NAPF

Securing the future of pensions

Corporate Governance Policy and Voting Guidelines for Investment Companies

April 2010

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Introduction

The UK Listing Authority requires all listed companies (other than those listed under Chapter 14) to describe how they have complied with the principles of the Combined Code on Corporate Governance published in June 2003 and last revised in June 2008. The Association of Investment Companies (AIC) also published a Code (AIC Code) in July 2003. The AIC Code, which was last updated in March 2009, forms a comprehensive guide to best practice in certain areas of governance where the specific characteristics of investment companies suggest alternative approaches may be preferable to those set out in the Combined Code. The intention behind the AIC Code is to provide Investment companies with a one-stop approach to general corporate governance, which deals with matters such as board independence and enables boards to satisfy their responsibilities under the Combined Code.

The NAPF Investment Companies policy is based on its ‘Statement of Underlying Principles’ and ‘Additional Issues’, which together with guidance from the Combined Code and the AIC Code, set the framework for the NAPF’s detailed policies and voting guidelines.

The Policy has been developed in cooperation with the Association of Investment Companies. It will be reviewed and updated periodically, as practice evolves among investment companies and their shareholders.

NAPF Investment Council
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AIC Code

(The NAPF Guidelines are based on the underlying provisions of the AIC Code which should apply as guidance to all UK-quoted investment companies).

- The chairman should be independent.
- The majority of the board should be independent of the investment manager.
- Directors should be elected for a fixed term of no more than three years. Nomination for re-election should not be assumed but be based on disclosed procedures.
- The board should have a policy on tenure, which is disclosed in the report.
- There should be full disclosure of information about the board.
- The board should aim to have a balance of skills, experience, ages and length of service.
- The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- Director remuneration should reflect their duties, responsibilities and the value of their time spent.
- The independent directors should take the lead in the appointment of new directors and the process should be disclosed in the annual report.
- Directors should be offered relevant training and induction.
- The chairman (and the board) should be brought into the process of structuring a new launch at an early stage.

NAPF Guidelines

(A) An Effective Chairman

The Combined Code emphasises the importance of the Chairman being independent on appointment. The application of the NAPF's policy may lead to a voting recommendation against the re-election of a chairman who on appointment does not meet the independence criteria set out below:

The AIC Code recommends that:

- The chairman should have no relationships that may create a conflict of interest between the chairman's interest and those of shareholders.
- No employee of the manager or executive of a self-managed company or ex-employee who has left the employment of the manager or the executive team of a self-managed company within the last five years should serve as chairman. Nor should a professional adviser to the manager or to the board of a company to which he/she provided services within the last three years serve as chairman. The chairman should not serve on any other boards of an investment company managed by the same manager.
- The other independent directors should discuss the performance and continuing independence of the chairman on an annual basis and one of them should be deputed to speak to the chairman about their discussion.

NAPF Policy

The NAPF supports the AIC policy. The Board Chairman is allowed to sit on all Committees (nomination, audit, management engagement and remuneration), provided he/she is considered independent.

(B) Board Balance

The Combined Code states that as a proportion, at least half the Board excluding the Chairman should comprise independent non-executive directors. Boards, which currently do not meet such requirements, are strongly recommended by the NAPF (i) to adopt compliant policies on Board composition and (ii) to establish plans and a timetable to achieve the required Board size, balance and structure as soon as possible.

The AIC Code recommends that:

- An independent majority is required for a UK listing and is best practice for other AIC Member companies.
- No more than one current or recent (i.e. in the manager's employment within the last five years) employee of or professional adviser to the manager should serve on a board and any such directors should offer themselves for re-election annually.
- In the case of a self-managed company, a majority of the board should be independent of the executive management but there is no restriction on the number of current or recent employees (i.e. in the manager's employment within the last five years) who may serve as directors.
- The board should state their reasons if they consider a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including:
    - Has, or had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
    - Has received or receives additional remuneration from the company apart from a director's fee;
    - Has close family ties with any of the company's advisers or directors;

- Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- Represents a significant shareholder;
- Holds a directorship in one or more other investment companies managed by the same manager;

And additionally in respect of self-managed investment companies:

- Has been an employee of the company or group within the last five years;
- Participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- Has close family ties with any of the company's senior employees.

The board should aim to have a balance of skills, experience, ages and length of service. A board can bring to bear appropriate expertise to as many of the issues that it may face as possible. It will also be best placed to refresh itself in an orderly manner over time. Boards should indicate in the annual report any gaps that they have identified and, if so, how they intend to improve their balance over time.

The AIC Code also emphasises the advantages in the concept of nominating a Deputy Chairman (who would fulfil the role of senior independent director – SID) or a SID in common with other companies. Alternatively, it may be appropriate for the chairman of the audit committee to fulfil the role. First, the Deputy Chairman or SID can take the lead in the annual evaluation of the chairman and secondly, he/she can act as a channel of communication where shareholders have a problem with the chairman.

