CORPORATE GOVERNANCE AND THE SPLIT CAPITAL INVESTMENT TRUST CRISIS

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Abstract

The aggressive pursuit of fees by certain fund management companies and broker/advisers drove them to launch new split capital investment trusts ("splits") that exploited the retail demand for high yield in the environment of falling interest rates of the late 1990s. This led in many cases to substantial bank debt financing, high charges to the capital account and investment in the ordinary income shares of other splits, to generate the required initial yield and meet demand for new split issues as interest rates fell. Thus, the need for ever-more demanding starting yields for income-bearing shares and gross redemption yields for zero dividend preference shares ("zeros") caused the promoters of splits to devise increasingly aggressively structured funds that did not fully take account of possible stock market conditions.

The impact of falling markets from 2000 accompanied by equity dividend cuts led to collapsing market prices and dividend cuts for the income-bearing shares of many splits. The substantial cross-holdings then caused dividend cuts to compound themselves across a section of the splits sector, and share prices fell yet further. Even the market prices of a number of zeros fell sharply, a type of share that had generally been sold as low risk. By the end of 2001, desperate measures were being taken to save many of the new splits and the FSA started to take a much keener interest. Confidence in splits then collapsed and many private investors incurred significant financial losses.

The boom and bust within the split capital investment trust sector was, in the true sense of the word, extraordinary. It tested investment trust directors in a way unknown for at least a generation and brought into focus a number of corporate governance issues for investment trust companies. We discuss the lessons to be learned from the crisis and the implications for investment trust corporate governance of the regulatory response to date. We believe that a fundamental change in the regulation of investment trusts is unnecessary and could be delivered only at a considerable cost.

1. INTRODUCTION: UK INVESTMENT TRUST COMPANIES

An investment trust company ("ITC") is a UK investment company, the ordinary shares of which must be listed on the London Stock Exchange ("LSE"). It enables investors to purchase an interest in a professionally managed portfolio held within the structure of a limited company. Like all UK limited companies listed on the LSE, an ITC is subject to the regulation of the Companies Act and the UK Listing Rules. It is not a "product" regulated directly by the FSA, unlike a unit trust ("UT") or an open-ended investment company ("OEIC"), and the use of the term "product" to describe an ITC is widely rejected within the investment trust industry.

Ultimate responsibility for running the affairs of an investment trust lies with the Board of directors, who (like the directors of any other limited company) are elected by the shareholders; but day-to-day investment management and administration is normally delegated by the Board to a fund management firm.[1] The conduct of such a firm (the "fund manager") in managing the portfolio of the investment trust is regulated by the FSA, as are its marketing activities.

In common with any other company, an ITC has a fixed number of issued shares. To realise their holdings, investors must normally sell their shares to other investors.[2] This "closed-end" structure is different from the "open-ended" structure of UTs or OEICs in which investors buy or redeem their investments by dealing directly with the managers. Furthermore, an ITC (as a limited company) has much greater freedom than UTs and OEICs (which are regulated "products") to borrow money and thereby obtain the benefits and risks of gearing. This can be done in the same way as any other company would do it, by issuing listed or unlisted loan capital or simply by borrowing from a bank or another lender.

Section 2 of this paper explains the concept of split capital investment trusts and describes the basic types to be encountered. Section 3 describes the split capital trust crisis itself and its significance. Section 4 discusses the lessons to be learned from the crisis for the governance of investment trusts. Section 5 provides a critical review of the regulatory response so far and the way in which the AITC, the industry's trade association, has moved to address the issues raised by the crisis. Section 6 sets out our conclusions.

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[1] There are, however, a number of well-respected self-managed trusts.

[2] However, a number of trusts have a limited life. There may be a fixed redemption date but very often there are a number of optional winding up dates. Furthermore, "buy-backs", in which a company buys its own shares and cancels them, have been permitted since 1999 and have become widespread; and it is also possible for an ITC which has sought the necessary permission from its shareholders in General Meeting to issue new shares. There are examples in the investment trust sector of ITCs which have contracted *or* expanded considerably in recent years through the use of buy-backs or the issuing of new shares.

2. TYPES OF SPLIT CAPITAL INVESTMENT TRUST

Split capital investment trusts ("splits") may be defined as ITCs with more than one main[3] class of share capital offering different rights to income and capital.[4] They aim to match simultaneously the risk, income and tax preferences of different types of potential investor. Splits are usually designed to be wound up at some future date, most of them having an original term of seven to ten years. If the company is wound up, its assets are sold and the proceeds are used to pay off the various classes of share capital in the order of priority assigned to them in the company's Articles of Association, after meeting the entitlements of holders of debt (if any).

