NAPF

Securing the future of pensions

Corporate Governance Policy and Voting Guidelines for Investment Companies

November 2012

www.napf.co.uk

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Introduction

At the NAPF we firmly believe that high standards of corporate governance make an important contribution to a company's long-term performance.

The UK Listing Authority requires all premium listed companies to describe how they have complied with the principles of the UK Corporate Governance Code (the "Code") which was last updated by the FRC in October 2012. In addition, the Association of Investment Companies (AIC) have a Code of Corporate Governance (the "AIC Code"); this AIC Code 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 Code. The purpose of the AIC Code is to provide boards with a framework of best practice in respect of the governance of investment companies. The AIC Code addresses the governance issues relevant to investment companies and enables boards to satisfy any requirements they may have under the Code.

The NAPF Corporate Governance Policy and Voting Guidelines ("NAPF IC Policy") for Investment Companies is based on the Code while utilising the AIC Code to set a framework for investment companies which is consistent with the expectations of long term institutional investors such as pension funds. .

NAPF Investment Council
November 2012

AIC Code

The key principles of the AIC Code, which should apply as guidance to all UK-listed investment companies, are as follows:

1. The chairman should be independent.
2. A majority of the board should be independent of the manager.
3. Directors should be submitted for re-election at regular intervals. Nomination for re-election should not be assumed but be based on disclosed procedures and continued satisfactory performance.
4. The board should have a policy on tenure, which is disclosed in the annual report.
5. There should be full disclosure of information about the board.
6. The board should aim to have a balance of skills, experience, length of service and knowledge of the company.
7. The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
8. Director remuneration should reflect their duties, responsibilities and the value of their time spent.
9. The independent directors should take the lead in the appointment of new directors and the process should be disclosed in the annual report.
10. Directors should be offered relevant training and induction.
11. The chairman (and the board) should be brought into the process of structuring a new launch at an early stage.

Also

12. The board should ensure that shareholders are provided with sufficient information for them to understand the risk:reward balance to which they are exposed by holding the shares.

NAPF IC Policy

(A) An Effective Chairman

The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role. The Code rightly 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 election/re-election of a chairman who on appointment does not meet the independence criteria set out below:

The chairman should have no relationships that may create a conflict of interest between the chairman's interest and those of shareholders. The AIC Code states that the Chairman should not be:

- an employee of the manager or an ex-employee who has left the employment of the manager within the last five years;
- an executive of a self-managed company or an ex-employee who has left the executive team of a self-managed company within the last five years; or
- a professional adviser who has provided services to the manager or the board within the last three years.

NAPF IC Policy

The NAPF supports the AIC recommendations as above. The chairman may sit on all Committees (nomination, audit, management engagement and remuneration), provided he/she is considered independent.

(B) Board Balance

The Code states that 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 and ensure that this is communicated to shareholders.

The AIC Code states that:

- An independent majority is required for a UK listing and is best practice for other AIC Member companies.
- Some shareholders may also expect that 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. The board may wish to consider whether any such directors should offer themselves for re-election annually (if they do not do so already).
- 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 its reasons if it considers a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- 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 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 and length of service and directors should also consider the diversity of the board, including gender. A board can bring to bear appropriate expertise to as many of the issues that it may face as possible.

The board should also satisfy itself that plans are in place for orderly succession for appointments to the board, so as to maintain an appropriate diversity, balance of skills and experience on the board and to ensure progressive refreshing of the board.

The AIC Code also emphasises the advantages in the concept of nominating a deputy chairman 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 IC Policy

The principal guidelines of the NAPF IC 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 a robust justification in the annual report, application of the NAPF IC 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.

Absence of a disclosed succession policy or an evaluation process may lead to shareholders abstaining on or opposing the re-election of the chairman of the nominations committee or, where appropriate, the chairman.

Open Ended Investment Companies

Open-Ended Investment Companies (OEICs) should also seek to adhere to the highest standards of corporate governance, however, we recognise that some provisions are less relevant to their circumstances. As such the NAPF would consider it appropriate for the Board of an OEIC to include a third of NEDs who are considered independent of the Company in that they are independent of the Investment Manager and other third party service providers such as the Administrator and Custodian.

In addition, for OEICs where multiple investment companies exist as part of the same product range it would be unduly costly and burdensome to have separate board of Directors for each company, as such in these instances, the issue of cross-directorships is not material to a directors' independence.

This balance is also deemed sufficient for all Board Committees at OEICs.

In cases where the board of an OEIC does not consist of at least a third independent directors, NAPF IC Policy would warrant a vote against the re-election of a director unless clear timelines are in place to address the issue.

(B.1) Policy on Tenure

The 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.

NAPF IC Policy

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.

In the absence of a convincing explanation of continued independence investors may choose to vote against the re-election of a director.

(C) Audit Committee and Auditors

The AIC Code supports the provisions of the Code 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). The board of a FTSE 350 company should also provide an explanation of why it believes it is appropriate for the company chairman to be a member of the audit committee if this is the case.

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NAPF IC Policy

The NAPF supports the principles above and the application of the IC 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

The 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 IC Policy

The NAPF supports the principles above. Application of the IC 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 AIC Code supports the provisions of the Code but also recommends 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 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 IC Policy

The NAPF supports the principles above and the application of the IC 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 whereby shareholders should be invited specifically to approve all new long-term incentive schemes and to consult with shareholders on remuneration plans more widely.

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, in the usual case, for them to be awarded in a performance-related form (e.g. share options or performance shares).

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

- Either the whole board 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.

- The company chairman or an independent non-executive director should chair the nomination committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship.

NAPF IC Policy
One of the key requirements in the 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 - hwww.pre-emptiongroup.org.uk ; 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 IC Policy

The application of NAPF IC 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 IC 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 IC Policy requires a company to disclose its corporate governance policies, including biographical details and other directorships of its directors and details of board committees.

NAPF IC 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.