Creating effective best practice principles for proxy voting agencies

Briefing from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the review by the Best Practice Principles Group for Shareholder Voting Research and Analysis (BPP Group) of its Best Practice Principles (BPP).

The AIC represents closed-ended investment funds whose shares are traded on public markets (usually the main market of the London Stock Exchange). Our members include UK investment trusts, Venture Capital Trusts, UK REITs and non-EU companies. We represent over 340 investment companies with assets under management of over £150 billion.

Unique features of investment companies

Investment companies prioritise effective corporate governance and constructive shareholder engagement. Our members with a premium listing on the main market of the London Stock Exchange are required to report against the *UK Corporate Governance Code* (the UK Code).

Investment companies have special factors which have an impact on their governance arrangements. These arise principally from two features. Firstly, investment companies often have no executive directors as they outsource the day-to-day activities of the company to external suppliers. This means that many are governed by boards made up entirely of non-executive directors. Secondly, where companies do outsource, the proper oversight of these relationships is a crucial aspect of achieving good corporate governance. For these reasons, good corporate governance practice within the investment company sector differs from other companies.

Due to the unique characteristics of our members, the AIC prepares '*The AIC's Code of Corporate Governance*' (the AIC Code). This sets out a framework of best practice in respect of the governance of investment companies. This has been endorsed by the UK Financial Reporting Council (FRC) as an alternative means for investment companies to report against the UK Code.

In practice, it is not just investment companies with a premium listing that report against this code, as many of our AIM and Specialist Funds Segment members see this model as setting out best practice for the sector.

Regulation of proxy advisers

Proxy advisers play an increasingly important role in corporate governance. However, they are unregulated and are not required to report against codes of best practice.

In contrast, issuers have substantial obligations under company law, the FCA's Listing Rules and its Disclosure Guidance and Transparency Rules, alongside reporting against the UK Code. Institutional investors have similar obligations. They may also sign up to and report against the UK Stewardship Code which aims to enhance the quality of engagement between investors and companies.

The AIC considers that proxy advisers are an increasingly important part of the governance environment. They should be held to appropriate standards to ensure their work is transparent, accurate and reliable. The AIC supports the provisions in Article 3(i) of the Shareholder Rights Directive. This would require proxy advisers to disclose certain information such as the methodologies they use, the policies and procedures they follow for voting and requiring them to manage conflicts of interest. The BPP can also assist in addressing these issues by setting specific best practice standards for proxy advisers to follow.

Terms of reference of the review

The AIC supports the terms of reference set out for the review. In particular, the AIC supports the assessment of the "*structure and content of the Principles*".

ESMA's report, 'Follow-up on the development of the best practice principles for providers of shareholder voting research and analysis' noted that there are "*specific concerns voiced by issuers in relation to how signatories operate regarding engagement with issuers"*. ESMA also stated "*it is up to the BPPG*" to consider whether this could be "*addressed in future updates of the BPP*".

The AIC **recommends** the review addresses the concerns identified by ESMA and reviews the content of the BPP regarding communication and engagement with issuers. The best practice principles should set a series of best practices that proxy agencies should be encouraged to adhere to in relation to communication and engagement with issuers.

Communication and engagement

Principle 3 in the BPP focuses on commercial relationships between the proxy agency and its clients. There are no principles setting out best practice in the relationship with issuers. The aim of proxy advisers is to inform their clients of governance arrangements and, through the application of governance policies, influence companies to achieve the best outcome for shareholders. Communication with the issuer is key to achieving these outcomes.

The AIC **recommends** the BPP are revised to establish best practice principles addressing the way in which proxy advisors communicate with issuers they report on. Specifically, the BPP should require proxy advisers to:

- spend sufficient time and devote sufficient resources to understand companies, particularly those with unusual or different market characteristics;
- engage with issuers on a timely basis, ensuring sufficient time to allow issuers to respond appropriately to any issues raised before reports are circulated to investors;
- commit, as a matter of best practice, to considering explanations provided by companies when proxy advisors have approached companies and passing these explanations on to clients;

- appropriately train their staff to ensure they have the expertise required to understand the companies they research and provide voting recommendations on;
- put in place procedures to prevent and detect factual inaccuracies in reports and amend their reports and voting recommendations where factual inaccuracies are identified;
- engage with issuers both during and outside of reporting season; and
- provider issuers with a point of contact to discuss any issues if they arise.

December 2017

To discuss the issues raised in this paper please contact:

Lisa Easton, Technical Manager
lisa.easton@theaic.co.uk 020 7282 5611