There are two basic types of splits – "traditional splits" and "quasi-splits".

A simple "traditional split" has its ordinary share capital divided into two distinct categories — income shares and capital shares. Holders of the income shares of traditional splits are entitled to all or most[5] of the distributed income and a pre-determined capital repayment on liquidation. Thus, they receive a much higher income yield than that of the underlying portfolio. Holders of the capital shares of traditional splits receive little or no income[6] but are entitled to the remaining assets on liquidation after the income shares have been redeemed. Dualvest, the first modern-day split, launched in 1965, was of this type, as were many of the splits launched up to the late 1980s. They generally invested in a broad portfolio of UK equities with an above average yield, and commonly had no borrowings.

A "quasi-split"[7] always has zero dividend preference shares ("zeros") in issue but, in its most straightforward form, there is only one class of ordinary share capital, namely ordinary income shares (also known as income & residual capital shares). Zeros are designed to pay a pre-determined capital sum when the trust is wound up, before any distribution can be made to ordinary income shareholders. They have no entitlement to income, so that, importantly, there is no liability to income tax for the investors who hold them. Ordinary income shares offer high income plus all the remaining assets of a quasi-split trust at the wind-up date, after the zeros have

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[3] A number of ITCs still have small numbers of preference shares outstanding, usually for historical reasons. Such ITCs are not regarded as being "splits", even though technically they have more than one class of share capital outstanding. ITCs which are not splits are often referred to as "conventional" trusts.

[4] In everyday usage, the term "split" is also often taken to include conventional trusts with high levels of bank debt. See Note 7 for the way in which such trusts are described in this paper.

[5] As laid down in the trust's Prospectus and Articles of Association.

[6] Again, as laid down in the trust's Prospectus and Articles of Association. The capital shares of a few splits also had a small entitlement to income, although this was not common.

[7] As alluded to in Note 4, some commentators use the term "quasi-split" to mean a conventional trust with high levels of bank debt. To avoid confusion, these highly geared conventional trusts are called "pseudo-splits".

received their capital entitlement. This type of structure was common from 1988 through to the late 1990s. Again, such quasi-splits generally adhered to prudent investment principles, holding a broad portfolio of UK or international equities and not incorporating additional complexities such as bank borrowings. The zeros in these simple structures were generally low risk.

A common variation on the above theme was to combine the traditional split and quasi-split concepts. In other words, a trust could have three classes of share – zeros, income shares and capital shares. When such a trust is wound up, zeros are (in the absence of borrowings) repaid first. So, other things being equal, the risk/return profile of the zeros is no different from that of zeros in a simple quasi-split. But the income shares are likely to be more risky than in a simple traditional split because they rank after the zeros (which are not present in a traditional split) for capital repayment. The capital shares would have the lowest priority for repayment in either case.

In the buoyant markets of the late 1990s, it became fashionable to launch splits that had complicated capital structures, often with significant levels of bank debt and other devices, to make the shares appear attractive to investors. Some invested in the high-yielding shares of other splits (hence "cross-holdings"). Many of them defied simple categorisation.

The aggressive features of the wave of new funds were often combined with a thematic investment strategy in the so-called "barbell" investment trusts. Barbell trusts held two distinct portfolios of investments — a growth portfolio and an income portfolio. In pictorial form this asset structure can look like a "barbell" such as is used in weightlifting. This is because assets are held at either end of the income/growth spectrum, with nothing in the middle. The income portfolio typically consisted of bonds (with varying degrees of risk) and high yield investment trust securities (including the ordinary income shares of other splits). The "growth" portfolio was typically invested in a sector or market that was popular at the time of issue (such as technology stocks). The liabilities side of the balance sheet of a barbell tended to include a significant amount of bank debt. The share capital typically consisted of zeros[8], ordinary income shares and in some cases other classes of share.

