

Response of the Association of Investment Trust Companies (AITC)

6 September 2002

Review of the Role and Effectiveness of Non-Executive Directors

The Association of Investment Trust Companies (AITC) welcomes the opportunity to submit its views to this review of the role of non-executive directors. Non-executive directors arguably play a more significant part in the governance of investment trusts than other forms of listed companies - however, the role they play is crucially different. Above all, it is extremely important to recognise that most investment trusts have boards composed entirely of non-executive directors, although not all would be considered "independent" (an issue which is fully discussed in the response). This means that we have approached this review from a different perspective to other companies.

We have set out our responses to the specific questions raised in the Consultation Paper in the attached Appendices. Our general comments are set out below.

Background

The AITC is the trade association that represents the interests of investment trust companies. Investment trusts are public limited companies, listed on the London Stock Exchange, whose primary business is investing in a diversified portfolio of shares and securities of other companies. They are therefore one of the main forms of collective investment available in the UK, for both institutional and retail investment, along with authorised unit trusts (AUTs) and open-ended investment companies (OEICs). The AITC currently represents the interests of around 300 members and the industry as a whole has assets under management of approximately £60bn.

The AITC supports actions that will strengthen the standards of governance of the UK's corporate sector. This is particularly important to the AITC, as its members are both investors in companies and listed companies in their own right. However, for clarity, our response addresses governance issues in relation to

investment trusts as listed companies, not as investors in other companies.

Measures that ensure proper accountability of companies to their shareholders are entirely welcome. The ability of shareholders to delegate management of their assets, while still retaining overall control, is a key advantage of the corporate structure and it is right that the Government should be concerned to understand and promote best practice. The AITC believes that significant progress has been made in recent years in the field of corporate governance through the promulgation of voluntary codes of best practice, such as the Combined Code and the Turnbull Report.

Current Governance Structure

As the above indicates, investment trusts are a unique form of listed company in terms of the function they perform for shareholders. Unlike other companies, their customers and their shareholders are one and the same.

The function of all investment trusts is the management of an investment portfolio on a diversified basis for the benefit of their shareholders. It follows that fund management is the key area of business activity. Investment trusts carry out this function in one of two ways:

- some employ their own staff to do this (these are known as “self-managed” trusts); or
- they make use of external fund managers (“externally managed” trusts).

Self-managed trusts make up only a very small minority (approximately 5% by number) of the investment trust industry. For these companies, corporate governance issues, including the role of non-executive directors, are more in line with other listed companies. As many of the governance issues for investment trusts arise from the fact that the day-to-day management of the company has been subcontracted to a third party, we have focussed, unless otherwise indicated, on the issues that the Consultation Paper raises in respect of externally managed trusts.

Externally managed trusts are very different from other listed companies in terms of governance, in that they are

typically governed by boards entirely composed of non-executive directors. The day-to-day operation of the fund will usually be undertaken by the fund management group, which is employed to manage the fund's portfolio. Very often, the manager is also responsible for promoting the fund to prospective shareholders through various "wrapper" products, such as Savings and Investment Schemes, ISAs, Investment Trust Personal Pensions etc.

Regulation

Investment trusts' status as collective investment funds means that, in terms of competition, they do not compete with other listed companies in industrial and commercial sectors, but with AUTs/OEICs. It is therefore important to consider questions of governance in respect of investment trusts not only in terms of how it should apply to listed companies but also to consider them in relation to other forms of collective fund.

It is important to recognise that, although investment trusts are subject to a different regulatory regime to AUTs/OEICs, it is not an inferior regime. The AITC is very concerned by occasional comments it reads that investment trusts are "not regulated", which is highly misleading. What commentators are referring to is the fact that the corporate vehicle itself is not FSA regulated, unlike most other forms of collective fund. However, investment trusts are subject to company law, the Listing Rules (which are, of course, part of the FSA's regulatory responsibilities as the UK Listing Authority) and must also comply with conditions set out in tax law which relate, amongst other things, to diversification of investments and the annual distribution of income.

