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CORPORATE GOVERNANCE AND
THE UK SPLIT CAPITAL
INVESTMENT TRUST CRISIS

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Abstract

The recent boom and bust within the UK 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. This paper draws on the results of a survey of investment trust directors and other investment professionals connected with the investment trust industry to examine the lessons to be learned from the crisis. The regulatory response to the crisis and its implications for the governance of investment trust companies are also discussed.
EXECUTIVE SUMMARY

The “splits crisis” has overshadowed the UK investment trust sector since 2001. It attracted wide and at times sensationalist coverage in the media, and even became the subject of a Treasury Select Committee inquiry. It raised many issues, notably in the areas of corporate governance, regulation and the disclosure of information.

The origins of the crisis lay in the aggressive pursuit of fees by certain fund management companies and broker/advisers by means of a stream of split capital investment trust (“split”) launches. These were designed to exploit the increasingly urgent retail demand for high yield in the late 1990s environment of falling interest rates. In many cases this involved substantial bank debt financing, high charges to the capital account and investment in the income shares of other splits, since all of these expedients were needed to generate the required initial yield on the income shares of the new splits. Ever more demanding targets for starting yields on income shares and gross redemption yields on zero dividend preference shares (“zeros”) caused the promoters of splits to devise increasingly aggressively structured funds that did not fully take account of possible changes to stock market conditions at a later stage in the life of the splits.

The impact of falling markets from 2000, accompanied by equity dividend cuts, led to collapsing market prices and dividend cuts for the income shares of many splits. The substantial cross-holdings then caused dividend cuts to compound themselves across an entire section of the splits sector, and share prices fell yet further. The crisis worsened when the market prices of a number of zeros fell sharply, a type of share that had generally been sold as low risk. Here, the name of the class of securities was a source of confusion. It had not been widely recognised that zeros ranking behind a substantial amount of bank debt (which was the case with many of the zeros issued by the new splits) were very different investment instruments from traditional zeros, which had ranked first in the order of priority for repayment. In nearly every case, traditional zeros genuinely had been low risk investments. By the end of 2001, increasingly desperate measures were being taken in attempts to save many of the new splits and the Financial Services Authority (FSA), alerted by a growing volume of concerned comment from analysts, private investors and the Press, started to take a much keener interest. Confidence in splits then collapsed and many private investors (especially those who held the zeros of geared and cross-invested splits) incurred significant financial losses.
We discuss the lessons to be learned from the splits crisis for the governance of investment trust companies (ITCs). The conclusions that follow have been tested against, and are strongly supported by, the results of surveys of two classes of investment practitioner involved in the investment trust sector — investment trust directors and investment professionals other than investment trust directors — that we conducted in May 2005:

(i) At least one independent director on the Board of each ITC should have the technical expertise and market knowledge to appraise the types of investments that the ITC holds and the suitability of its gearing level and capital structure.

(ii) The entitlements of each class of capital, covering all eventualities, should be clearly laid down by the Articles and clearly spelt out in the Prospectus.

(iii) The Board should be visibly independent of the managers.

(iv) Clear initial limits for gearing should be set in percentage terms by the Board, and these percentages should be monitored when market movements cause significant changes in gross assets.

(v) There should be limits in the percentage of gross assets which can be invested in other funds, and particularly in funds which themselves invest significantly in other funds.

Rather to our surprise, there was relatively little agreement among respondents to the survey about our conclusion that “fees should not be based on gross assets (including assets financed by bank debt)”. We remain convinced, however, that any incentive to boost fees by introducing and maintaining borrowings, regardless of the interests of shareholders, is undesirable.

We also assess the response to the crisis by the FSA, the Association of Investment Trust Companies (AITC) and the Treasury. We believe that changes to the Listing Rules for investment companies (including ITCs) together with the new Code of Corporate Governance for ITCs produced by the AITC represent a balanced and largely sufficient response to the crisis. Our belief is corroborated by the strong agreement with this analysis expressed by the respondents to our survey. The vigorous approach adopted by the AITC is particularly to be commended, showing as it did that the trust industry is determined to learn from the splits crisis and to put its own house in order. We believe that in the light of this response fundamental change in the regulation of ITCs is unnecessary and could be delivered only at considerable cost. Any further changes in regulation deemed necessary by the authorities can be conveniently carried out through the Listing Rules.
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 is the UK equivalent of a US closed-end fund. 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 Financial Services Authority (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 ITC lies with its Board of Directors, who (like the directors of any other limited company) are elected by the shareholders, while 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 ITC 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

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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.
way as any other company would do it, by issuing listed or unlisted loan capital or simply by borrowing from a bank or other lender.