It was often very difficult to understand the investment attributes of the shares issued by the new splits, both as regards the entitlements of different share classes *and* as regards how shares of the same class issued by different splits compared one with another. This was not least because sufficient information was not readily available to outsiders. Traditional risk statistics that were used to assess the risk of unfamiliar types of shares in a complicated split often became

dangerously misleading.[9] As a result, there was a general lack of understanding of the true risks involved. The obvious risk created by geared trusts investing in other geared trusts was generally missed by directors, investors, their advisers and possibly even the inventors of the new splits themselves. Zeros in aggressively-structured splits, often ranking below large quantities of bank debt, were generally sold to the investing public as simple low-risk investments comparable to the undoubtedly low-risk zeros issued before the splits boom.

3. THE SPLIT CAPITAL INVESTMENT TRUST CRISIS

In November 2000, the directors of European Technology & Income, a barbell trust with a split capital structure, were forced to carry out a restructuring as the trust's bank covenant was endangered. This was the first concrete evidence of the problems that these aggressive trust structures could create. Then in March 2001 the directors of Framlington NetNet.Inc announced that the company had repaid £41m of its borrowings and was left with net assets of only £7.8m, a far cry from the £57.8m of net assets at the time of its launch only a year earlier. There were also many other highly geared trusts started to get into difficulties as equity markets fell.

There had been some criticism in the press of new splits launches during the boom years but most articles missed the point that the bulk of splits launched since 1998 had aggressive structures, very different than those that had gone before. However, from the spring of 2001, stronger warnings were appearing about barbells, bank debt and the "magic circle" of split capital trust managers whose trusts held shares in one another. An article "*For Whom the Barbell Tolls...*" (Adams & Angus, 2001), published in the April 2001 issue of *Professional Investor*, warned about the risks created by geared trusts investing in other geared trusts and the significant costs to equity shareholders. It argued that there was an urgent need for the significant risks and expenses involved in barbell trusts to be spelt out more clearly in their Prospectuses and Reports & Accounts. Then a report entitled "Barbells Unbalanced" by stockbrokers Cazenove & Co was sent out to clients on 25 July 2001. The 32-page report (Cazenove & Co, 2001) concentrated entirely on barbells and their problems, arguing that a downward spiral could develop, exacerbated by high gearing.

On 25 July 2001, the same day as "Barbells Unbalanced" was sent out to Cazenove's clients, European Technology & Income announced the suspension of the monthly dividend on its

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[8] Although barbells launched before August 2000 rarely issued zeros at launch, they were sometimes introduced to the capital structure later in restructuring deals.

[9] They were even more misleading when the shares had familiar names but unfamiliar entitlements and priorities, as was the case with the zeros issued by trusts which had large bank borrowings.

income shares. With the possible exception of Framlington NetNet.Inc, this was the first time that a barbell had paid a lower dividend than indicated at launch, and came as a shock to the market. After that, there was a general fall in the price of income-bearing shares; and a number of splits with cross-holdings started to suffer financial difficulties as most cross-holdings were in income-bearing shares. Managers of splits the portfolios of which contained a mixture of quality stocks and lower quality illiquid shares in splits, often had to sell the former to reduce gearing, leaving them with a portfolio of much lower overall quality than had originally been intended.

The banks were now in a difficult position. They did not wish to trigger a crisis in which they would be major losers, so they allowed troubled splits to offset cash holdings against their bank debt while giving them time to arrange restructuring deals. There was a brief spate of such restructurings in the autumn of 2001. However, these deals often involved splits making further investments in each other's newly issued paper, a short-term "fix" that only served to make the cross-holdings problem worse. The vast majority of new "income" securities were sold to other splits, or other funds the managers of which also managed splits.[10] Moreover, many of these transactions were carried out by stock swaps at mid-market prices. Given the illiquidity and very large spreads of these shares, mid-market prices were a purely theoretical value at which to transfer holdings.

By the end of 2001, concerns were mounting that in order to repay the banks, splits in breach of their covenants might be forced to sell illiquid holdings in the income shares of other splits, thereby initiating the kind of self-feeding downward spiral that Adams & Angus and Cazenove & Co had warned against. Meanwhile, splits holding the ordinary income shares of other splits that cut their dividends were compelled to cut dividends on their own ordinary income shares as a result of the lower income they received. So the existence of substantial cross-holdings caused dividend cuts to compound themselves across large numbers of splits. Dividend cuts also caused the share prices to fall, thus reducing the portfolio valuations of other trusts that themselves held these shares.