NAPF Policy

The NAPF Policy should not deviate from the provisions listed under the AIC Code. The principal guidelines of the policy are based on the evaluation of independence using the criteria set out in the AIC Code. The issue of board size should have no impact on the disclosure of such information.

If a Board does not comply with the requirement of having a majority of directors independent of the manager and fails to provide an explanation/robust justification in the annual report, application of the NAPF Policy would normally result in a recommendation to vote against a non-independent director who is standing for re-election. Alternatively, the Board Chairman's re-election may be targeted as he/she is deemed to be responsible for the Board's overall corporate governance practices.

(B.1) Policy on Tenure

The Combined Code states that a director may not be considered independent if he/she has served on the Board for more than nine years from the date of their first election.

The AIC, however, does not believe that long service will necessarily compromise independence and states that there is no evidence that this is the case for investment companies. It therefore does not recommend that long-serving directors be prevented from forming part of an independent majority. However, it notes that where a director has served for more than nine years, the board should state in the annual report, its reasons for believing that the individual remains independent.

It is the AIC's intention that the preamble to the Combined Code and the AIC's recommendations on tenure and balance will give boards confidence in explaining why a director is viewed as independent, notwithstanding service which may be considerably more than nine years.

NAPF Policy

The NAPF Policy should adhere to current best practice to ensure independent balance on the board and that the company provides a good level of disclosure.

Each board should disclose its policy on directors' tenure. Evidence of a succession planning policy and a robust board evaluation process can be important in assessing a director's independence, particularly when he/she has served for more than nine years.

Given the importance of having an independent board, the board should consider whether a long serving director should be subject to annual re-election. NAPF Policy on this issue will not normally lead to a recommendation to vote against the re-election of a director who is considered non-independent if the balance of the Board or the composition of the Board's Committees are in accordance with the guidelines.

(C) Audit Committee and Auditors

The Combined Code requires that:

- The board should establish an audit committee of at least three, or in the case of companies below the FTSE 350 two, members, who should all be independent non-executive directors. For companies below the FTSE 350, the Chairman may be a member of the Committee, providing that he/she is independent apart from his/her being chairman. The board should satisfy itself that at least one member of the committee has recent and relevant financial experience.

The AIC Code supports this provision but also notes the recommendation that the board should disclose in the annual report what arrangements it has made for an audit committee. If the board has decided that the entire board should fulfil the role of the audit committee, it will need to explain why it has done so (i.e. a board might considers its size to be such that it would be unnecessarily burdensome to establish a separate audit committee).

<u>NAPF Policy</u>

The NAPF Policy supports the principles above and, the application of the policy will normally lead to a voting recommendation against the re-election of any non-independent non-executive director who is a member of the audit committee (whether organised as a separate committee or not).

(D) Management Engagement Committee and Manager Evaluation

AIC principles dealing with the relationship between a board and the manager are:

- Boards and managers should operate in a supportive, co-operative and open environment.
- The board should regularly review both the performance of, and contractual arrangements with, the manager (or executives of a self-managed company).

The AIC Code recommends that management engagement committees should be established, consisting solely of directors independent of the manager or executives of self-managed companies, which should review the manager's performance and contractual arrangements annually and for any resulting decisions to be disclosed in the annual report.

NAPF Policy

The NAPF Policy supports the principles above. Application of the Policy will normally lead to a voting recommendation against the re-election of any non-independent non-executive director who is a member of the management engagement committee (whether organised as a separate committee or not).

(E) Remuneration Committee and Directors' Remuneration

The Combined Code requires that:

- The board should establish a remuneration committee of at least three members, or two in the case of companies below the FTSE 350, who should all be independent non-executive directors. The Chairman may be a member of the Committee, providing that he/she is independent apart from his/her being chairman.

- The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, a statement should be made available of whether they have any other connection with the company.

The AIC Code supports this provision but also notes the recommendation that the board should disclose in the annual report what arrangements it has made for a remuneration committee. If the board has decided that the entire board should fulfil the role of the remuneration committee, it will need to explain why it has done so (i.e. a board might consider its size to be such that it would be unnecessarily burdensome to establish a separate remuneration committee).

In addition to this, the AIC Code notes that the role and responsibilities of the remuneration committee should be:

- in conjunction with the chairman, to set the directors' remuneration levels;
- to judge where to position the company relative to other companies; and
- to consider the need to appoint external remuneration consultants.

NAPF Policy

The NAPF Policy supports the principles above and the application of the policy will normally lead to a voting recommendation against the re-election of any non-independent non-executive director who compromises the independent balance (majority independent), of the remuneration committee (whether organised as a separate committee or not).

