

Best Practice Principles for Governance Research Agencies Submission from The Association of Investment Companies (AIC)

The Association of Investment Companies (AIC) represents some 340 closed-ended investment companies with assets under management of approximately £100 billion. The AIC's members include UK investment trusts, Venture Capital Trusts and non-EU companies.

Investment companies are a type of collective investment fund whose shares are traded on public markets. They have a board of directors with legal duties and corporate governance obligations to the company's shareholders. The vast majority of our members are listed on the London Stock Exchange. Our members are subject to scrutiny by governance research agencies on behalf of their clients.

Investment companies have a number of unique features. Notably, the vast majority of companies in the sector have boards comprised entirely of non-executive directors. These companies tend to contract out the majority of the day-to-day management and administration of the company to third parties. This operating model means that the sector has unique governance arrangements and issues. There have been a number of occasions over the last few years where investment company boards have encountered problems dealing with governance research agencies.

For example, an agency recommended voting against the re-appointment of a board director on the grounds that they had been in the position for over nine years and could no longer be considered independent. This was despite the fact that the individual was part of a board which had changed the fund manager shortly before this recommendation was made. Changing manager is commonly considered the act of a board with a very independent character. It seems likely that the recommendation by the governance research agency was the result of a mechanistic adherence to a time limit as an indicator of independence rather than an informed decision based on considered engagement.

It is also not uncommon for our members to raise queries with agencies over factual errors in governance reports and/or being provided with very little time (sometimes a matter of hours) to comment on a proposed report.

These issues could be resolved with better quality processes and engagement between agencies and the investment company sector. The AIC therefore welcomes the opportunity to comment on the proposed Best Practice Principles for Governance Research Providers as a means to stimulate a more effective engagement process.

Best practice in corporate governance

Corporate governance can facilitate a continuing process of dialogue which delivers mutual understanding between investors and the investee company. It can encourage more robust questioning of the assumptions which drive commercial decisions and, in turn, enhance the quality of choices made.

For institutional investors with large and diversified portfolios the sheer volume of resolutions upon which they could be expected to vote makes engagement a potentially costly and time consuming activity. Increasingly they are outsourcing this activity to help them discharge their responsibilities in a cost-effective way.

Given the important (and increasing) role that governance research agencies play, it is vital that a clear view of “best practice” is developed. Ill-considered or poor quality assessments of governance issues by agencies risks raising unnecessary concerns amongst investors and attracting unhelpful media attention. This could potentially lead to shareholders voting unjustifiably against legitimate arrangements which deviate from standard practice. This is not an acceptable outcome from a governance, stewardship or accountability perspective.

The AIC **recommends** that best practice principles should aim to deliver the highest quality stewardship through fostering high quality, engagement, accountability and transparency across the governance research industry. These best practice principles should recognise the importance of engagement and that governance arrangements may not be “one size fits all”

The proposals of The Best Practice Principles for Governance Research Providers Group (BPP group)

The decision to develop principles based upon a comply or explain model is welcome. This will allow governance agencies to adopt, and justify, an alternative approach where they conclude this creates a more appropriate outcome for their clients.

The AIC **agrees** with the three headline principles (Service Quality, Conflict of Interest Management and Communications Policy) identified by the BPP group as the key areas in which best practice principles need to be established.

However, the AIC is concerned that the guidance for each principle focusses too much on the disclosure of the policies applied by governance research agencies and not their content. Transparency will not deliver improvements to the practices of governance research agencies unless there are some basic expectations about the underlying practices that should be adopted.

The AIC **recommends** that the BPP group should more clearly set out specific best practice regarding how government research agencies produce reports and voting recommendations and how they engage with issuers which agencies should comply with (or explain where their approach differs).

Principle 1: Service quality

Research policy

The policies applied by governance research agencies to assess a company should support better governance outcomes. For example, it cannot be considered best practice if an agency does not consider local conditions and customs as part of its research process. If an agency automatically considers any deviance by a company

from their corporate governance code as unacceptable, then this constrains the effectiveness of standards based on a comply or explain approach.