Indeed, this different regulatory regime offers distinct benefits to shareholders. As Companies Act companies, shareholders in investment trusts have a far stronger say in the running of the company than investors in other types of collective funds. In addition, the requirement for an independent board, as set out in the Listing Rules (which is not a requirement for other collective funds), also provides a layer of independent oversight, one where the duties of boards are not simply to observe the letter of specific regulatory rules - they must run the company in the best interests of shareholders at all times and are accountable to shareholders for their actions.

To give an example of how this difference in governance structure can manifest itself in practice to the benefit of investors, take the example of costs. This Government has tried to stimulate cost competition in the collective investment area but it is still the case that cost is a minor driver of purchase decisions. With investment trusts, it is very noticeable that trusts enjoy significantly lower costs as fund size increases compared to other comparable collective funds. In part, this is due to the fact that the board is under an ongoing obligation, as with all service providers, to ensure that the management fee structure represents value-for-money.

AITC Initiatives

Although the AITC has responded in detail to the questions raised in the Consultation Paper, it has already taken a number of steps to assist the boards of investment trusts in the performance of their duties, the first two of which are of direct relevance to the consultation:

- the production of *A Handbook for Directors of Investment Trusts* ("Handbook"), a reference work received by all directors of Member Companies. The Handbook aims to provide directors with information and assistance directly relevant to their work. We enclose a copy of the Handbook.
- in addition, the Higgs Review has coincided with a research project the AITC has undertaken over the last year in respect of updating boards on issues that arise in respect of the governance of investment trusts. We enclose the most recent draft of the *AITC Report into Attitudes Towards the Governance of Investment Trust Companies* ("Report"), but would stress that work on the document is ongoing and is intended as a review of attitudes of key parties to issues in the governance of the investment trust sector. After consultation with our members and other interested parties, we would anticipate that this work would lead to the publication of a best practice guide.
- it has an annual Conference for Directors, which is well attended, to update directors on developments in the investment trust sector. These forums have had a broad range of speakers

including directors, representatives of institutional shareholders, brokers and analysts, management groups and Independent Financial Advisers, to ensure that boards are aware of the views of all stakeholders in the sector and are kept up-to-date on key issues that affect their companies.

As both the Handbook and the Report cover many of the issues raised in the Consultation Paper, we have cross-referenced our detailed response to identify the most relevant passages. In addition to the above work, the AITC sends out ad hoc communications as and when issues come to light which we consider boards should be made aware of.

General Approach

In principle, the AITC supports voluntary approaches to governance rather than statutory measures. While there are some very fundamental issues related to governance (for example, the protection of minority shareholders and market integrity) which are properly governed by law, the value of this type of intervention is limited.

Not all issues related to corporate behaviour require a statutory response and many governance issues are not best dealt with through this route. Law is more suitable for enshrining minimum standards that are unlikely to change dramatically over time, whereas the corporate governance debate should be aimed at encouraging the highest possible standards. Statutory approaches to governance can also be problematic as they are unable to change as quickly as might be required. The fact that the current company law regime is having its first major overhaul in many years is an excellent illustration of this.

Also, if companies are increasingly subject to detailed and prescriptive rules which are insufficiently flexible to cater for the special circumstances of individual companies, this risks leading to a view that it is acceptable to contrive ways around such rules. In other words, the danger is that "best practice" becomes simply observing the letter of the law, not its spirit. We believe that some aspects of the corporate accounting scandals in the US reflect this.

As the Report indicates, there are some issues in relation to the governance of investment trusts for which

there are no clear-cut answers. On particular details, some highly experienced and knowledgeable commentators come to precisely opposite conclusions for perfectly valid reasons. Any legislative approach to such issues would have to decide who is "correct", although it may be that, in fact, there is no correct answer and that what is right for one company may not be right for the other, and vice versa.

