



The Association of Investment Companies

Corporate Governance Update

August 2008

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Background

There have been a number of recent developments in the area of corporate governance regulation and guidance. In order to assist AIC Members in keeping up to date with the changes and in meeting their corporate governance obligations, the AIC has produced the following summary.

This summary covers the new version of the Combined Code. Disclosure against the Combined Code (as required by Listing Rule 9.8.6) is only mandatory for listed companies which are incorporated in the UK. However, in practice offshore investment companies may choose to follow the Combined Code, especially in light of the approach taken by UK voting agencies.

This summary also covers the new FSA Corporate Governance Rules which are only applicable to UK incorporated investment companies.

Combined Code issues

An updated version of the Combined Code on Corporate Governance has been published by the Financial Reporting Council. The new version follows a review of the impact and effectiveness of the Code last year and can be found at [http://www.frc.org.uk/images/uploaded/documents/Combined%20Code%20Web%20Optimized%20June%202008\(2\).pdf](http://www.frc.org.uk/images/uploaded/documents/Combined%20Code%20Web%20Optimized%20June%202008(2).pdf)

The key points to note are as follows:

- The most significant change is a revised preamble which sets out more clearly the purpose, context and application of the Code. The last version referred to investment companies and explained that some of the provisions of the Code may not be so relevant to them because of their unique board structure. The revised edition enhances this reference. The preamble now says that the AIC Code of Corporate Governance and its accompanying guide can be used to assist boards in meeting their Listing Rules obligations in relation to the Combined Code. More information on reporting against the AIC Code can be found in the code itself which is on the AIC's website at <http://www.theaic.co.uk/files/technical/AICCode.pdf>
- Requirements for reporting against the Combined Code have also changed. Listing Rule 9.8.6(5) now only requires a company to report on how it has applied the 'main principles' set out in Section 1 of the Combined Code, as opposed to reporting against all the elements of the supporting principles as well. There is no real benefit to shareholders if a company reproduces the list of principles in its governance report and therefore the preamble states that it should be sufficient to simply report that it has applied the main principles by complying with the associated provisions. However, extra narrative is encouraged where the board has taken additional steps to apply the principles or otherwise to improve its governance.

- Listing Rule 9.8.6(6) requires a company to state whether it has complied with the provisions set out in Section 1 of the Combined Code and provide reasons where it has not. Where a company chooses not to comply, the revised preamble of the Combined Code now obliges the board to give shareholders a “*careful and clear explanation*” which aims to “*illustrate how its practices are consistent with the principle to which the particular provision relates and contribute to good governance*”. Therefore, where a board decides not to comply with a particular provision, it will need to review the explanation in its corporate governance statement to ensure that this objective is achieved.
- Overall the FRC is trying to discourage boilerplate statements and the revised preamble emphasises that the Combined Code is not a rigid set of rules and that disclosures should give shareholders “*a clear and comprehensive picture of a company’s governance arrangements*”. Boards may wish to review the content of their corporate governance report to see if there is any scope for providing more specific information which more closely reflects the particular circumstances of the company and the practices of the board.
- The Code’s revised preamble also places more emphasis on the need for improved engagement on governance issues by shareholders (or their agents) with the board, particularly where a company has departed from the Code. Shareholders are encouraged to evaluate carefully the explanations given by boards and to discuss their views, rather than automatically treating departures as a ‘breach’. This amendment may be particularly helpful where third party governance agencies are involved.
- The 2008 Combined Code also contains two changes to the detailed provisions:
 - The Code now allows an individual to chair more than one FTSE 100 company.
 - The Code gives more flexibility to smaller listed companies (i.e. those outside the FTSE 350) and allows the company chairman to sit on, but not chair, the audit committee providing he or she was considered independent on appointment.

The new edition of the Code applies to accounting periods beginning on or after 29 June 2008. The next review is scheduled to take place in 2010.

FSA Corporate Governance Rules

The FSA has recently issued its own Corporate Governance Rules following the implementation of the 8th Company Law Directive. These rules have been introduced into the Disclosure and Transparency Rules in the form of two new chapters, DTR 1B and DTR 7, which effectively copy out the European legislation. They are effective for accounting periods beginning on or after 29 June 2008 (the same as the 2008 Combined Code). They can be accessed at <http://fsahandbook.info/FSA/html/handbook/DTR>

The new FSA Corporate Governance Rules cover audit committees and corporate governance statements, and include the following requirements.

