CITY OF LONDON
Investment Group PLC

# January 2001 Statement on Corporate Governance and Voting Policy for Closed-End Funds

# Contents

# I. Introduction

## About this Update

*City of London still stands by these guiding principles and is pleased to see that they have been generally adopted as the minimum standards that Shareholders expect*

City of London first published its statement on corporate governance in Summer 1999 and in doing so helped set the trend for what at the time was best practice. In doing so it was merely publicising the set of standards that City of London believes are reasonable to expect of any well managed closed-end fund. Prior to publication City of London was discussing these privately with fund Boards and using them as an internal policy to guide its voting but felt that in order to have a more positive influence on the sector as a whole, greater publicity was required.

City of London still stands by these guiding principles and is pleased to see that they have been generally adopted as the minimum standards that shareholders expect. However, as the sector continues to develop, new governance issues arise and City of London continues to strive for continuing improvement in the sector. As such our policy statement has been updated to include these new issues.

These additions include suggested ways by which the flow of information between Funds, the Board and Shareholders can be improved, the concept of Boards having stated targets and the issues relating to ancillary services.

## About City of London

*City of London believes that a fund with poor corporate governance will generally trade at a wide discount*

City of London invests primarily in closed-end funds that themselves invest in emerging markets.

City of London believes that a fund with poor corporate governance will generally trade at a wide discount. For this reason the issue of the discount and its management is integral to City of London's approach to corporate governance.

This policy statement should be read and interpreted against this background.

## Emerging Markets Closed-End Funds

*This statement is addressed to Boards, Managers, Investors and the Professional community*

The closed-end fund industry is a global phenomenon. In addition to the traditional developed markets of the United States and the United Kingdom, many emerging stock markets and governments have encouraged the development of domestic closed-end fund industries. Thus, countries as diverse as Taiwan, the Czech Republic, Thailand and latterly Poland have active closed-end fund industries managed by local management companies.

This statement is therefore addressed to Boards, Managers, Investors and the Professional community and should be read recognising that the industry's state of development varies from country to country and that the applicability of some of the views expressed will vary accordingly.

## The Importance of Corporate Governance

*In closed-end funds, understanding the relationship between the Board, the Manager and Shareholders is fundamental to improving the return to Shareholders*

In closed-end funds, understanding the relationship between the Board, the Manager and Shareholders is fundamental to improving the return to Shareholders. This statement of corporate governance policy is prepared from the Shareholder perspective; however, it is in Managers' best interests to promote the long-term survival of the closed-end fund industry and for this, such best practice is vital. It is hoped this document will promote comment and discussion. It is City of London's intention that, as with all good investment strategies, it will evolve and develop as the industry changes and the corporate governance debate in general moves on.

In our first policy statement we observed that the future of the closed-end fund industry had been questioned once more as discounts drifted wider. Since then we have seen investors respond and apply greater pressure on Boards to act in the best interests of their Shareholders in keeping with good corporate governance. Funds with unresponsive Boards have been aggressively targeted and funds with proactive Boards have been rewarded with shareholders, including City of London, supporting their initiatives.

City of London accordingly invites the views of Boards, Managers, Investors and the Professional community involved in closed-end funds.

## Underlying Concepts and Policy

*City of London believes that good corporate governance encourages a more accountable and focused Board*

Corporate governance is, as is implicit from the term, the manner by which the control and direction of a corporation is determined and the relations between the relevant parties–the Board, the Shareholders and the Management–are safeguarded. In Shareholder terms, this means delivering long-term financial returns versus some measurable benchmark.

City of London believes that good corporate governance encourages a more accountable and focused Board which, in turn, leads to increased Shareholder value and aids the performance of the shares relative to their underlying net asset value–i.e. narrows and keeps narrow the discount.

City of London is, prima facie, a passive investor. Involvement in corporate governance issues is generally limited to those Funds where City of London perceives there is potential for either a tangible financial benefit to, or cost for, Shareholders. Indeed, City of London would generally support a Board that attempts to 'do the right thing'.

Within City of London, decision making on corporate governance issues, in the broader sense, is a collective process involving both the Investment Management and Corporate Governance Teams. Exceptions to a policy or changes to a decision are always considered on a case by case basis by both Teams.