In dealing with such contentious issues, what is important is that the boards of investment trusts are aware that such contentious issues exist, the views on both sides of the argument, and then to ensure that there is sufficient transparency of information so that shareholders can take an informed decision based on the particular circumstances of the company. We are aware that there are Government concerns that shareholders are not sufficiently active in the use of their shareholder powers and that there is ongoing work in this area, which the AITC is contributing to. It is therefore important to consider the position of governance in conjunction with the very considerable powers that shareholders have to influence, indeed control, the direction of their companies.

Split Capital Investment Trusts (Splits)

While investment trusts have had an excellent governance record, some issues have recently emerged relating to parts of the Splits sector (i.e. investment trusts with a limited life that issue more than one class of share capital). These were precipitated by a distinct set of circumstances, which did not affect all Splits. Non-split trusts, which make up a substantial majority of the investment trust sector, have also been largely unaffected.

The AITC is aware that the FSA intends to bring issues related to Splits to the attention of the Review Team. In the absence of specific details of the issues raised, this paper focuses on broad issues of governance that are of interest to the investment trust sector as a whole. We will, of course, be keen to respond to any specific issues raised in relation to Splits once the nature of these concerns have been made clear.

Conclusion

The AITC hopes this exploration of the specific issues that face non-executive directors of investment trusts is

helpful. Above all, we hope it has impressed upon the Review Team that not all listed companies are the same and that great care is required to ensure that any recommendations flowing from the review can cater for the significant differences that exist between investment trusts and other companies. In some cases, special provision for the unique position of investment trusts may be necessary, but we would hope that these could be kept to a minimum through a sufficiently flexible approach.

We would be pleased to meet with the Review Team if there are any points on which it requires more information or clarification. The AITC is particularly keen to respond to specific queries about the governance of Splits, which it understands may be of particular interest. In the meantime, if you have any queries on any aspect of this response, please do not hesitate to contact me or our Technical Director, Ian Sayers, on 020 7282 5612 or ian@aitc.co.uk.

With best wishes

Yours sincerely

Director General

What role should non-executive directors perform, and how does this compare to the present position?

What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive directors?

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What should be the key roles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?

The Role of the Board

In many ways, the whole of *A Handbook for Directors of Investment Trusts* ("Handbook" - a copy of which is enclosed) relates to the role of the Board. However, the role of directors as a group is dealt with specifically in Section 3, Chapter 2 (page 10 onwards) of the Handbook. In summary, the following were identified as key aspects of what shareholders expect from directors of investment trusts:

1. First and foremost, to represent and protect shareholders' interests.
2. To act as steward of the company and to monitor the stewardship of its assets.
3. To monitor investment performance, to address persistent poor performance and, if necessary, to initiate a change of manager.
4. To be active in addressing persistent discounts¹ and to be prepared to initiate corrective measures such as marketing support or share buy-backs or even - in some instances - a wind-up of the trust.
5. To communicate with shareholders and be honest and open in those communications. To listen to what shareholders have to say and provide an

¹ Being listed companies, the shares of investment trusts will often trade at a price different to the value of the underlying assets. When the market price of an investment trust share is below its asset value, it is said to be trading "at a discount". It is also possible for a share to trade at a premium, although this is less common. When discounts widen, share price performance lags behind the performance of the investment portfolio, which can be a problem for investors wanting to sell their shares.

opportunity for shareholders to express their views to directors.

More detail on the role of directors can be found throughout the Handbook and also in the *AITC Report into Attitudes Towards the Governance of Investment Trust Companies* ("Report").