The shares of Quilter Global Enhanced Income were suspended on 3 April 2002. This was the first split to have its shares suspended; but it was to be only the first of many. Perhaps more significant was the announcement on 18 April 2002 of the controlled liquidation of Gartmore Monthly Income. It seemed likely at the time that (as, indeed, eventually happened) this would

[10] In its evidence to the Treasury Select Committee Enquiry on 11 July 2002, the AITC said that *"as much as 70% of the income shares issued in 2001 were bought by split funds and other funds whose managers also managed splits."* (HCTC, 2003, Ev 31).

result in the first ever failure to repay a zero in full on the due date. Things then went from bad to worse. Given the significant number of cross-holdings within the sector, share suspensions became a vicious circle. By the end of 2002, 19 splits or highly geared funds had been suspended.[11]

In February 2002, the FSA announced formal investigations into what was by this time being described in some circles as the splits "scandal". This was followed by an FSA policy statement in May 2002. Soon after that, the Treasury Select Committee announced that it was to conduct its own inquiries, in which the FSA and leading splits industry figures would be called to give evidence. The hearings produced moments of great theatre which were widely written about in the press. The Committee then reported in February 2003 (HCTC, 2003) and recommended bringing investment trusts directly within the scope of investment product regulation by the FSA. In November 2004 the Treasury produced its consultation document (HM Treasury, 2004) and this we consider in Section 5.

4. LESSONS FOR THE GOVERNANCE OF INVESTMENT TRUSTS

Directors owe a fiduciary duty and other duties of care to a company and to its shareholders. What are the lessons to be learned from the splits crisis for directors of investment trusts? This is a matter of prime concern for investment trust Boards, because as a result of the close attention recently paid to ITCs by the FSA and the Treasury Committee[12], outside intervention will probably be inevitable if the investment trust industry shows itself not to have learned adequately from its past mistakes.

4.1 Board recruitment and training

Those joining the Board of an ITC have traditionally "learned on the job" by serving alongside more experienced colleagues. But in the extraordinary circumstances of the splits boom, the traditional system could not work. For the directors of a new trust of a new type there is no fund of shared experience and no chance of "learning on the job". While there had been waves of new trusts in former years, these had generally been straightforward conventional trusts. Structures as untried as those of some of the new splits had arguably not been seen since the industry's earliest days.

Could the directors of the new splits have foreseen a downward spiral brought about by holdings of what proved to be highly risky securities in split trusts which themselves held the highly risky

[11] Adams, A T (ed) (2004) *The Split Capital Investment Trust Crisis*, p. 55.
[12] *Vide supra,* Section 2.

securities of other split trusts? Probably not, unless they were very seasoned (non-conflicted) investment managers who not only had experienced previous bear markets but also rejected the notion of the "new paradigm" and the widely-held conviction at the end of the 1990s that "it really *is* different this time".

When the problems started to emerge towards the end of 2001 and managers began to propose restructuring deals, directors were required to make quick decisions. With the benefit of hindsight, many commentators argue that directors should not have approved some of these deals. But for directors knowing little about investment, lacking in-depth knowledge of the new structures and yet desperate to uphold shareholder confidence in the company, the challenge of having to take near-instant judgments about the interests of several classes of shareholders with different claims on a shrinking pool of assets was more demanding than they could possibly have expected on appointment.

In an ideal world, technical skill should be an important consideration when recruiting directors. Those legislating for corporate governance, however, face a dilemma: potential directors who are expert enough are (at least as conventionally defined) usually not independent enough, while those who are independent enough are usually not expert enough. Finding sufficient independent directors with the necessary technical skills would seem, on the face of it, an impossible task. The best hope therefore lies in a continuing programme of education and training of ITC directors, to which the Association of Investment Trust Companies ("AITC") is currently devoting careful attention.[13]

4.2 Early appointment of directors

By the time the Chairman and other directors were appointed, the structure and investment policy of the new splits were all too often *faits accomplis*. It would have been better had the Chairman-designate been appointed at a much earlier stage and the other directors appointed before the trust's initial marketing. Boards could then have questioned the trust's managers and advisers while there was still time to change the structural design of the trust, and to take independent advice to help them do so. Directors should be able to influence what in future they may have to defend. And paying them to do a professional job at the beginning of the life of a trust might save much greater expense and loss of shareholder value at such a trust's premature end.