The AIC **recommends** that a best practice research policy should include, but not be limited to:

- fully considering local conditions and customs, including recognising corporate reporting against best practice standards on a comply or explain basis;
- allocating sufficient resources to ensure that a qualitative, rather than mechanistic, assessment is made of a company's governance arrangements;
- ensuring that research is independent and free from inappropriate bias or undue influence;
- having systems and controls in place to ensure the reliability of the use of information in the research process, and the limitations thereof; and
- disclosing the average amount of time spent analysing each company, including reviewing the annual report and accounts. Time spent might vary between sectors. The policy should also disclose if there are factors which differentiate between companies, for example a distinction could be made between large (e.g. FTSE 100) and other companies.

Voting guidelines

The AIC **recommends** that the best practice principles state that signatories should incorporate feedback from clients and issuers into the voting guidelines development process.

The AIC **recommends** that the best practice principles state that signatories should publically disclose voting guidelines on their company website and make them freely available to issuers.

Research methodologies

The AIC **recommends** that the best practice principles state that signatories should make their research methodologies available to issuers for free upon request.

Quality of research

The AIC **recommends** that the principles state that verification and double-checking of the quality of research and voting recommendations is considered to be best practice regardless of the agencies size or any other factor.

Employee qualification and training

The AIC **recommends** that the best practice principles state that governance research agency employees should have appropriate skills for the work they are performing. Clearly there will be some activities that require less experienced staff, but there would be obvious benefits if the actual analysis and final recommendations are the responsibility of individuals with sufficient experience.

The AIC **recommends** that it should be considered best practice for employees of signatories to be trained on the relevance and importance of their activities and how they contribute to service delivery.

Timeliness

Use of the most up-to date information is essential for delivering effective governance outcomes. The AIC **recommends** that the best practice principles state that signatories should use the most up-to-date information available and publish details of their systems for how they seek to achieve this.

Complaints and Feedback Management

The AIC supports the principle that signatories should have and disclose their policies for managing and responding to complaints, comments or feedback about their services.

The AIC **recommends** that the best practice principles state that signatories should have procedures for receiving representations and publish contact details where queries can be directed.

The AIC **recommends** that the best practice principles state that signatories should publish regularly updated information detailing how many complaints have been made by issuers each year regarding:

- factual inaccuracies;
- a lack of engagement by the signatory; and
- short (or no) notice given of recommendations to abstain or vote against resolutions.

Agencies should be required as best practice to disclose how many of these complaints resulted in amendments to reports or other actions being taken.

Principle 2: Conflicts of interest management

The AIC **supports** the approach the BPP group has taken to establishing best practice principles for managing conflicts of interest.

Principle 3: Communications policy

Engagement with issuers is most effective when it enables an ongoing relationship between shareholders and boards. This can help build trust and understanding and enable shareholders to make informed decisions and properly hold the management of the company to account. It should also help shareholders assess when a company's explanation of a deviation from corporate governance best practice is appropriate by allowing issuers to explain these arrangements.

Engagement with issuers should therefore be considered to be one of the most important activities a governance research agency can undertake as part of the service it offers to its clients.

The BPP group's guidelines state that *"it is for signatories to choose whether or not to engage in dialogue"* with issuers and that best practice should be to disclose this policy. This approach cannot be considered to promote best practice as it is clear that engagement with issuers is likely to deliver far better governance outcomes.

The AIC therefore **recommends** that the guidelines should make clear that the best practice principles for governance agencies include signatories:

- being open to dialogue with companies throughout the year, not just during the general meetings season, to discuss governance issues;
- providing companies with a draft report on voting recommendations in advance of the relevant meeting free of charge; and
- giving companies a reasonable timeframe to respond to proposed voting recommendations and disclose the reason for such recommendations before submitting them to clients.

For all best practice policies described above, and those already proposed by the BPP group, the comply or explain model would require signatories to explain why they have chosen to deviate from best practice if they do so. This will enable best practice to be spread in a proportionate and non-regulatory way.

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