The Role of the Chairman

The role of the Chairman, and the relationship with other directors, is dealt with in Section 4 (pages 24-25) of the Handbook. This summarises the responsibilities of the Chairman as follows:

1. To ensure that the board is composed of directors of sufficient calibre, skills and experience for the board to be able to discharge its function effectively. To review the composition of the board and take steps to change its shape and introduce new blood when necessary.
2. To establish the nomination and selection process for the new board appointments.
3. To prepare and agree the agenda for board meetings in conjunction with the company secretary and decide on what supporting documentation or reports are required.
4. To ensure that all directors are properly briefed on issues arising at board meetings.
5. To critically appraise the effectiveness of the board either through a formal or informal process and consider ways in which its effectiveness might be improved.

More details of the skills, knowledge and experience that the directors and the Chairman should bring to these roles are given in Appendix B.

How does this compare to the present position?

The AITC believes that the fundamental duties of directors have changed very little over the last 10 years and that directors of investment trusts take these duties very seriously. However, there is an ongoing need for the role of directors to be reviewed and adapted according to changes in the market for investment trust shares, or to take account of changes in law or taxation.

Trade associations play an important role in helping to assimilate views and information on particular issues to ensure that all directors are made aware of the pro and cons of various forms of action. For example, one of the specific duties of an investment trust director is perceived to be in addressing persistent discount problems. One recent response to this issue has been the undertaking of regular share buy-backs, facilitated by changes to tax legislation in 1999. However, the use of share buy-backs was a largely untested area due to previous tax limitations. This has meant that the knowledge and experience of the buy-back process has developed only recently. The AITC has been key in keeping directors informed of developments in this area and summarised the risks and rewards of a buy-back programme in a report on share buy-backs, which forms Appendix 6 of the Handbook.

How independent do non-executive directors need to be for the different roles?

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What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?

The term "independence", when used in the context of investment trust directors, tends to be used in a slightly different context to that of other listed companies. As indicated in the covering letter, most investment trusts subcontract their fund management, and most other administrative functions, to external fund management groups in return for a fee (usually based on a percentage of funds under management). There is clearly an alignment of interests between managers and shareholders in this arrangement in the sense that, if the manager invests the portfolio successfully, funds under management will grow leading to higher fees.

However, there may be other situations where there is a conflict of interest between what is best for shareholders and what is best for the management company. For example, the use of share buy-backs to control discounts and discount volatility reduces funds under management, which might make managers less willing to exploit these tools. To take a more extreme example, it might be the case that the best option for shareholders is a straightforward liquidation of the assets of the company. Managers keen to maintain a management contract may recommend alternative forms of action to prevent this. In these cases, the presence of an independent

board is crucial to ensure that shareholder interests are best served.

Clearly, there would be a serious question mark in terms of governance if a board were faced with the above type of situation and all, or even a majority, of the directors were current employees of the fund management group. For this reason, rule 21(9)(d) of the Listing Rules states:

“the board of directors.... must be able to demonstrate that it will act independently of any investment managers.... and a majority must not be directors or employees of or professional advisers to the investment managers”

It is noticeable that this requirement focuses on the balance of the board as a whole rather than on individual directors, which we believe is the correct approach to questions of board composition.

The Report discusses the issue of a director's connection with the fund management group, and questions of the independence of individual directors, an area that has provoked considerable debate. As the Report indicates, there are currently some areas of broad consensus and others where there is disagreement.

There are no easy answers to some of these questions. For example, the AITC strongly supports directors owning shares in their own companies, as this directly aligns their interests with those of their shareholders. With the exception of split capital investment trusts (where we believe that substantial ownership of one class of share, without the equivalent ownership of all other classes, could give rise to governance concerns), we fail to see why a notifiable ownership of shares (see Report, page 3, the section headed “Large Shareholders”) should have an adverse impact on independence. In fact, we believe the opposite is true and believe it would be extremely detrimental to the sector if directors were discouraged from holding shares in their own companies due to concerns over independence. However, we respect the views of those who think otherwise, even if we disagree with them.