Section 2 of this paper explains the concept of split capital investment trusts (“splits”) and describes the basic types to be encountered. Section 3 describes the splits crisis which broke in late 2001 and its significance. Section 4 outlines the survey of investment trust directors on the splits crisis that we carried out in May 2005 as part of our study of the implications of the splits crisis for corporate governance. Section 5 discusses the lessons to be learned from the crisis for the governance of ITCs in the light of this survey. Section 6 provides a critical review of the regulatory response and the way in which the Association of Investment Trust Companies (AITC) has moved to address the issues raised by the crisis, again drawing on the results of our survey. Section 7 sets out our conclusions.

2. TYPES OF SPLIT CAPITAL INVESTMENT TRUST

Split capital investment trusts (“splits”) may be defined as ITCs with more than one main class of share capital offering different rights to income and capital. Equivalent investment vehicles no longer exist in the US closed-end fund market. They aim to match simultaneously the risk, income and tax preferences of different types of potential investor to a greater extent than is usually possible for a conventional trust, especially since the preferences of different types of investor can be made to complement one another to the benefit of all (Buchan & Angus, 1988). Splits are usually designed to be wound up at some future fixed date, most of them having an original term of seven to ten years. When 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”.

3 A number of ITCs still have small numbers of preference shares outstanding (their total par value being typically a fraction of a percentage point of the ITC’s total assets), 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 ITCs with high levels of bank debt and offshore split capital (or highly geared) investment companies listed in the UK.

5 Dual-purpose funds were created in the US in 1967 but changes to the tax code have led to their demise.
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\(^6\) 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\(^7\) 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”\(^8\) 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 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 split 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.

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\(^6\) As laid down in the trust’s Prospectus and Articles of Association.

\(^7\) Again, as laid down in the trust’s Prospectus and Articles of Association. The capital shares of a few traditional splits also had a small entitlement to income, although this was not common.

\(^8\) Some commentators use the term “quasi-split” to mean a conventional ITC with high levels of bank debt. To avoid confusion, we prefer to call these highly geared conventional ITCs “pseudo-splits”.

In the buoyant markets of the late 1990s, it became fashionable to launch splits that had more complex capital structures, often with significant levels of bank debt and other devices, to make the shares appear attractive to investors. The income shares\(^9\) offered a high starting yield which would attract investors no longer able in a post-inflationary environment to find comparable high yields from fixed-income investments or bank/building society deposits. Some of these new splits invested in the high-yielding income shares of other splits (hence “cross-holdings”). Large fees were generated for fund management companies and broker/advisers to the splits.

The aggressive features of the wave of new ITCs were often combined with a thematic investment strategy in the so-called “barbell” trusts. Barbell trusts held two distinct portfolios of investments — a growth portfolio and an income portfolio. In pictorial form this asset structure can resemble 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 “growth” portfolio was typically invested in a sector or market that was popular at the time of issue (such as technology stocks). The “income” portfolio typically consisted of bonds (with varying degrees of risk — sometimes issued by companies in the same sector as those held in the growth portfolio, which added to the risk) and high yield ITC securities (including the income shares of other splits). The liabilities side of the balance sheet of a barbell trust tended to include a significant amount of bank debt. The share capital typically consisted of zeros\(^10\), ordinary income shares and in some cases other classes of share.

It was often 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.\(^11\) As a result, there was a general lack of understanding of the true risks involved. The risk created by geared splits investing in other geared splits appears to have been missed by directors, investors, their advisers and possibly even the inventors of the new splits themselves. Unfortunately, however, zeros in aggressively-structured splits, often ranking below large

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\(^9\) Henceforth, the term “income shares” is taken to mean income-bearing shares, including traditional income shares and ordinary income shares.

\(^10\) Although barbells launched before August 2000 rarely issued zeros at launch, they were sometimes introduced to the capital structure later in restructuring deals.

\(^11\) 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.
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 bank borrowings and 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 ITC 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. These two troubled ITCs were destined, however, to be only the first of many. As equity markets fell from the all-time highs they had reached in 1999 and 2000, many other highly geared trusts were starting to get into difficulties.

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 barbell trusts, bank debt and the so-called “magic circle” of split capital investment trust managers whose splits 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 disproportionately heavy management costs that were being borne by the equity shareholders of these trusts. It argued that there was an urgent need for the significant risks and unusually heavy expenses (to equity shareholders) 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 barbell trusts 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 distributed, European Technology & Income (which, as we have seen, had already been forced to restructure itself in November 2000) announced the suspension of the monthly dividend on its income shares. With the possible

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12 The term ‘equity shares’ in this context includes income-bearing shares and capital shares but not zeros.
exception of Framlington NetNet.Inc, this was the first time that a barbell had paid a lower dividend than indicated at launch. It came as a shock to the market. After that, a number of splits with cross-holdings suffered financial difficulties because most of their cross-holdings were in income shares. Managers of splits, the portfolios of which generally contained both quality stocks and lower quality illiquid shares in splits, often had to sell the former (which were more immediately realisable) to reduce gearing quickly, in accordance with the terms of the covenants on their bank borrowings, leaving them with a portfolio of much lower overall quality (and also much less liquid) than had originally been intended.