## The Importance of Voting

*City of London values its vote as an asset and as such will normally exercise its right to vote*

City of London values its vote as an asset and as such will normally exercise its right to vote; if City of London does not vote, then it will generally be as a result of a conscious decision. In keeping with City of London's passive nature, the starting point for its voting policy is to vote 'For' Board proposals. But, in the absence of reasons to the contrary, City of London will generally vote 'Against' proposals contrary to the tenets and beliefs set out below.

City of London will, however, review each Board/Fund proposal/resolution individually, on its merits. Further, City of London will consider approaches from Boards and their advisors suggesting reasons why it should deviate from its normal voting policy. If City of London decides to vote 'Against' Board proposals this will generally be communicated to the Chairman, or Senior Independent Director, of the Fund in advance of the meeting stating the reasons behind the decision.

A shareholder's vote is his voice. It is one of the few times during the year that a shareholder is able to make his views known in a formal setting. City of London does not believe in 'voting with its feet', and merely selling the shares of funds that have unresponsive Boards. City of London believes it is more desirable to work with Boards and Managers to improve shareholder value, and exercises its vote accordingly.

# II. The Board

## 1. Role of the Board

### Physical safeguarding

*Principal Responsibility– To ensure assets are safeguarded both physically and financially*

City of London is aware that it is normal for the Board to 'contract out' the physical safeguarding to a recognised global custodian and believes that problems in this area are relatively rare. Problems that do occur are usually a result of direct fraud or malpractice.

### Financial safeguarding

In reality, this is the main area of concern for the Board.

The Board's primary role is to ensure that the Manager operates within the Fund's investment remit and that Shareholders receive the rewards engendered by the Manager's efforts. Consistent failure in either of these areas leaves the Board with the ultimate two options: the removal of the Manager; or the liquidation of the Fund. Consistent failure in either of these areas leaves the Board with the ultimate two options: the removal of the Manager; or the liquidation of the Fund.

## 2. Composition of the Board

### 2.1 Structure

*City of London believes that the entire Board should be truly independent of the Manager*

The position is sometimes advanced that the experience, knowledge and expertise brought to the Boardroom by parties related to the Manager are invaluable. City of London believes this argument is flawed. A representative from the Manager should routinely be invited to attend Board meetings, but not have the automatic right to attend or vote. The representative from the Manager should be senior within the management company, but not be responsible for the day to day management of the Fund's assets. This allows the Board to communicate more fully and productively with the Manager as there can be less of a confrontational/personal nature to criticism levelled directly at the management team.

One should remember that the Manager is, after all, employed by the Fund, and as such, is answerable to the officers of the Fund–the Directors. There are certain times when Board discussions should not be known to the Manager, e.g. when performance or remuneration is being debated and the Manager's position is in doubt.

## 2.2 Period of Tenure

*A Director should serve no longer than three years without there being a vote by Shareholders for his re-election*

Shareholders must have the opportunity to express their discontent with the performance of a Director or the Board as a whole. Shareholders should have the ability to vote to remove a director without having to run a competing candidate in opposition.

Assuming a three year tenure, one would expect that there would be at least one Director seeking re-election every year. If a Director serves more than three terms then his views may have become entrenched. The regular addition of new Board members encourages both the development of fresh ideas and the regular questioning of existing opinions.

## 2.3 Age/Experience

*Directors must be capable of performing their duties, having regard to such issues as health, time commitments and awareness of relevant issues. Spurious restrictions should not interfere with Shareholders' free choice of representative*

Directors should not start a new term in office beyond the age of 67 or if they have been retired from active employment for more than 5 years, whichever is the earlier. Nor should any spurious restrictions or qualifications be imposed limiting who can be a director.

As a general rule, City of London believes that the skills and contribution of a Director outside this criteria may be too far removed from current business practices or thinking to allow them to truly add value to the Board over the long term.

The value of democracy is in allowing shareholders to freely elect whoever they wish to represent them. It is shareholders' interests at stake, they are unlikely to appoint someone who does not have the requisite skills. Shareholders do not need protecting from themselves and are sufficiently sophisticated to make such judgements themselves.

## 2.4 Remuneration

*The method of remuneration of Directors must ensure that their interests are allied to those of Shareholders*

City of London believes the best way of achieving this is by remunerating Directors in shares. Either through shares purchased in the market or by issuing new shares at the higher of net asset value per share or the prevailing mid-market price. At the very least, stock should comprise half of a Director's remuneration.