4.3 Management fees

The charging of fees, both by the fund management companies and their broker/advisers, on the basis of gross assets undoubtedly contributed to the splits boom. Expressed as percentages of gross assets, initial and annual fees often looked reasonable at the time trusts were issued; but the presence of a significant amount of bank debt on which a percentage fee was being paid by the shareholders meant that the fees were much larger than appeared at first sight. This became clear if fees (and other expenses) were expressed as a percentage of net assets attributable to the equity[14] shareholders, who in fact bear all the initial and annual costs. And if the underlying assets declined after launch, fees (and expenses) could become excessive (unless they were waived) from the equity shareholders' viewpoint. This, in turn, affected the security of any zeros in the capital structure; and it has to be remembered that the holders of zeros also did not benefit from the high dividend distributions to holders of income shares.

Directors should insist that fees be charged on net assets or market capitalisation, which better aligns the interests of managers and shareholders. Otherwise, there could be an incentive for fund managers and broker/advisers to boost initial fees by arranging a bank loan before the launch of a new trust and thereafter to put pressure on Boards to increase borrowing (or keep existing borrowings in place) regardless of the interests of shareholders, simply in order to safeguard or increase the fee income of the fund managers and the other advisers.

4.4. Fair treatment of all shareholders

One of the most controversial issues in the splits crisis was whether zeros were fairly treated compared to income-bearing shares. This is important partly because a much higher proportion of zeros was held by private investors. The splits crisis saw different legal interpretations concerning the rights and ranking of shareholders, with no consistency across the industry.

When the rights of shareholders are at stake, there is no room for uncertainty. Shareholder entitlements should be clearly laid down by the Board at the very beginning and adhered to strictly thereafter. Directors should ensure that the Articles of Association and Prospectus of a new trust set out in the most explicit and unambiguous terms the rules governing distribution of the revenue reserves at wind-up. There must also be explicit and unambiguous guidance in the

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[13] *Vide infra,* Section 5.
[14] The term "equity shares" includes income-bearing shares and capital shares, but not zeros.

Prospectus on dividend policy, to assist Boards in deciding on dividend distributions when, say, zeros are uncovered.[15]

4.5 The need for clear information to shareholders

Shareholders should be given sufficient information for them to value and assess the risk of their shares. However, information can confuse and obscure as well as enlighten. It is vital that directors report to shareholders in a way private investors can understand, not least in the Report & Accounts. However hampered they may be by statutory ways of reporting[16], the Board's moral duty is to provide clear information for shareholders.

Before the splits crisis, it was possible for splits to have large numbers of undisclosed holdings in other splits, so there was a need for improved portfolio disclosure. Basic facts about a trust may be unknown after its launch. Initial NAV, capital structure, details of debt, and details of the underlying investment portfolio may be very different after launch from those in the Prospectus. This problem has been tackled both by changes to the Listing Rules and by the new AITC Code on Corporate Governance, which we consider in Section 5. However, from the point of view of ITC directors it should not be a matter of waiting for rules and codes to change. Why should directors dole out the bare minimum of information as if they wanted to keep shareholders in the dark? The "culture of disclosure" we would like to see in the industry — what might even be described as a "culture of partnership with shareholders" — would lead ITC directors to disclose all necessary information as fully and as quickly as possible as a matter of course.

5. THE REGULATORY RESPONSE

The title "The Regulatory Response" is used loosely here. This section of our paper deals mainly with the response to the split capital crisis by the FSA (which is a regulator) and the AITC (which is not). The AITC is a trade association representing the interests of the investment trust industry. Its main purpose is the protection, promotion and advancement of the common interests of its member trusts and their shareholders. It is funded by the trust companies themselves and therefore by their shareholders, not by their investment managers. It might be said, however, that if the AITC did not exist there would be pressure for a regulatory body to take on certain of its functions in setting standards of disclosure and governance in the trust industry.

[15] "Cover" for zeros is defined as the ratio of gross assets less any prior ranking capital, to the assets required to pay the predetermined redemption amount of the zeros at the redemption date.

5.1 The new Listing Rules

The FSA published a consultation document (FSA, 2003) on proposed changes to the Listing Rules and Conduct of Business (COB) rules in January 2003 in response to the splits crisis. Changes to the Listing Rules and COB rules were subsequently announced in October 2003 and were designed to ensure that the circumstances which led to the splits crisis could not recur. They were far less draconian than many had feared. Included in all listing documents from now on should be a prominent "Risk Factors" section setting out the risk factors specific to the company (including risk through its gearing), its industry, its investment policy and the securities it proposes to issue. Then there is to be increased portfolio disclosure, notably monthly disclosure of all investments in other trusts which may hold 15% of their assets or more in other trusts, enhanced COBS risk warnings and a requirement for all material changes to the company's investment policy to receive prior shareholder approval.