Given the divergence of views on some of these issues, we believe that disclosure and transparency are the only ways to deal with such contentious areas. It is then up to shareholders to decide whether or not they are happy for such individuals to sit on the boards of their companies. As the Report indicates (page 5), the

following are the factors that are considered the most relevant information in the context of investment trust directors:

- length of service;
- other directorships (including other investment trust appointments);
- any current or historic employment with the fund manager;
- age;
- current employment;
- whether or not a director is a director or employee in a company in which the investment trust owns a notifiable stake or where that stake represents more than 5% of the investment trust's portfolio; and
- whether or not a director is also a director of another investment trust where there are significant reciprocal holdings.

What time commitment is needed for the role of the Chairman and for non-executive director roles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?

Time commitment would vary considerably, not simply between companies, but in particular if certain events, such as corporate actions, occur during a particular year. However, the Handbook (Section 4, page 21) refers to research conducted by the AITC in 1999, which demonstrated that the average time commitment was 69 hours for directors and 101 hours for Chairmen. Although this research has not been updated, we would envisage that, in the more difficult market environment of recent years, with higher levels of corporate actions, these averages have risen somewhat.

Clearly, this has implications on the number of non-executive roles that an individual can take on. However, we see no reason why an investment trust director could not hold a number of investment trust directorships without running into severe time constraints. The AITC would not welcome regulatory attempts to circumscribe the number of non-executive posts that an individual can take on, as the number will depend upon, for example, whether or not an individual is in full-time employment. It is therefore possible that a person holding one non-executive post may struggle to commit sufficient time to that post (if he/she has a full-time job and other commitments) but that a retired person may be able to

hold down numerous non-executive posts and discharge his/her duties well.

The key issue is that non-executive directors should be given an indication of the work that is expected of them and a realistic estimate of the time that is involved. If they fail to do the work required of them, it is up to the Chairman to ensure that they perform as expected or seek their removal from the board. At the same time, shareholders should be made aware of these other commitments so that an informed assessment can be made of the likely impact of these commitments on the non-executive director.

Should there be a special role for a "senior independent" non-executive director?

We believe that, to the extent that this would be required by an investment trust, this role would be fulfilled by the Chairman. As the Report indicates, there is near unanimity that the Chairman of an investment trust should be independent of the fund management group.

Do you have comments on the proposed statutory statement of directors' duties, which does not seek to distinguish between executive directors and non-executive directors?

The AITC put forward its views into the lengthy consultation process concerning company law which formulated the proposed statement and supports its creation. Most of the duties set out in the statement are simply a restatement of the duties that are already long established under existing case law.

In addition, the statement relates primarily to how directors should carry out their functions, not to what those functions should be. Having considered the requirements of the statement, we see no reason to distinguish between executive and non-executive directors, as we believe that the duties apply equally to both groups. Any suggestion that a non-executive director should be subject to less stringent tests than an executive director would be extremely unwelcome.

What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?

What are the key skills, knowledge and experience which are needed by non-executive directors to perform the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?

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What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.

This is covered in Section 4 (pages 17-18) of the Handbook. The keys skills, knowledge and experience that have been identified which should be represented on an investment trust board are:

- Investment expertise
- An understanding of investment performance measurement
- Familiarity with the investment trust industry
- Knowledge of corporate governance
- Skills in managing shareholder relations
- Financial/accountancy skills

The AITC believes that it is unrealistic to expect each and every director of an investment trust to have all these skills at the same level. This is not required to enable the board collectively to discharge its functions. Whilst there is certainly a case that each director should have a minimum grounding in each area, what matters is that the board as a whole has the relevant skills required in the performance of its duties.

The only skill that has been consistently cited as being essential for an investment trust director is the ability to take an independent view, which is one of the directors' duties in the proposed new statutory statement.

What personal qualities and attributes are needed?

As the Report indicates (page 2), confidence, integrity and good judgement have been singled out, as being particular characteristics required of an investment trust director.

How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?

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What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on boards?