This has the virtue of encouraging Directors to be conscious of the discount. It also ensures that a Director's personal financial circumstances are directly linked to the long-term success of the Fund.

City of London believes that, if the above policy is applied, it would generally be inappropriate for a Director to dispose of such shareholding whilst a Director. However, City of London acknowledges that a Director's personal circumstances may occasion the need for a disposal.

Needless to say, Directors should not receive fees, either directly or through another entity, for any other business that they might perform to the benefit of the Fund, or fund management group.

## 3. Definition of Independent

*City of London believes that current or former Directors, current or former senior employees or relatives of the Manager are not independent*

The independence of the Board and individual Directors is a crucial requirement for providing effective corporate governance in a closed-end fund. Independence has many differing, and often opposing, definitions. However, consensus generally emerges on when a Director is not independent. For a Director to have the trust and support of Shareholders he must not only be independent, but must also be seen to be independent. Shareholders often have to vote on a Director's election never having met the individual and on the basis of a very brief biography.

*For a Director to have the trust and support of Shareholders he must not only be independent but must also be seen to be independent*

In the absence of evidence to the contrary, City of London's initial premise is that a Director is independent. However, City of London believes that any Director who falls within one of the following categories is not independent:

- current employees of the Manager, or a relative of such a person;
- former employees of the Manager (within the previous 5 years), or a relative of such a person;
- individuals with an on-going financial link to the Manager;
- representatives of a Shareholder with a significant holding in the Fund;
- individuals currently or previously associated with a firm which provides, or has provided within the past five years, professional services to the Fund or the fund management group;
- individuals who sit on more than one Fund Board managed by the same fund management group; or
- individuals with cross-directorships with executives of the Fund, or similar arrangements.

City of London holds the view that a Director should hold a maximum of 3-4 Board positions if in full-time employment, and 5-6 if retired.

It is also expected that any person appointed to a Fund Board will have been selected by a committee of other independent, non-executive directors.

City of London will consider exceptions to its policy on a case by case basis.

# III. The Board and Shareholders

*Good Shareholder/Board communication leads to effective control and direction of the Fund*

*An independent point of contact, preferably the Chairman, should be clearly identified as the principle point of contact for Shareholders*

*General Shareholder meetings are the formal opportunity for all parties to communicate issues. Whilst all legal obligations must be satisfied, good practice dictates certain other obligations*

## 1. Communication with Shareholders

### 1.1 Contact with the Board

He must be readily contactable and the Manager should not act as an obstructive sentry to Shareholders wishing to contact him. He must be available to deal with Shareholder requests and be a conduit for Shareholders' views. In addition, he should give a prompt, reasoned response to Shareholders' questions.

### 1.2 Shareholder Meetings

#### Before the Meeting

The Annual General Meeting should be publicised well in advance. The finalised agenda should be circulated prior to the meeting, including a detailed description of the motions to allow Shareholders to cast an informed vote. Consideration should be given to the practicalities of the slow and inefficient distribution of materials by custodians. While the Board will no doubt be advised as to an appropriate timetable, they must take responsibility for the final decision. Similarly, while they might delegate various duties to third parties (such as the distribution of proxy materials) they cannot eschew their responsibility of ensuring their satisfactory performance.

Suitable procedures must be in place to allow Shareholders to vote in person or by proxy. The use of votes cast by third parties in the absence of shareholder instructions (eg. Broker votes, as occurs in the US) is a questionable practice. Boards should not allow such votes to thwart the intent of the mass of shareholders who are interested enough in their investment to register their vote.

If a meeting is to be adjourned, as much notice as possible should be given and the reconvened meeting should be well publicised.

#### At the Meeting

The agenda should be strictly adhered to.

City of London will not permit its proxy to be used to approve motions raised under 'Any Other Business' as Shareholders are not given time to make considered judgements.

The Board should announce the results of the shareholder vote. This should disclose the number of votes cast 'For', 'Against' and 'Abstentions'. Most jurisdictions manage to do this at the shareholder meeting but there are certain noticeable exceptions. There is no valid reason why this should not be possible.