The disclosure issue was only partially addressed in the new Listing Rules. Unfortunately, several splits managers have interpreted the new Listing Rules as only requiring disclosure of the name of the company in which an investment is held, not the number of shares held or their market value, or even what class of share is held. This rather destroys the usefulness of the disclosure and it is regrettable that where the demands of the Listing Rules are both reasonable and beneficial there is not whole-hearted compliance with their spirit rather than grudging compliance with their letter.

Changes to the Listing Rules are also designed to ensure that there is sufficient information available on crucial matters such as the cash position, debt and bank covenants. However, even after the introduction of the new Listing Rules, we still have the strange situation whereby basic facts about a trust may be unknown after its launch. Initial NAV, capital structure, details of debt, and details of the underlying investment portfolio may be very different after launch from those in the Prospectus. Shareholders should not have to wait six to nine months to learn this.

In addition, the changes to the Listing Rules lay down additional criteria to ensure what they describe as "enhanced director independence". Perhaps unsurprisingly, in the light of the splits crisis, these relate chiefly to ensuring the separation of the interests of the ITC and the fund manager.

- Any director of an investment company who is also a director of another investment company

[16] It seems to us a sad irony that the more the authorities concerned attempt to enforce higher standards of disclosure, the more difficult it becomes to read and understand Reports & Accounts.

managed by the same firm will not be regarded as "independent" for the purpose of the eligibility criteria in LR 21.9(d)

- No more than one director or employee of or professional adviser to the investment management firm concerned may sit on the board of a given investment company. This person will not be considered "independent" and must be subject to annual shareholder election.
- The chairman of the board of the investment company must be independent[17]

5.2 The AITC Code of Corporate Governance

The AITC Code of Corporate Governance (AITC, 2003) was published in August 2003 and updated in January 2004 to take account of the revised Combined Code.[18] It provides ITC Boards with a framework of best practice in respect of the governance of ITCs and is intended to be both practical and realistic.

Although there is some overlap with the Combined Code, the AITC Code concentrates on the particular characteristics of ITCs for which alternative practices to those of the Combined Code may be preferable. The main issues considered include Board independence, monitoring the managers and communicating with shareholders.

Board independence

While *"the AITC code is 'principles' rather than 'rules' based and the detailed recommendations recognise that most issues Boards will face may have different 'right' approaches depending on the individual circumstances of the company"*[19], it is strong on Board independence and its recommendations have been generally welcomed by the trust industry.

1. The Chairman should be independent.
2. A majority of the Board should be independent of the manager.
3. 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.

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[17] HM Treasury (2004) *The Regulation of Investment Trust Companies — Consultation Document*, November, p. 18.

[18] The Combined Code on Corporate Governance, annexed to the Listing Rules, was updated in July 2003 to reflect the review by Sir Derek Higgs of *The Role and Effectiveness of Non-Executive Directors*, January 2003 ("Higgs") and the report by Sir Robert Smith on *Audit Committees Combined Code Guidance*, January 2003 ("Smith").

[19] AITC (2003) *The AITC Code of Corporate Governance: A Framework of Best Practice for Member Companies, Association of Investment Trust Companies*, London. p. 5.

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, ages and length of service.
7. Director remuneration should reflect their duties, responsibilities and the value of their time spent.
8. The independent Directors should take the lead in the appointment of new Directors and the process should be disclosed in the annual report.
9. Directors should be offered relevant training and induction.
10. The Chairman (and the Board) should be brought into the process of structuring a new launch at an early stage.

These are good ground-rules and a useful starting-point for any Board. Nevertheless, there is no denying that the question of "independence", which so dominates thinking on corporate governance today, is a very vexed one. Some of the most independent investment trust directors have been ones who would never have qualified as "independent" under any set of rules that could have been drawn up. Independence is not a paper qualification but a cast of mind.

In particular, corporate governance which (as suggested by the Combined Code, endorsed by the AITC Code) strives to attain "independence" through the creation of a multiplicity of committees, each monitoring the next, suggests nothing so much as the frantic scene of backstage mayhem in the Marx Brothers' *A Night at the Opera* where Herr Gottlieb is mistaken for Groucho and hit on the head with a frying pan by a detective, who is simultaneously hit on the head with another frying pan by Harpo — brilliant slapstick, but unhelpful as a model for corporate governance.