Faced by sharply deteriorating cover for their lending to splits, 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 one another’s newly issued paper, a short-term “fix” that served only to make the cross-holdings problem worse. The vast majority of new “income” securities were sold to other splits, or to other funds the managers of which also managed splits. Moreover, many of these transactions were carried out by stock swaps at mid-market prices. Given the illiquidity and very wide bid to offer spreads of these shares, mid-market prices were a purely theoretical value at which to transfer holdings and led in turn to calculations of cover and net asset value which were also purely theoretical.

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 income shares of other splits that cut their dividends were compelled to cut dividends on their own 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 splits 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 again it was to be only the first of many. Perhaps even more ominous was the announcement on 18 April 2002 of the controlled liquidation of Gartmore

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13 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).
Monthly Income. This would result in the first ever failure by an ITC to repay a zero in full on the
due date. Now the new highly-gearing splits were indeed starting to unravel. 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.\textsuperscript{14}

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 Treasury Select Committee then reported in February 2003 (HCTC, 2003) and
recommended bringing ITCs 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 6.3.

4. SURVEY OF INVESTMENT TRUST COMPANY DIRECTORS AND INVESTMENT
PROFESSIONALS

As part of our study of corporate governance and the UK split capital investment trust crisis, we
carried out in May 2005 a wide-ranging survey of investment trust company directors and
investment professionals on their attitudes to corporate governance in the wake of the crisis. The
questionnaire we used was formulated in consultation with industry experts.

In the light of the survey, and drawing on the views of trust directors and investment
professionals who added comments on specific issues from their own experience, we consider the
lessons of the splits crisis for the governance of ITCs in Section 5. Implications of the survey for
the regulatory response to the crisis are considered in Section 6.

4.1 Investment trust company directors

The AITC kindly sent out an e-mail to 623 member company directors inviting them to complete
our web-based questionnaire. Responses were received from 67 directors, a response rate of
10.8%. The directors who responded to our survey included both those who had been connected

with splits\textsuperscript{15} (43\%) and those who had not (57\%). The results of the survey are given in the appendix to this paper.

Cynics concerning the splits crisis might have expected ITC directors to minimise or even deny responsibility for the problem. Our survey found, however, that respondent directors did indeed attribute a considerable degree of responsibility for the splits crisis to the trusts’ Boards. In answer to the question: “\textit{How important were each of the following parties in creating the splits crisis?}”, the response average in respect of trust Boards was 3.31 within the range 5 (very important) to 1 (not important). This response was much less than that for trust managers (4.67)\textsuperscript{16} and broker/advisers to the trusts (4.33) but higher than that for all the other possible contributing parties we listed: Independent Financial Advisers (IFAs) (2.98), individuals who “failed to do their homework” (2.87), private client brokers/wealth managers (2.83), banks who lent money to the trusts (2.65) and the Press/media (2.33).

It is interesting here that trust directors were not keen to blame IFAs, private client brokers and individuals who “failed to do their homework”. One might perhaps have expected among trust directors a higher reliance on the doctrine of “caveat emptor” than we actually found. Furthermore, there was a weak level of apportionment of blame to the banks (who, some have argued, were on occasion over-eager to press loans on splits during the boom) and the Press/media, who are not normally popular. Looking around for external scapegoats does not seem to be a feature of trust directors’ reaction to the crisis, although they are inclined to put more of the blame on managers and on broker/advisers than they do on themselves.

Perhaps unsurprisingly, those trust directors who had not been connected with splits were more inclined to blame Boards (response average 3.89) than those directors who had been connected with splits (response average 2.55). The difference in response patterns between the two groups is significant at the 1\% level on applying the chi-squared test. Nevertheless, it is clear that in the minds of a significant proportion of respondents, trust Boards do have a case to answer and that there are lessons to be learned.

\textsuperscript{15} Other than as an investor.
4.2 Investment professionals

In addition to the above, 481 investment professionals active in a range of managerial, advisory and technical capacities in the trust industry, including contacts of the AITC and Centre for Financial Markets Research (University of Edinburgh), were invited to complete the questionnaire and 74 of them responded, a response rate of 15.4%. Respondents included both those who had been connected with splits (57%) and those who had not (43%). The results of this survey are also given in the appendix to this paper.

Responses to the question “How important were each of the following parties in creating the splits crisis”, are very similar to those for investment trust directors. In fact in each case the response patterns are not significantly different at the 5% level (chi-squared test). Not surprisingly, the response average of 3.85 for the importance of trust Boards was higher than the corresponding response from investment trust directors (3.31) but the response pattern is only significantly different at the 10% level.

There are significant differences between the response patterns from investment professionals compared to directors in respect of questions 2b), 2f), 3a), 3b), 3c) and 7. These differences are discussed below. However, applying the chi-squared test to responses within the investment professional group, there is no significant difference for any of the questions (at the 5% level) between those who have been connected with splits and those who have not.