**After the Meeting**

A public announcement should be made as soon as possible after the meeting declaring the results and disclosing the voting pattern. The most efficient distribution media for this is via the newswires and recognised news services.

Where Shareholders have voted approving a motion, the Board should take steps, and be seen to take steps, to implement their wishes.

## 1.3 General Communication

Boards must take responsibility for ensuring that major Shareholders automatically receive all annual and interim reports and copies of other major announcements directly.

As an observation, City of London suggests that, particularly when a Fund stands at a significant discount, Boards contact major Shareholders at the time general meetings are announced, whatever is on the agenda.

Recent regulatory developments (such as Regulation FD in the US) should promote the free flow of information between parties and should not be used as an excuse for avoiding discussion.

In most jurisdictions the Board are required to notify Shareholders and the market of significant events, such as when a company repurchases its own shares. However, the US only require notification to the regulators. This is unacceptable; timely, market disclosure of all relevant facts (e.g. number of shares repurchased, when and price paid, as well as the accretion to NAV) is necessary for evidencing the transparent nature of Board actions.

## 1.4 Directors Responsibility

*Directors have a legal obligation to look after the interests of all Shareholders. However, the Board can only be expected to act as directed by shareholders*

This tenet is central to the role of the Board and must underpin all their decisions and actions. If Shareholders do not vote they cannot complain when their views are not taken into account. Similarly, it is contrary to the principles of democracy if the views of Shareholders who do vote are obstructed by the apathy of the silent Shareholders. It is analogous to the winner of an election not being allowed to take up their post because a large number of the population did not vote.

## 2. The Board/Shareholder Contract

*A Board in promoting a new Fund enters a contract with Shareholders*

A Board in promoting a new Fund enters a contract with Shareholders, the terms of which are both explicitly stated in the prospectus and implied through asking Shareholders to acquire shares at net asset value. Shareholders are entitled to hold Boards responsible and accountable for these commitments.

### 2.1 Awareness of the Discount–an implied term

*A Board's disregard of the emergence of a persistent discount is a breach of the implicit contract with Shareholders*

When a Fund is launched a Board implicitly promises Shareholders that net asset value is a fair market price for the shares. A Board is therefore under an obligation to monitor the Fund's discount, particularly if it persists for a "substantial period of time". A failure by a Board to address the emergence of a persistent discount is a breach of the implicit Board/Shareholder contract.

### 2.2 Rights Offerings and Issues

*Further share issues at a discount to net asset value not only dilute Shareholder value but compound the breach of the Board/Shareholder contract*

Rights issues and the like, other than in exceptional circumstances, should not be made at a discount to net asset value. To do otherwise dilutes the net asset value to the detriment of existing Shareholders, particularly those who are unable to take up their entitlement.

### 2.3 Pre-emption Rights

*City of London believes that there is rarely a need for the Board of a Fund to have 'authorised but unissued shares' that it can issue to parties other than existing Shareholders in proportion to their existing holding*

New share issues, other than pro rata to Shareholders, are dilutive in effect and are potentially harmful to Shareholder interests. Therefore, Shareholders must always have the ability to take up any fresh issue of shares or be given the opportunity to make an informed decision as to why it is in their interests not to subscribe.

City of London will routinely vote against any resolution that gives a Board the power to allot new shares, other than to Shareholders pro rata to their existing holding, unless the resolution expressly states that such issues cannot be at a price less than the net asset value per share.

## 2.4 Prospectus Commitments

*The Board must honour statements and commitments, however non-specific, made in their name*

Many Fund prospectuses and annual reports contain statements by Boards that "if shares of the Fund's stock trade at a substantial discount from the Fund's then current net asset value for a substantial period of time, the Fund's Board of Directors will consider taking such actions as may seem appropriate to eliminate or reduce the discount." Such policy statements are generally discretionary to the Board.

Boards owe an obligation to Shareholders to explain what is meant by both "substantial discount" and "substantial period of time". A Board may retain discretion, however the credibility of any Board is irretrievably linked to how it exercises that discretion. Board credibility is enhanced by highlighting its view of the meaning of vague statements as by so doing it demonstrates its independence from the Manager.

## 3. Measurable Targets

*When a Board embarks on a particular course of action it should clearly define in a quantitative manner what the objective is and how this success should be measured*

In the same way as a Manager's performance is measured against a benchmark, it is desirable for Shareholders to have a quantifiable standard against which to measure a Board. This is especially true when Boards are seeking specific permission from Shareholders for a course of action.