The split capital investment trust crisis was an accident waiting to happen. Yet perhaps the only type of Board that might have prevented it would have been one deemed unacceptable today by at least some commentators in corporate governance — a Board containing one or two experienced and respected fund managers active in the investment world or recently retired from it. Unlike "independent" non-specialists, they might have been able to spot the huge risks lurking beneath the splits' clever structures and their promoters' sunny assumptions about perpetually rising equity markets.

Some argue that, during the time of the splits boom, trust Boards should have raised questions in a more searching and persistent way. Perhaps they did and were ignored, or (more likely) were too easily blinded by science into letting their concerns drop. How can we know what happened

behind closed doors at the Board meetings of splits? It does, however, indicate the need for the education of directors in what might be called the basic grammar of investment. It is encouraging that this is alluded to in the AITC Code and it is also to be hoped that the new agitation for directors to hold office for short, fixed terms will not work against directors with education and experience. The AITC Code does not fall into the trap of recommending a fixed term for directors, such as nine years, but instead contents itself with asking Boards to have a policy on tenure which is disclosed in the Annual Report.

The AITC itself has an important rôle to play in the education and training of directors. It has recently introduced two training courses for directors – "Governance and management" and "Accounting, tax and audit committees". It is hoped that the range of courses for directors will be extended.

Monitoring the managers

The AITC Code's stated objectives — *"regular review of the structure, objectives, target audiences, fund manager and existence of the company", "maintaining proper internal controls", "ensuring that the fund manager manages within the agreed parameters"* and *"objective monitoring of fund manager performance and willingness to press for remedial action if necessary"* — are all well-established and familiar parts of a Board's duties, and the AITC has fleshed out these objectives in a newly-published paper produced for the guidance of non-executive directors (AITC, 2004).

One of the AITC Code's suggestions here, however, is worth singling out for special comment: that a Board should from time to time review the existence of the company. Just because a company exists is not a reason why it should continue to exist. All those involved in the trust sector will have known companies which had lost any *raison d'être* but soldiered on from year to year without real purpose — or, worse, kept resorting to elaborate schemes and expedients just to give themselves the illusion of a purpose.

Communicating with shareholders

The objectives set out here by the AITC Code cannot be faulted:

- *Directors must put the interests of shareholders above all others*
- *Directors must treat all shareholders fairly*
- *Directors should be prepared to resign or take steps that could lead to a loss of office at any time in the interests of long-term shareholder value*

- *Directors should ensure that they address all issues of relevance and that they disclose the outcomes of those deliberations in a way that non-financial shareholders can understand*

The AITC Code is refreshingly clear in its insistence that Boards should keep under review the company's target audience. For whom is a trust run? Every Board should ask this question — and should keep asking it at frequent intervals. This accords well with the second set of objectives the AITC Code sets out for trust Boards: *"ensuring that marketing, promotion and investor relations is conducted professionally, efficiently and cost effectively", "ensuring that effective shareholder communications are established"* and *"monitoring and responding to shareholder opinion"*.

On disclosure of information to shareholders, the AITC Code is equally helpful. It contains recommendations which are aimed specifically at split capital trusts and which cover both the problem of high but semi-hidden expense ratios (Adams & Angus, 2001, 2002) and the difficulty of gauging the tensile strength of splits' structures. They include a sensitivity analysis showing the effect on the asset backing of each share class of a matrix of possible returns; the calculation of wipe-out hurdle rates for all share classes except annuity shares; the impact of expense ratios and interest costs on capital erosion per class of share; and much more detailed disclosure of the terms of banking covenants and the various possible consequences were they to be breached.

These recommendations are to be applauded. Much financial loss and bad publicity would have been avoided had the recommendations in the voluntary AITC Code been in place before the splits boom began. Shutting the stable door? Perhaps, but the point is that there are still plenty of horses left in the stable and the AITC, like all others who value the trust sector, is keen to keep them there.