Audit committees (DTR 7.1.1 to DTR 7.1.5)

- A company must have a body which is responsible for:
 - monitoring the financial reporting process
 - monitoring the effectiveness of the internal control, internal audit and risk management systems
 - monitoring the statutory audit
 - reviewing and monitoring the independence of the external auditor and in particular the provision of additional services to the company.
- At least one member of that body must be independent and at least one member must have competence in accounting and/or auditing. These requirements can be met by the same or different members.
- The company must make a public statement disclosing which body carries out these functions and how it is composed. This disclosure may be made in the corporate governance report.
- Any decision to appoint a statutory auditor must be based on a recommendation made by this body.

It is expected that in the vast majority of cases the audit committee already carries out these functions, and that it will already operate in a way which meets these FSA requirements.

DTR 7.1.7 says that, in the FSA's view, compliance with provisions A.1.2, C.3.1, C.3.2 and C.3.3 of the Combined Code will result in compliance with DTR 7.1.1 to DTR 7.1.5.

Corporate governance statement

- A corporate governance statement must be included either as a specific section in the directors' report, in a separate report published together with and in the same manner as the annual report, or on the company's website in which case there must be a cross-reference in the directors' report (DTR 7.2.1 and 7.2.9).
- The corporate governance report must include a reference to:
 - the corporate governance code to which the company is subject (for UK listed companies this would be the Combined Code), and/or
 - the corporate governance code which the company voluntarily applies (for investment companies this may be the AIC Code of Corporate Governance) and/or

- all relevant information about the corporate governance practices applied beyond the requirements of national law (DTR 7.2.2).
- The directors' report must state where the relevant corporate governance code is publicly available (for the AIC Code this will be the AIC's website at www.theaic.co.uk) and the extent of any departures from that code, explaining the areas of departure and the reasons for doing so (DTR 7.2.3).

DTR 7.2.4 says that a listed company which complies with Listing Rule 9.8.6(6) (the comply or explain rule in relation to the Combined Code) will satisfy the requirements of DTR 7.2.2 and 7.2.3.

- The corporate governance statement must contain a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process (DTR 7.2.5).
- The corporate governance statement must contain a description of the composition and operation of the company's administrative, management and supervisory bodies and their committees (DTR 7.2.7).

DTR 7.2.8 says that, in the FSA's view, the information specified in provisions A.1.1, A.1.2, A.4.6, B.2.1 and C.3.3 of the Combined Code will satisfy the requirements of DTR 7.2.7.

As explained above, DTR 7.1.7 and 7.2.8 refer to certain provisions of the Combined Code in relation to meeting the DTR requirements. **However, it should be noted that if a company chooses to 'explain' rather than 'comply' with the Combined Code, it still needs to demonstrate that it meets the full requirements of the DTR.**

It is also worth highlighting that DTR 7.2.5, which requires the corporate governance report to include a description of the main features of its internal control and risk management systems in relation to the financial reporting process, is different to the Combined Code provision which requires the board to report that a review of the effectiveness of the internal control system has been carried out.

Companies will therefore need to ensure that they comply with DTR 7.2.5 in addition to the Combined Code provisions. In practice many boards may find that they are already meeting DTR 7.2.5 by providing information on areas such as risk management processes and the duties of the audit committee. However, boards should review their corporate governance reports to ensure that they are satisfied that sufficient information is provided to meet the DTR requirements.

Companies may choose to amalgamate their Combined Code and DTR disclosures in this area into a single internal control statement.

Companies should be aware that DTR 7.2.6 requires the inclusion of certain information contained in Schedule 7 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 in the corporate governance report. This information may currently be set out elsewhere in the annual report and it may be necessary to review the layout of the disclosures.

Finally it is worth emphasising that the requirements of the DTR are mandatory, and do not have the flexibility provided by the 'comply or explain' approach of the Combined Code. **It is therefore recommended that companies review their compliance with the new FSA Corporate Governance Rules first and foremost, before considering the provisions of the Combined Code, or the AIC Code of Corporate Governance** where the board has elected to follow the AIC Code as a means of meeting its obligations in relation to the Combined Code.

AIC Code of Corporate Governance and AIC Corporate Governance Guide

Given the above changes to the Combined Code and the introduction of the FSA's Corporate Governance Rules, the AIC is currently carrying out a review of its own Code of Corporate Governance and associated guide. Further information on this will be available in due course.



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