5. LESSONS FOR THE GOVERNANCE OF INVESTMENT TRUST COMPANIES

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 ITCs? This is a matter of prime concern for trust Boards because, as a result of the close attention recently paid to ITCs by the FSA and the Treasury Committee, outside intervention will probably be inevitable if the trust industry shows itself not to have learned adequately from its past mistakes. Here the views of the trust directors themselves, as expressed in our survey, are of particular interest and relevance in studying the industry’s response to the crisis.

16 Applying the chi-squared test shows a difference in the response pattern of directors who had been connected with splits and those that had not, which is significant at the 5% level. The response average for
5.1 Technical expertise of directors

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 ITC of a new type there is no pool of shared experience and no chance of “learning on the job”. While there had been waves of new ITCs in former years, these had generally been straightforward conventional ITCs. 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 splits which themselves held the highly risky securities of other splits? Probably not, unless they were very seasoned (although, of course, 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 in what must have been an atmosphere of crisis. 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 shareholder with different claims on a shrinking pool of assets was more demanding than they could possibly have expected on appointment.

In our survey, 84% of director respondents and 51% of investment professional respondents said it was very important that “at least one independent director should have the technical expertise and market knowledge to appraise the types of investments that the trust holds and the suitability of its gearing level and capital structure.” (response averages 4.73 and 4.44 respectively).

5.2 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

the former is 4.41 and for the latter is 4.87.
initial marketing of the shares. Boards could then have questioned the trust’s managers and
advisers while there was still time to change the structural design of the ITC, 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 an
ITC might save much greater expense and loss of shareholder value at such a trust’s premature
winding-up.

This lesson has clearly not been lost on the directors who responded to our survey. The
suggestion that “directors (particularly the Chairman) should be appointed much earlier than
they are now and paid during the set-up period, so that they can influence the design of a trust”
elicted a response average of 4.18 — a notably positive figure, we consider, for what is a fairly
new proposal within the trust sector. Given, perhaps, that working with new directors at an earlier
stage would add notably to the workload of those involved in the creation of new ITCs, the
response pattern from investment professionals is significantly different (at the 1% level) and the
response average of 3.45 for this group is lower.

5.3 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 splits were launched; 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 shareholders, who in fact bear all the initial and annual costs. As was noted in “For
Whom the Barbell Tolls...” (Adams & Angus, 2001), “management fees are typically 1% of gross
assets per annum . . . [but] the holders of the ordinary share capital may be paying management
fees at the rate of 2% or 3% per annum of the assets actually attributable to them”. Furthermore,
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 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

17 The term “equity shares” includes income-bearing shares and capital shares, but not zeros.
managers and broker/advisers to boost initial fees by arranging a bank loan before the launch of a new ITC 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 other advisers.

The response average to the question “Fees should be based on gross assets (including assets financed by bank debt)” was 3.61 for directors and 3.19 for investment professionals, the lowest of the eight shown under Question 2 in each case and to us the biggest surprise of the survey. For each of the two groups, there was no significant difference (even at the 10% level) between the responses of those who had been connected with splits and those who had not. Perhaps it was unrealistic of us to expect that managers and other management group employees (e.g. Company Secretaries) would be keen on a reform which threatened their fee income. Our opinion, however, remains unchanged, that the charging of fees based on gross assets was important in causing the managers of the new splits to gear up the trusts too aggressively at the beginning and then to keep gearing in place for too long when things began to unravel.

5.4. Fair treatment of all shareholders

One of the most controversial issues in the splits crisis was whether zeros were fairly treated compared to income 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 ITC 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 Prospectus on dividend policy, to assist Boards in deciding on dividend distributions when, say, zeros are uncovered. It is no surprise, given the known difficulties some Boards faced in this respect that the need for clarity in such entitlements should gain a response average as high as 4.58 in our survey from directors. The response average for investment professionals is 4.21.

5.5 Clear information to shareholders

Shareholders should be given sufficient information for them to value and assess the risk of their

18 “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.
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 reporting requirements\textsuperscript{19}, 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. There was therefore an obvious and pressing need for improved portfolio disclosure, which again is borne out by our survey of directors (response average 4.06). The response pattern from investment professionals is not significantly different (at the 5% level) although the response average of 3.63 is lower.

5.6 Boards should be visibly independent of managers

Among private investors, naïveté sometimes goes hand in hand with extreme cynicism; indeed, everyone loves a conspiracy theory, and it can be possible to read a set of ITC accounts through the spectacles of \textit{The Da Vinci Code}. It is not surprising, therefore, that (once alerted) people can read far too much into apparent connections between directors and managers. This is regrettable, but it is a fact of life that trust directors and trust managers have to live with; and the response average of 4.49 revealed by our survey shows that trust directors are well aware of the potential difficulty. The response pattern from investment professionals is significantly different at the 1% level but the response average is still high at 4.07.