Although the skills mix required is relatively specialised, the investment trust sector has generally been very successful in securing these skills. What has been more difficult to achieve is creating boards with a more balanced social mix. The AITC does not believe that there is anything inherently wrong with the gender and social mix of currently serving directors but it is aware that, for example, women and ethnic minorities are under-represented. This is a reflection of the fact that, in the City, which is a major source of candidates with appropriate skills, these groups have traditionally been under-represented.

We would expect the diversity of investment trust directors to change over time as the City, and other potential sources of directors, such as the professions, become more diverse themselves as recruitment patterns have changed. The AITC also provides a service whereby potential candidates for directorships provide a CV, a summary of which is then circulated to the industry and a full copy is available on demand. What is crucial to acknowledge is that the most important attributes of directors are their skills and personal attributes such as honesty and integrity. Social and other factors are very much a secondary consideration where the protection of shareholder interests is concerned.

The AITC believes that diversity of directors could be enhanced by ensuring that shareholders are aware of the particular skills, expertise or knowledge that each director brings to the board. Shareholders would then be better able to suggest appointments to further enhance the skills represented on the boards. There must, however, be some constraints on this. Whilst the special expertise of certain individuals can be invaluable in terms of what boards can offer, such expertise cannot be offered at the expense of a core understanding of a number of key issues.

Investment trusts with offshore investment mandates already take advantage of directors with international

experience. We are not aware that there are any particular problems in recruiting directors with suitable experience.

Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes - e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted.

The 2002 Deloitte & Touche Investment Trust Accounts Survey showed that the average level of remuneration for an investment trust director of externally managed trusts in 2000 was £11,000, compared with an average of £10,300 for 1999. There is a general view from other sources that directors' fees will continue to rise at above inflation levels due to the increased demands being placed on them, particularly in terms of corporate governance matters. It should also be noted (see page 8 of the Report) that shareholders generally do not object to increases in directors' remuneration providing it can be demonstrated that this results in enhanced performance.

In most cases, directors receive their remuneration in the form of cash. The AITC also strongly welcomes directors holding shares in their companies, as this aligns their interests with those of shareholders. As the Report makes clear (page 8), share options are a more contentious area and there is a concern that this could introduce incentives which are not necessarily in the best long-term interests of shareholders.

Do you have comments on the issue of risks or insurance provision for non-executive directors?

As greater demands are placed on non-executive directors, coupled with a more litigious society, so the question of insurance becomes increasingly important. Remuneration of £11,000 per annum, whilst it might reflect fair recompense for time spent, cannot on its own begin to adequately compensate directors of investment trusts for the responsibilities, and therefore the risks, that they assume.

Insurance is therefore a vital component if directors' remuneration is to be kept at today's low levels. As is common in most areas of the insurance market, we are beginning to hear reports that the cost of insurance for directors of investment trusts is increasing and that the terms on which such insurance is being offered are increasingly onerous.

Do existing structures and procedures facilitate effective performance by non-executive directors?

How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?

As our previous responses indicate, not all listed companies are the same and investment trusts operate in a very different way to companies in other sectors. Whilst we believe that the Combined Code has brought about improved governance in investment trusts since its introduction, it has, on occasion, been difficult for directors of investment trusts to apply some its recommendations. One obvious example would be applying the provisions in relation to the balance between executive and non-executive directors to a board made up exclusively of non-executive directors.

Even when further guidance has been provided in respect of Code provisions (e.g. the Turnbull Report), it has not always been clear how these should be applied to the special circumstances of investment trusts. The AITC has taken steps to assist its Members in applying some of these recommendations, for example by issuing its *Guidance Notes for Directors on Monitoring Internal Controls and Procedures* (which now forms Appendix 2 of the Handbook), which was warmly received by the industry.

This emphasises the importance of any review of governance by non-executive directors to be sufficiently flexible to cater for the wide range of companies on which non-executive directors serve. The Consultation Paper makes it clear that a primary function of non-executive directors is considered to be monitoring and questioning the actions of the executive directors - in the case of most investment trusts, this function is irrelevant. The key function is instead the monitoring of the actions of the fund manager.

Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have any comments on board size?

The most common size of an investment trust board would be approximately 6 people, all of whom would typically be non-executive. Given the non-executive role that the

directors are performing, we believe that this is an appropriate board size, although larger boards may be appropriate depending on the size and complexity of the company.

It is therefore inevitable that, in many cases, the committees recommended by the Combined Code (Audit, Nomination and Remuneration) use predominantly the same personnel as sit on the main board. Indeed, in many cases, the board as a whole simply serves as the Nomination and Remuneration Committees. Very often, the Audit Committee is restricted exclusively to non-executive directors with no connection with the fund management group, which goes beyond the requirements of the Combined Code.

We believe that board meeting procedures are working effectively.

Do you have comments on the composition and duties of the Audit Committees? How effectively are Audit Committees working in practice? Do you need to strengthen the existing Combined Code provisions on Audit Committees?

We believe that consideration should be given as to whether, instead of a simple majority of directors being independent, the rule should be changed so that all directors serving on an Audit Committee are independent. This should apply to all listed companies, including investment trusts.

In respect of non-audit services (Code Provision D.3.2), the question is largely irrelevant in respect of investment trusts, as the provision of non-audit services to the companies themselves is limited. There is, however, a question of auditor independence where the fund management group managing the investment trust is either audited by the same accounting firm as the investment trust, or the audit firm audits a considerable number of other funds managed by the same management group. We believe that boards of investment trusts should be aware of the total fees (audit and non-audit) received by their auditors directly from the management group managing their company and from funds managed by that fund management group. The board should also consider carefully any recommendation by the fund management group to change the auditor and question the management group as to reasons.

Similarly, do you have any comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?

We are less certain whether there have been any benefits arising from Nomination and Remuneration Committees, given the special circumstances of investment trusts.

It is interesting to note that, under the terms of the Code, a company is specifically permitted not to establish a Nomination Committee if the board is small (Code Provision A.5.1). The same does not apply to the Remuneration Committee, although the Listing Rules provide some specific exemptions to investment trusts in this respect (see Rule 21.20(i)). We suspect that a strong motivation for the establishment of a Remuneration Committee is concerns over excessive boardroom pay and complex remuneration packages (e.g. share options) which might create inappropriate and short-term incentives which work against the long-term good of the company. In the case of investment trusts, these concerns are unlikely to be a factor.

What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?

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Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?

As previously mentioned (see Appendix A), the evaluation of the performance of directors is considered to be one of the key duties of the Chairmen. However, this is unlikely to entail setting specific and different objectives for each and every board member. Given the nature of the role of investment trust directors, we do not consider that a formal evaluation process (e.g. the use of external agents to review performance) would be appropriate.

There is a commonly held view that investors buy funds on their view of the fund manager, and never the strength and quality of the board. Whilst there is a good deal of truth in this, the AITC believes that the board of an investment trust is a strength of the structure and that the role of the board is undervalued by many investors. Clearly, however, if the perception of the role boards play does not match the reality, then there is a question of how successfully boards communicate what they do to shareholders.

As investment performance is clearly an overriding issue in assessing the performance of the company by shareholders, we believe that there is a natural tendency for shareholder communications to focus on investment matters. However, there are many other non-investment issues that shareholders would welcome further information on (e.g. the use of share buy-backs, the creation of investment wrappers to stimulate demand and other promotional/marketing activities). The AITC believes that, whilst boards and fund managers are generally good at communicating on investment matters, they could improve their communications with regard to their strategy and activities in these non-investment areas. Better communication of the role that boards play in these issues would help shareholders evaluate board performance.

Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?

Investment trust boards can easily challenge the decisions taken by the fund managers and we have recently seen an example of a board of a substantial trust replacing the fund manager due to sustained underperformance. This demonstrates that boards can take radical action when they believe that it is the best interests of shareholders to do so.

