to spend more time focusing on critical business issues, whilst at the same time ensuring that the company maintains high standards of governance which are best suited to the particular circumstances of the sector. For example, provision 4.5 of the

GFSC Code says that the board should establish clear accountability for all outsourced functions. For an investment company board, monitoring the performance of, and contractual arrangements with, the investment manager is one of the key tasks of the board and a significant part of the AIC Code is dedicated to this activity.

It is also worth noting that, if Guernsey adopted another international corporate governance code, this would not be out of line with normal practice. For example, the Irish Stock Exchange has a requirement in its Listing Rules for companies to make a compliance statement against the Combined Code.

'Comply or explain' regime

The AIC fully supports the adoption of a 'comply or explain' regime for the GFSC Code. However, it is **recommended** that the way in which companies are required to report against the GFSC Code be clarified.

Page 9 states that companies must confirm to the GFSC that they have complied with each Level One Outcome, each Level Two Best Practice provision and each Level Three Guidance and, where there has been compliance by alternative means or where companies have not complied, to explain why. Page 8 says that *"it is intended that each companywill report annually to shareholders and relevant stakeholders, including the GFSC"*. Furthermore, provision 6.2 says *"Boards have a duty to comply with annual reporting requirements to disclose their corporate governance arrangements and compliance with this GFSC Code of Corporate Governance."*

It is not entirely clear whether companies are required to include a corporate governance statement on their compliance, or otherwise, with the GFSC Code in their annual report and accounts, and if not, how the information should be communicated to shareholders.

It is also not clear whether the report to shareholders would be sufficient to make the formal disclosure to the GFSC or whether a different form of declaration is required.

The AIC **recommends** that the GFSC Code is amended to state that companies must produce a corporate governance statement for publication in their annual report and accounts and that this can be used for the purposes of reporting to the GFSC. This will minimise the burden placed on the company whilst at the same time ensuring that both shareholders and the GFSC have access to the required information.

The AIC also does not support requiring companies to report *"by the close of business on 30 April each year on their compliance "during the previous calendar year"*. Although a single reporting deadline may be appropriate for some entities, in most cases a more practical approach to align the governance reporting process with the company's year end may be more suitable. The corporate governance compliance statement would therefore cover the same period as the financial information set out in the annual report

and accounts. This is also the approach adopted by other internationally recognised governance regimes, such as the Combined Code. It makes it easier for companies to consider compliance disclosures as part of their normal reporting processes and, in most cases, will provide shareholders with more up to date information than under the approach which is currently proposed. For example, a listed company producing its annual report and accounts for the year ended 31 December 2010 may only be able to include a corporate governance compliance report for the year to 31 December 2009 (as the compliance report for the year to 31 December 2010 may take until 30 April 2011 to be produced). Under the Disclosure and Transparency Rules, the company has four months to publish its annual report and accounts. Therefore, by the time that the annual report and accounts for the year to 31 December 2010 is sent to shareholders, the corporate governance report will be 16 months old. Therefore, the AIC **recommends** that the GFSC Code is amended to require companies to report compliance in conjunction with their annual financial reporting requirements.

The AIC also **recommends** the implementation date of the GFSC Code is changed to reflect the proposed approach to annual reporting. As currently drafted, a company must submit its first compliance report by 30 April 2012 for the 2011 calendar year. It is **recommended** that the implementation date is changed to “accounting periods beginning on or after xxx”. Each company’s compliance report would then be disclosed in its first set of annual reports and accounts produced after this date.

Comments on Level One and Level Two text

In addition to the points raised above, the AIC has the following specific comments on the drafting of certain Level One outcomes and Level Two provisions in terms of their application to the investment company sector. If, as recommended above, the GFSC is able to endorse the AIC Code as an alternative approach to applying the GFSC Code, many of these comments become irrelevant.

- Provision 1.5 says that *“The Board should ensure that a clear senior management structure is in place”*. The vast majority of investment companies outsource all their day-to-day management and administration such that there is no internal management team. Investment companies will therefore not be able to comply with this provision in its current format. It may, however, be possible to address this through Level Three guidance.
- Outcome 2 refers to the board’s responsibility *“in directing and supervising the affairs of the business on behalf of all shareholders and relevant stakeholders”*. The AIC asks the GFSC to clarify the meaning of ‘relevant stakeholders’ and the reasons for including this wording. We are concerned that this may create some confusion with the board’s overall objective to act in the best interests of shareholders as a whole. It may be the case that the reference to other stakeholders is intended to ensure that the board meets its broader obligations. If this

is correct, we **recommend** amending the wording to say “*on behalf of all shareholders and in accordance with legal and regulatory responsibilities*”. This is more specific and may be more helpful for boards. In any event, we **recommend** that the reference to “*relevant stakeholders*” is deleted.

- Provision 2.3 says “*Directors should robustly and constructively challenge management*”. Although we do not disagree with this requirement in principle, as discussed above investment companies do not have an internal management team. Instead, an appropriate provision for an investment company would be to ‘robustly and constructively challenge the manager’. It may be possible to address this through Level Three guidance.
- Provision 2.6 covers performance evaluation. As a general point we note that the Combined Code includes a specific reference to the performance evaluation of the chairman. This is a useful provision and we **recommend** that consideration is given to whether it should be addressed in the GFSC Code. It may be possible to address this through Level Three guidance.
- Provision 2.7 says “*All directors should regularly update and refresh their skills and knowledge and undertake ongoing professional development*”. It is not entirely clear what is meant by ‘ongoing professional development’. It could be taken to mean that directors should undertake 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 words “*and undertake ongoing professional development*” are deleted”.
- Provision 4.4 says that “*The Board should maintain a sound system of internal control to safeguard shareholder and stakeholder investments*”. It is not entirely clear what is meant by ‘stakeholder investments’. The AIC **recommends** that this wording is either clarified or removed.
- Provision 5.2 says that the board should “*support and be supported by an appropriate senior executive of the company whose primary responsibility it is to assess and manage risk*”. As explained above, investment companies do not have a senior management team and the responsibility for managing risk falls to the whole board. This scenario is not reflected in the drafting of this provision. It may however be possible to address this through Level Three guidance.
- Provision 5.4 covers contingency planning to ensure that companies “*safeguard against disruption of their operations and services and to protect against risk of loss*”. The AIC fully supports this approach but **recommends** that the provision is made wider by including a specific reference to critical business areas maintained by third parties. As

discussed above, all of the management and administrative processes of an investment company are maintained by the management company and/or administrator and these are vital to managing the investment portfolio. Contingency considerations by an investment company board would primarily focus on these areas.

- Provision 7.1 says “*The Board should review and approve all remuneration policies for executive and senior management*”. As discussed above, investment companies do not have executive directors or senior management teams and therefore this provision is not applicable. This issue could be addressed through Level Three guidance.

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