It is a simple precaution for a Board not only to be independent but also to be seen to be independent. Sometimes all this will require is a little extra information in the Directors’ Biographies section of the Prospectus and subsequently in the Report & Accounts, setting matters in context.

5.7 Setting clear limits on gearing

Gearing (borrowed funds as a percentage of shareholders’ funds) which looked manageable at the time of the launch of a new split sometimes rapidly became disastrously high as markets fell. This experience shows that what is needed is a system of warning signals. Since the total sum borrowed seldom changes, the best warning signal is the change in the percentage of shareholders’ funds that the borrowed funds represent (a suggested signal that elicited a response average of 4.42 from directors and 4.15 from investment professionals in our survey). If a Board of a split has decreed that gearing should never exceed, say, 100\% of shareholders’ funds, the

\textsuperscript{19} It seems 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.
managers (who will be monitoring gearing levels daily) can act immediately to prevent it from doing so in the knowledge that they are not acting precipitately but in accordance with the Board’s considered instructions. Such a system is fair to the managers and to the shareholders as well as to the Board. It is also fair to the lender(s), because it preserves the level of cover and can forestall breaches of covenants.

5.8 Limits on investment in other “funds of funds”

Few respondents to our survey believe that the effect of cross-holdings was not damaging for the splits sector during the crisis. However, it is vital that “funds of funds” should not be seen as bad things in themselves. A case can even be made for “funds of funds of funds”, where the aim is to increase the spread of risk. The trouble with the new splits, however, was that they sometimes became “funds of the same kind of funds of the same kind of funds” — in other words, not diversifying away risk and thereby reducing it, but concentrating it and gearing it up.

Part of the remedy for this is fuller and more helpful disclosure, so that shareholders can see what their ITC holds and find out quickly when this changes. However, even the best-informed shareholder might have found it difficult to understand what they would find at the bottom if they “looked through” an apparently well-diversified portfolio. Ultimately, it is the Board’s job to set down prudent limits, which are agreed with the managers, and then make sure that the limits are adhered to.

5.9 Other lessons perceived by respondents

We were conscious that our list of “main lessons” from the splits crisis for the governance of investment trusts could not be exhaustive. Indeed, one of the purposes of the questionnaire was to discover aspects of it that had so far been missed. The responses under “Other” showed a strong desire for Boards to be aware of their responsibilities and of the (sometimes harsh) facts of investment life and to translate this into firm action. Some of the responses from directors are given below:

“Boards should pay close attention to the terms on which the banks lend money.”

“Directors should be fully aware of the distribution process and ideally approve it. In other words, they should have full knowledge of how and who the product is sold to.”

“The extent to which they charged much of expenses to capital in order to prop up/increase the yield on the ordinary/income shares.”
“Companies formed offshore should not employ ‘rubber stamping’ professional directors (one of the directors of a Guernsey company was a director of 42 other companies; some Cayman companies have even worse examples with directors who are directors of maybe 100 companies).”

“Conflicts of interest between managers and shareholders are endemic.”

“Caveat emptor!”

Some of the responses from investment professionals are given below:

“The highly geared splits that fell into disarray did so fundamentally because they were promising the unattainable.”

“Complicated structures are dangerous.”

“The model portfolio should be included in the prospectus. Then people would know exactly what they’re buying and the Board should ensure that the actual portfolio is not very different.”

6. THE REGULATORY RESPONSE

The title “The Regulatory Response” is used loosely here. This section of our paper deals mainly with the response to the splits 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 ITCs 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.

6.1 Changes to the Listing Rules

The FSA published a consultation document (FSA, 2003a) 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 (FSA, 2003b) and were designed to ensure that the circumstances which led to the splits crisis could not recur. They were far more sensitive to the realities of running an ITC than many had
expected, and therefore far less intrusive and limiting than many had feared.

With effect from November 2003, investment companies (including investment trusts) are prohibited from investing more than 10% of gross assets in other investment companies, except where they have a stated investment policy to invest no more than 15% of their gross assets in other listed investment companies. In other words, one can have “funds of funds” but not “funds of funds of funds”.

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 COB 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. Such an approach does a disservice not only to the ITCs concerned but to the sector as a whole, and it is noteworthy that 72% of directors and 78% of investment professionals who responded to our survey agreed that this interpretation was too narrow and that disclosure of the market value of shares held in each class should be required.

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. This is because the trust’s NAV, capital structure, details of debt, and details of the underlying investment portfolio may be very different after launch from those in the Prospectus. Investors should not have to wait six to nine months until publication of the first Report to shareholders to learn this. In our survey, 90% of directors and 80% of investment professionals who responded agreed that the Listing Rules should require basic facts such as NAV, capital structure, details of debt and details of the underlying portfolio to be announced immediately after the launch of a new ITC.
In addition, the changes to the Listing Rules lay down additional criteria to ensure what is described as “enhanced director independence”. These rules were implemented later in April 2005. Perhaps unsurprisingly in the light of the splits crisis, these criteria relate chiefly to ensuring the separation of the interests of the investment company and the fund manager.