Do existing relationships with shareholders or others need to be strengthened?

How well do relationships between non-executive directors and shareholders, and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?

This is addressed in the Handbook in Section 7, Chapter 12 and also pages 9-10 of the Report.

To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?

We believe that the structures in place are more than adequate to allow Chairmen, and the other directors, to do their jobs in the best way that they see fit. Ultimately, it is a matter of an individual's personal abilities how well they perform the role of Chairman.

What should be the relationship between non-executive directors and executive directors, and with senior management? What should their relationship be with the Chairman and the Chief Executive? What should their relationship be with key advisers to the company?

As previous responses indicate, these questions are largely irrelevant for an externally managed investment trust with a board made up entirely of non-executive directors.

How can Company Secretaries support effective performance by non-executive directors?

Company Secretaries play a vital role in the operation of the board of an investment trust, which is reflected in Section 4, pages 25-28, of the Handbook. Company Secretaries of investment trusts will very often be employees of the fund management group.

How can non-executive directors best be supported to perform their role?

How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?

The typical information normally provided for a board meeting is set out in Section 4, pages 28-29, of the Handbook. However, as our earlier response indicated, it is considered one of the main duties of the Chairman to determine what supporting documentation or reports are required to ensure that all directors are properly briefed on issues arising at board meetings. Where appropriate, this would include taking independent professional advice, in line with the Combined Code (A.1.3).

*What training and development opportunities are available? Could they be improved and, if so, how?
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Can induction for non-executive directors be improved?*

Whilst there are training courses for non-executive directors, we are not aware of any specific training courses tailored to the needs of investment trust directors. As the Report indicates, there is considerable support that relevant training be offered to new Directors, as is required by A.1.6 of the Combined Code. The AITC is considering whether the induction process for new directors could be improved by, for example, the creation of an induction course specifically tailored for new directors of investment trusts.

Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?

The Handbook (and ultimately the Report) helps boards in general terms to understand what is expected of them. The AITC regularly has speakers at its Directors' Conference from both the institutional and retail shareholder perspective to update directors on how they, as investors, see these expectations changing in response to different market conditions. However, as indicated in Section 7, Chapter 12 of the Handbook, investment trust boards have perhaps not been as proactive as they could have been in the past in terms of actively seeking feedback from shareholders. As the Report (pages 9-10) indicates, there is a strong view in the industry that good communication with shareholders is an integral part of good governance.

In part, weaknesses in communication may have stemmed from the fact that, as boards of investment trusts are comprised of non-executive directors, it has not always been that easy from a practical perspective for shareholders to know how they should contact a board member. They may therefore have fallen back on contacting the fund management group, which may not always be appropriate. The AITC supports the suggestion in the Report that a contact procedure should be set out in the Report & Accounts for shareholders who wish to communicate directly with the board rather than through the investment manager.

In what ways is the position different for smaller listed companies?

To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?

Although there are some very large investment trusts, many investment trusts would fall within the category of smaller listed companies if compared to companies of the size found in the FTSE 100. However, in the case of investment trusts, we feel that the case for separate provision would not arise specifically from questions of size but from their very different line of business and board structure. That said, it is certainly true to say that, for the smaller investment trusts, the ability, say, to become self-managed would be more difficult than for the larger trusts.

Our overall view is that governance principles should be sufficiently flexible and non-prescriptive to ensure that they can cater for the individual circumstances of differing companies, including those of widely differing sizes.

What can we learn from international experience?

What can be learnt from international experience, either in terms of structures or behaviours?

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Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?

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Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?

We are not aware of any overseas models for the governance of closed-ended funds such as investment trusts that operate significantly better than that in the UK. To the extent that improvements could be made to the UK system, we believe these can be achieved through market forces and best practice recommendations rather than wholesale changes to the current structure which, by and large, has served investors well for over a hundred years.