By stating what their intention is, it allows a Board to manage Shareholders expectations. Contrary to intuitive logic, stating its objective can also help a Board to achieve their goal, e.g. City of London's experience shows that when a Board states it will aggressively buy back shares if the discount is greater than 15%, it is frequently found that the discount will narrow to around 15% without the Board having to purchase a share.

# IV. The Board and the Manager

## 1. The Board's Relationship with the Manager

*The Board has an obligation to oversee and monitor the Manager*

The independence of the Board allows them to take an objective view as to issues concerning the Manager. Regular meetings between the two parties should provide an opportunity to review the performance and activities of the Manager. The Manager should furnish the Board with sufficiently detailed and accurate information to allow the Board to fulfil its duties. A Board who questions and challenges the Manager on occasion, is likely to focus the mind of the Manager to the benefit of Shareholder value.

City of London believes that best practice would involve the Board reviewing the Manager's internal compliance procedures and the financial controls in place within the Manager and Custodian. It is, after all, the Board's responsibility to ensure that the Fund's assets are safeguarded, particularly with respect to areas such as stockbroking relationships and settlement issues.

## 2. Investment Policy

*It is the Board's duty to ensure the Manager adheres to the stated investment policy and that a relevant benchmark is provided to gauge the performance of the Manager*

Compliance with the Fund's stated investment objectives and restrictions is to be expected from the Manager. It is the Board's obligation to ensure that Shareholder assets are not abused by investment outside those criteria.

In order to facilitate a meaningful measure of the Manager's performance it is imperative that an appropriate benchmark is chosen. This becomes of particular concern when the Manager is to be paid a performance related fee. The Board should periodically review the continuing relevance of the chosen benchmark.

The Board should be responsive to the wishes of the Shareholders as to the amendment of the investment remit and benchmark index in response to changes as the markets evolve.

## 3. Ancillary Services

*The Board must exercise equal care when employing the services of support functions such as the company secretariat, proxy solicitation agents or fund administration*

### 3.1 Value and Quality

*The Fund should receive good value in terms of both quality of service and price*

When support services are provided by subsidiaries of the Manager the issues are especially acute. It should not be viewed as a way that the Manager can supplement their management fee.

The Board should exercise prudence and monitor all expenses against the quotes received, as it is all too easy for the total expense ratio to rise above an acceptable level. Good practice requires that periodically the Board should seek competing tenders for auditors and lawyers to ensure that the Fund is not being disadvantaged.

### 3.2 Control and Supervision

*It is advisable for the Board to implement a process by which it can monitor, and demonstrate its control over, the services provided to the Fund*

A recent global trend that can be applied to closed-end funds has been to require directors of companies to be able to demonstrate the fulfilment of their duties. The UK regulators have issued CP35 (Senior Management Arrangements, Systems & Controls) and various follow up papers to develop this point.

This principle can equally be applied to closed-end fund Boards. One example of where it could be applied is ensuring that the company secretary is making the necessary regulatory disclosures. Similarly, Boards should be able to demonstrate management control over proxy solicitation agents, who are there to aid and facilitate shareholder voting but all too often act as an obstruction to the two way flow of information between Boards and Shareholders. Boards should also be able to demonstrate that appropriate action is being taken with respect to the voting of securities and collection of dividends due to the fund.

# V. The Fund and the Manager

## 1. The Manager's Tenure

*The management contract should be terminable on no more than 12 months notice*

A management contract longer than 12 months is unreasonably onerous on Shareholders in the event of termination.

When a new Fund is launched, City of London will be receptive to the needs of the Manager for some degree of security of tenure to compensate for the heavier workload and expense in the early years of a Fund's life. As a general rule, City of London believes it is appropriate for a Manager to have no more than two years security of tenure at the launch of a new Fund or fundamental restructuring of an existing Fund.

## 2. The Manager's Remuneration

*The remuneration should be reasonable given the nature of the Fund*

The level of compensation payable to the Manager must be appropriate for the particular type of Fund. It is to be generally assumed that a lower level of remuneration would be payable for a passive, index tracking fund than for an actively managed fund with a high level of complexity. The Board should also be conscious of the potential economies of scale for a Manager as a Fund grows in tandem with the market and ensure that the benefits of such economies are shared with Shareholders.