- **The Chairman of the Board of the investment company must be independent.**

- **Any director of an investment company who is also a director of another investment company managed by the same firm will not be regarded as “independent” for the purpose of fulfilling either the requirement that a majority of the Board be independent or the requirement that the Chairman be independent.**

- **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.**

### 6.2 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.²⁰ It provides trust 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/negotiating with the managers, and communicating with shareholders.

Most directors who responded to our survey feel very strongly that the AITC Code is helpful in respect of Board independence and monitoring/negotiating with the managers. Respondents seemed slightly less sure that the Code is helpful in respect of shareholder communications, but only 10% believe it to be unhelpful in this respect.

The majority of investment professionals also believe that the AITC Code is helpful but a much higher level of respondents are undecided in each case. This may simply reflect the fact that

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²⁰ 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”).
investment professionals have less reason than directors to study the Code in detail.

Board independence

The AITC Code is strong on Board independence: “The Chairman should be independent.”, ”A majority of the Board should be independent of the manager”, “The independent Directors should take the lead in the appointment of new Directors and the process should be disclosed in the annual report”, “Directors should be offered relevant training and induction”.

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 inquisitive and impartial 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. Furthermore, 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.

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 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 splits 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 many corporate governance commentators — 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’ optimistic 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. Perhaps they were kept in the dark by the managers. 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.

**Monitoring and negotiating with 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 in a constructive development the AITC has fleshed out these objectives in a newly-published paper produced for the guidance of non-executive directors (AITC, 2004). However, one respondent to our survey stated: “Too much formal reviewing of the manager will lead to greater management turnover . . . ‘Buy at the top, sell at the bottom’.”

**Communicating with shareholders**

The AITC Code is clear in its insistence that Boards should keep under review the company’s target audience, regularly asking itself the question, “For whom is the trust run?” This accords well with the following 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 contains recommendations which are aimed specifically at splits and which cover both the problem of high but semi-hidden expense ratios (Adams & Angus, 2001, 2002) and the difficulty of gauging the stability of splits’ structures. They include a sensitivity analysis showing the effect on the asset backing of each share class of a range 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.

**6.3 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 incompetent Boards of Directors before lawsuits became an option, or that Boards would have sacked 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 clearly favoured by both investment trust directors and investment professionals as demonstrated in our survey. The response pattern from the investment professionals is significantly different (at the 5% level) from that of the directors but nevertheless 65% of investment professionals who responded believe that ITCs should not come under direct FSA regulation with only 23% in favour. There is, however, one proposal which has been advanced by the AITC itself: an extension of the Financial Ombudsman Service to cover execution-only purchases on the stock market if the investor relied for information on a misleading promotion of a “wrapped product” even though the investor did not buy the “wrapped product” promoted. Our survey shows that, among those respondents who believe that investment trusts should not come under direct FSA regulation, some 63% of investment directors and 60% of investment professionals favour this proposal, with only 25% and 31% respectively against the idea.

Our views about this are ambivalent. On the one hand, a misleading promotion may not just mislead its readers about the “wrapped product” advertised. It may mislead them about the investment attributes of the underlying shares. On the other hand, to extend what is undoubtedly a proper responsibility for the product advertised to a wider responsibility for other actions people may decide to take after having read the advertisement could be a dangerous precedent to set, even though it is better than subjecting ITCs to direct regulation by the FSA. To agree that managers should not issue misleading advertisements, and that they should be punished if they do, is not to say that they should be held responsible for investors’ acting on the advertisements in ways that were never intended. As one of the investment professionals who completed our questionnaire stated: “Our promotions are designed so that respondents apply through a channel which will confer FOS protection; if respondents choose to ignore this channel and take the
It is certain, at any rate, that subjecting ITCs to direct regulation by the FSA would cause much upheaval and would be difficult to justify on a cost/benefit analysis. 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. Direct regulation 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 and would be interference with the relationship between Board and shareholders other than by the ordinary officers of the law. The investment trust industry as we know it would be destroyed, an industry which has served investors by and large extremely well for over a century. It would benefit no-one if the FSA’s approach to the trust industry were to be modelled on the celebrated phrase of Tacitus, “desertam faciunt, pacem appellant” (“they make a desert and they call it peace”).

7. 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. Managers, broker/advisers, Independent Financial Advisers (IFAs) and other parties involved failed to think through the possible implications of such a combination of high gearing and cross-holdings in other highly geared trust securities in market circumstances different from those in which the new splits were launched. Our survey confirms that directors themselves attribute part of the blame for the crisis to the splits’ Boards.