(E.1) Directors' Remuneration

Investment Company directors are usually appointed under a letter of appointment and they are not entitled to compensation for loss of office upon termination. Directors are entitled to fees only, determined within the limits set out in the Company's articles of association. Investment Companies do not normally operate annual bonus plans, long-term incentive plans or pension schemes. However, in the rare cases where a Company has Executive Directors or provides remuneration in a similar manner to a company that has Executive Directors, the remuneration report should be reviewed in light of best practice for 'normal' PLCs.

The AIC Code recommends that:

- Directors' remuneration should reflect their duties, responsibilities and the value of their time spent.

There should be a formal and transparent procedure for developing policy for fixing the remuneration of individual directors. No director should be involved in deciding his/her own remuneration.

The ownership of shares by directors is strongly encouraged. There are advantages for directors of companies that have more than one class of share in holding the shares on a pro rata basis. There is support for directors to be paid or part-paid in shares, but not for them to be awarded in a performance-related form (e.g. share options or performance shares).

NAPF Policy

The level of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. We note that remuneration for non-executive directors should not be in a performance-related form (e.g. share options or performance shares) and if options are granted, the application of the policy will normally lead to a voting recommendation against the remuneration report.

(F) Appointments to the Board

The Combined Code requires that a nomination committee should be established to make recommendations to the board on new board appointments.

There are five provisions relating to the process and considerations that should be made by the nominations committee. However, a key requirement is that the nomination committees should be made up of a majority of independent non-executive directors.

AIC principles dealing with the appointment of directors to investment company boards are:

- The independent directors should take the lead in the appointment of new directors and the process should be disclosed in the annual report.
- Either the whole board, excluding any directors who are connected to the manager, should together nominate candidates for the board, or the board should establish a nomination committee of independent directors. If the whole board nominates candidates, it should explain in the annual report why it has done so rather than establish a separate nomination committee. In either case, only the independent directors should vote on candidates for the appointment of new independent directors.

NAPF Policy

One of the key requirements in the Combined Code is that the nomination committee should be made up of a majority of independent non-executives. However, where compliance is not achieved due to an insufficient number of independent directors, we would consider that the Committee Chairman could be regarded as independent for this purpose provided chairmanship is the only cause of his not being independent. Ultimately, a company should demonstrate its intentions to ensure that the members of the committee remain independent and that the committee adopts transparent procedures.

(G) Issuance of Shares from Treasury

The NAPF recognises that the ability to issue shares from treasury can be a useful aid for investment companies in managing the supply and demand for shares in the market and that this can be beneficial for shareholders. However, the issuance of shares at a discount to net asset value is dilutive and therefore any powers taken by the company should be used sparingly and in the interests of all shareholders. Boards are advised to apply the Pre-emption Principles which were published by the Pre-emption Group in 2006; key among which are the need to consult with shareholders in advance of any issue and to explain why such an issue is in shareholders' best interests.

Where a company has passed this first test, we would expect it to limit the dilution associated with the reissue of treasury shares at a discount to a maximum of 0.5% of net asset value in any year. For example, using the simple equation P X D = 0.005 where P is the percentage of the equity being issued in the year and D is the discount, if a company uses the full 10% authority in a year, the maximum discount that they could sell stock at would be 5% (as 0.1 X 0.05 = 0.005). However, if less than 10% of the equity is issued in a year, the re-issuance could be at a much higher discount. The authority should be renewed annually.

NAPF Policy

The application of NAPF Policy will normally lead to a voting recommendation against the issuance of shares without pre-emption rights if the authority requested is in excess of 5% of the company's current issued capital and the shares may be issued at a discount to net asset value. Issuance up to 10% of current issued capital may be permitted when the shares are to be issued at a premium to net asset value or the company has explained fully its reasons for seeking authority to issue more than 5% of its current issued share capital at a discount.

(H) Share Repurchases

On 1 December 2003, regulations came into force that enable companies traded on the London Stock Exchange to purchase their own shares and, instead of cancelling such shares immediately, as was previously required, to hold them in treasury for subsequent resale or cancellation.

NAPF Policy

A company may hold treasury shares provided the holding is restricted to 10% of the Company's issued share capital. When shares are held by the Company in treasury, all voting rights are suspended and no distribution is permitted (either by way of dividend or on a winding-up).

We expect that any shares bought back under the buy-back facility will normally be held in treasury until the 10% limit is reached or they are re-sold. If the Directors believe that there is no likelihood of re-selling shares held in treasury, we expect the holding of treasury shares to be cancelled after 12 months. Failure to comply with this may lead to a recommendation to vote against the market repurchase authority.

(I) Disclosure of Corporate Governance Information

The NAPF Investment Company policy expects a company to disclose its corporate governance policies, including biographical details and other directorships of its directors and details of board committees.

NAPF Policy

Failure to provide transparent information with regard to the identity of directors, including their biographical details, or the governance structure adopted by a particular company, may lead to a recommendation to vote against the annual report and accounts and/or against the director in question. Continuous poor corporate governance practices may lead to a vote recommendation against the re-election of the Board Chairman who is deemed ultimately responsible for a company's corporate governance structures.