5.3 The Treasury's consultation document

ITCs are currently not subject to direct regulation by the FSA. There is no requirement that "controlled functions" be identified or that those performing controlled functions, including the directors of investment trusts, be approved by the FSA. So there is no requirement to comply with the minimum standards that approval involves. The Treasury's consultation document (HM Treasury, 2004) sets out four possible options for the future:

i. Amend the Financial Services and Markets Act 2000 so as to put the regulation of investment trust companies on a similar basis to authorised unit trusts and OEICs. Investment trust companies would be regulated as products as well as having to be authorised persons;

ii. Amend secondary legislation so that investment trust companies would be brought within

the definition of "collective investment schemes", and become subject to general regulation under the Financial Services and Markets Act 2000. They would be regulated as authorised persons, but not as authorised products;

iii. Amend secondary legislation to create a new regulated activity of "establishing, operating or winding up an investment scheme based and listed in the UK, which has a stated objective of spreading risk such that no single holding exceeds 15 percent of the value of the scheme's assets". Investment trust companies would be deemed to be carrying on the new regulated activity and would therefore come within the scope of Part 4 of the Financial Services and Markets Act 2000. They would be regulated as authorised persons, but they would continue not to be collective investment schemes. Nor would they be regulated as products;

iv. Continue to rely on existing FSA rule making powers (e.g. the Listing Rules).

Under options (i), (ii) and (iii), there would be consultation on whether and, if so, which of the functions performed on behalf of the ITC should be "controlled functions". However, the consultation paper states that it would seem likely that the directors would have to be approved by the FSA.

The three options for change are, broadly speaking, in descending order of stringency, (i) being the most and (iii) the least restricting compared to (iv), the *status quo*. Each of them would see investment trusts regulated either as "products" like unit trusts and OEICs (i), as "collective investment schemes" (ii) or as entities carrying out a new kind of regulated activity (iii). All of these would be in stark contrast to ITCs' present status as limited liability companies like any other. All of them also call for ITCs, or those running them, to be "authorised persons", which at present is not the case. (At present, ITCs are run either by directors directly elected by the shareholders or by managers whom those directly elected directors appoint.) Much of the importance of authorised persons could be summed up crudely as "someone to sue"; and it is interesting to speculate on the effect this might have on ITC directors, most notably in the case of self-managed trusts. One would hope that shareholders would have voted out grossly incompetent Boards of Directors before lawsuits became an option, or that Boards would have sacked grossly incompetent fund managers. Both remedies are there, and always have been — and are very potent if shareholders take their rights seriously. So if any of the Treasury's three options for change is introduced one may as well wave goodbye to the idea of ITCs as listed limited companies like any other.

Perhaps it is not surprising that option (iv) is the one generally favoured by the investment trust industry, although there is no unanimity and views tend to be coloured, for instance, by whether an ITC is self-managed or is run by a fund manager which also manages UTs, OEICs and other pooled funds.

Should ITCs be subject to direct regulation by the FSA? It might mean that the regulator would be better able to consider marketing material in advance. Some would say, however, that directors who approved misleading marketing material were not up to the job as individuals and should be dealt with as individuals, while others would say that ITCs have no need to issue marketing material at all.

It is certain, at any rate, that subjecting ITCs to direct regulation by the FSA would cause much upheaval. In our view it would be an unfortunate development, rendered unnecessary by the regulatory changes that have already been imposed and by the enhanced standards of corporate governance the AITC, as the industry's trade body, has already embraced. Investment trusts are not products; they are subject to company law, with a battery of protection. If investment trusts were FSA regulated products, it would impose a significant burden on trusts, thereby increasing their costs and reducing their competitive advantage. It could lead to the erosion of benefits traditionally associated with investment trusts, so that they effectively became managed funds under a different name. It would be interference with the relationship between Board and shareholders other than by the ordinary officers of the law. The investment trust sector as we know it would be destroyed, a sector which has served investors by and large very well for over a century.

6. CONCLUSIONS

The fundamental flaws of the new splits were really very simple. They had too much bank debt and too many cross-holdings. But cross-holdings had been known in the trust world for generations and high gearing was also a well-established sector feature. It was the combination of them that turned out to be financially lethal.

For better or worse, the splits crisis is likely to have a permanent effect on corporate governance within the whole investment trust industry through the new Listing Rules, AITC Code of Corporate Governance, and possible changes to be laid down by the Treasury. However, it is difficult to see how a different *régime* of corporate governance could have averted the splits crisis. It is notoriously difficult to legislate for extraordinary events and no amount of legislation can change human nature. Experienced and knowledgeable directors together with full and

prompt disclosure of relevant information at all times are our best guards against a repetition. Our concern now is that *force majeure* will impose regulation on the investment trust industry of a kind that would alter its character beyond recognition, at the very time when reforms have been actively welcomed and implemented by the industry itself.

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