Our survey also shows that there is a very substantial — and, in many areas, overwhelming — degree of consensus among ITC directors and investment professionals about the way ahead for investment trust corporate governance. The main lessons from the splits crisis for the governance of ITCs are:

- At least one director should have the technical expertise and market knowledge to appraise the types of investments that an ITC holds and the suitability of its gearing level and capital structure.
• The entitlements of each class of capital, covering all eventualities, should be clearly laid down by the trust’s Articles and clearly spelt out in the Prospectus.

• The Board should be visibly independent of the managers.

• Clear initial limits for gearing should be set in percentage terms by the Board, and these percentages should be monitored when market movements cause significant changes in gross assets.

• There should be limits on the percentage of gross assets which can be invested in other funds, and particularly in funds which themselves invest significantly in other funds.

There was also support, particularly among directors, for the following conclusions:

• Directors (particularly the Chairman) should be appointed much earlier than they are now and paid during the set-up period, so that they can influence the design of an ITC.

• There is a need for clear information to shareholders about the portfolio shortly after a launch, and about changes to it on a regular basis.

Rather to our surprise and disappointment, there was least agreement about the desirability of not charging fees on gross assets (including assets financed by bank debt). We believe this to have been one of the major flaws in the “splits boom” of the later 1990s, leading managers to gear too aggressively and keep gearing in place too long.

The splits crisis is likely to have a permanent effect on corporate governance within the whole ITC industry through the new Listing Rules, AITC Code of Corporate Governance, and possible changes to be laid down by the Treasury. Nevertheless, 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. Furthermore, “the spirit gives life but the letter kills”. The greater the quantity of codes and regulations, the easier it is for directors and other investment practitioners to become not thinkers but box-tickers. Experienced and knowledgeable directors and an increased emphasis on education and training, together with full and prompt disclosure of relevant information at all times, are our best guards against a repetition of the splits crisis. 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.
References


### APPENDIX

CORPORATE GOVERNANCE AND THE SPLIT CAPITAL INVESTMENT TRUST CRISIS – SURVEY OF INVESTMENT TRUST DIRECTORS AND INVESTMENT PROFESSIONALS

1. How important were each of the following parties in creating the splits crisis?  
*Please rate from 5 to 1, where 5 is very important and 1 is not important, and N/A for Not applicable/No opinion.*

<table>
<thead>
<tr>
<th>Party</th>
<th>Investment Trust Directors (67)</th>
<th>Investment Professionals (74)</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Trust boards</td>
<td>3.31</td>
<td>3.85</td>
</tr>
<tr>
<td>b) Trust managers</td>
<td>4.67</td>
<td>4.50</td>
</tr>
<tr>
<td>c) Broker/advisers to the trusts</td>
<td>4.33</td>
<td>4.49</td>
</tr>
<tr>
<td>d) The press/media</td>
<td>2.33</td>
<td>2.37</td>
</tr>
<tr>
<td>e) Banks who lent money to the trusts</td>
<td>2.65</td>
<td>2.96</td>
</tr>
<tr>
<td>f) Independent Financial Advisers</td>
<td>2.98</td>
<td>2.82</td>
</tr>
<tr>
<td>g) Private client brokers/wealth managers</td>
<td>2.83</td>
<td>3.11</td>
</tr>
<tr>
<td>h) Individual investors who failed to “do their homework”</td>
<td>2.87</td>
<td>2.51</td>
</tr>
</tbody>
</table>
2. What do you think were the main lessons from the split capital investment trust crisis for the governance of investment trusts?

*Please rate from 5 to 1, where 5 is very important and 1 is not important, and N/A for Not applicable/No opinion.*

<table>
<thead>
<tr>
<th>Response</th>
<th>Average</th>
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<tbody>
<tr>
<td><strong>Investment Trust Directors</strong></td>
<td><strong>Investment Professionals</strong></td>
</tr>
<tr>
<td>(67)</td>
<td>(74)</td>
</tr>
<tr>
<td>a) At least one independent director should have the technical expertise and market knowledge to appraise the types of investments that the trust holds and the suitability of its gearing level and capital structure.</td>
<td>4.73</td>
</tr>
<tr>
<td>b) Directors (particularly the Chairman) should be appointed much earlier than they are now and paid during the set-up period, so that they can influence the design of a trust. (**)</td>
<td>4.18</td>
</tr>
<tr>
<td>c) Fees should not be based on gross assets (including assets financed by bank debt).</td>
<td>3.61</td>
</tr>
<tr>
<td>d) The entitlements of each class of capital, covering all eventualities, should be clearly laid down by the Articles and clearly spelt out in the Prospectus.</td>
<td>4.58</td>
</tr>
<tr>
<td>e) There is a need for clear information to shareholders about the portfolio shortly after launch, and about changes to it on a regular basis.</td>
<td>4.06</td>
</tr>
<tr>
<td>f) The Board should be visibly independent of the managers. (**)</td>
<td>4.49</td>
</tr>
<tr>
<td>g) Clear initial limits for gearing should be set in percentage terms by the Board, and these percentages should be monitored when market movements cause significant changes in the trust’s gross assets.</td>
<td>4.42</td>
</tr>
<tr>
<td>h) There should be limits in the percentage of a trust’s gross assets which can be invested in other funds, and particularly in the funds which themselves invest significantly in other funds.</td>
<td>4.16</td>
</tr>
<tr>
<td>i) Other (please specify):</td>
<td></td>
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</tbody>
</table>
3. Have you been associated in any way (other than as an investor) with split capital investment trusts?

<table>
<thead>
<tr>
<th></th>
<th>Investment Trust Directors</th>
<th>Investment Professionals</th>
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</thead>
<tbody>
<tr>
<td>Yes</td>
<td>43% (29)</td>
<td>57% (42)</td>
</tr>
<tr>
<td>No</td>
<td>57% (38)</td>
<td>43% (32)</td>
</tr>
</tbody>
</table>

4. The new Listing Rules require monthly disclosure of all investments in other trusts which hold 15% of their assets or more in other trusts. Several splits managers have interpreted this as only requiring disclosure of the name of the company in which the investment is held. Do you think that disclosure of the market value of shares held in each class should be required?

<table>
<thead>
<tr>
<th></th>
<th>Investment Trust Directors</th>
<th>Investment Professionals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>73% (49)</td>
<td>78% (58)</td>
</tr>
<tr>
<td>No</td>
<td>12% (8)</td>
<td>8% (6)</td>
</tr>
<tr>
<td>Undecided</td>
<td>15% (10)</td>
<td>14% (10)</td>
</tr>
</tbody>
</table>

5. Basic facts about a trust may be unknown after its launch. Do you think the Listing Rules should require basic facts such as NAV, capital structure, details of debt and details of the underlying portfolio to be announced immediately after a new trust launch?

<table>
<thead>
<tr>
<th></th>
<th>Investment Trust Directors</th>
<th>Investment Professionals</th>
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</thead>
<tbody>
<tr>
<td>Yes</td>
<td>90% (60)</td>
<td>80% (59)</td>
</tr>
<tr>
<td>No</td>
<td>1% (1)</td>
<td>8% (6)</td>
</tr>
<tr>
<td>Undecided</td>
<td>9% (6)</td>
<td>12% (9)</td>
</tr>
</tbody>
</table>
6. Do you believe that the AITC Code of Corporate Governance, published in January 2004 (and available via website www.aitc.co.uk/technical), is helpful in respect of:

<table>
<thead>
<tr>
<th></th>
<th>Investment Trust Directors</th>
<th>Investment Professionals</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board independence (</strong>)**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>96% (64)</td>
<td>69% (51)</td>
</tr>
<tr>
<td>No</td>
<td>1% (1)</td>
<td>8% (6)</td>
</tr>
<tr>
<td>Undecided</td>
<td>3% (2)</td>
<td>23% (17)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Monitoring and negotiating with the managers (</strong>)**</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>85% (57)</td>
<td>55% (41)</td>
</tr>
<tr>
<td>No</td>
<td>3% (2)</td>
<td>14% (10)</td>
</tr>
<tr>
<td>Undecided</td>
<td>12% (8)</td>
<td>31% (23)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Shareholder communications (*)</strong></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>70% (47)</td>
<td>54% (40)</td>
</tr>
<tr>
<td>No</td>
<td>10% (7)</td>
<td>7% (5)</td>
</tr>
<tr>
<td>Undecided</td>
<td>19% (13)</td>
<td>39% (29)</td>
</tr>
</tbody>
</table>

7. Do you think that investment trusts should come under direct FSA regulation? (*)

<table>
<thead>
<tr>
<th></th>
<th>Investment Trust Directors</th>
<th>Investment Professionals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>10% (7)</td>
<td>23% (17)</td>
</tr>
<tr>
<td>No</td>
<td>84% (56)</td>
<td>65% (48)</td>
</tr>
<tr>
<td>Undecided</td>
<td>6% (4)</td>
<td>12% (9)</td>
</tr>
</tbody>
</table>
8. If your answer to Question 7 is no, do you think that the Financial Ombudsman Service should be extended to cover execution-only purchases on the stock market if the investor relied for information upon a misleading promotion?

<table>
<thead>
<tr>
<th></th>
<th>Investment Trust Directors</th>
<th>Investment Professionals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>63% (35)</td>
<td>60% (29)</td>
</tr>
<tr>
<td>No</td>
<td>25% (14)</td>
<td>31% (15)</td>
</tr>
<tr>
<td>Undecided</td>
<td>13% (7)</td>
<td>8% (4)</td>
</tr>
</tbody>
</table>

Chi-squared test

* means significant difference in the response patterns between investment trust directors and investment professionals at the 5% level.

** means significant difference in the response patterns between investment trust directors and investment professionals at the 1% level.