Where a performance fee is payable, the hurdle level should be set high enough to encourage genuine outperformance, attributable to the Manager, against both a peer group and a market benchmark. Managers should not be incentivised–and therefore rewarded–for achieving what is to be expected from an average investment manager with reasonable skill and diligence. A high watermark should also be in place so that a period of good performance subsequent to a period of under-performance is not rewarded.

## 3. The Name of the Fund

*The association of the Manager with the Fund through the use of the Manager's name implies a degree of 'ownership' of the Fund which is not in Shareholders long term interests*

By naming a Fund after a Manager, City of London believes that all parties–the Board, the Manager and Shareholders–can lose sight of for whose benefit the Fund exists and is managed.

The argument is sometimes advanced that attaching the Manager's name gives a marketing edge which helps avoid discounts developing and imposes a moral obligation on a Manager to address issues of poor performance which may reflect badly on the Manager's other Funds.

The evidence, in City of London's view, does not support either contention.

## 4. The Manager's Personnel

*Changes to senior personnel directly involved with the management of a Fund should be regarded as price sensitive information and released to Shareholders forthwith*

Many Funds become associated, in Shareholder eyes, with a particular individual(s) within the Manager. Such association will often prompt Shareholder investment decisions. City of London regards the timely public dissemination of information concerning such individuals and their involvement with the Fund and/or the Manager as a paramount obligation of both the Board and the Manager.

City of London recognises, but does not endorse, that certain Funds become associated with individuals. In the event that such individuals cease to be involved with the management of the Fund, the Board should formally review the appropriateness of the prevailing management arrangements for the Fund.

## 5. Cross Shareholdings

*The Manager should limit cross investment by Funds under his control*

If there is to be any investment into a Fund by another fund under the control of the same Manager, it should be limited to 5% of a Fund's voting equity. Further, the rights of the investing Fund as a Shareholder should not be used to prejudice other Shareholders. Therefore a Fund's Board should consider restricting the voting rights of the Manager in their capacity as a Shareholder. Additionally, care should be taken to ensure there is no double charging of fees by management.

# VI. Conclusion

City of London's views upon the key issues of:

the need for Board independence

and

the primacy of shareholder value

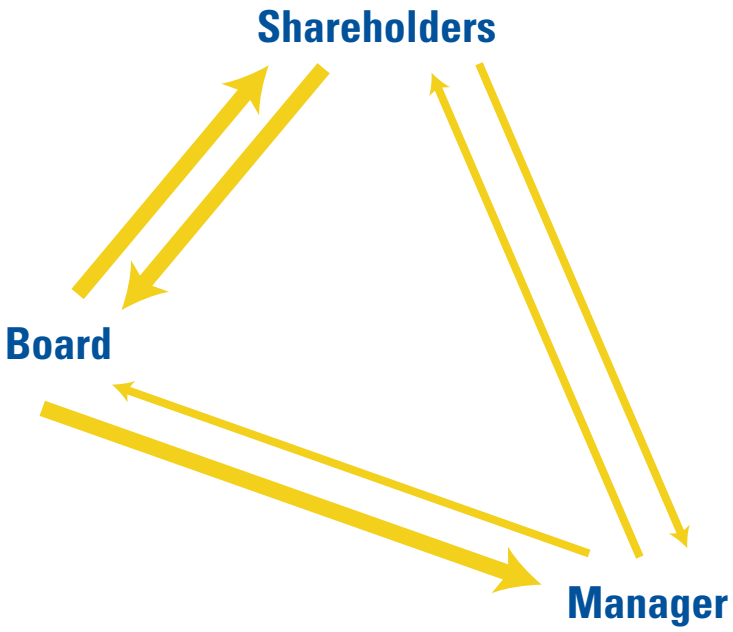
are best illustrated by concept of the "Eternal Triangle"– a partnership between Shareholders, the Board and the Manager.

## Ideal Relationship

### The Eternal Triangle – 1

Such an approach:

- Reinforces Shareholder ownership of the Fund
- Emphasises the need for Board Independence
- Focuses on the Board as quasi-trustee
- Distances the Manager from corporate control



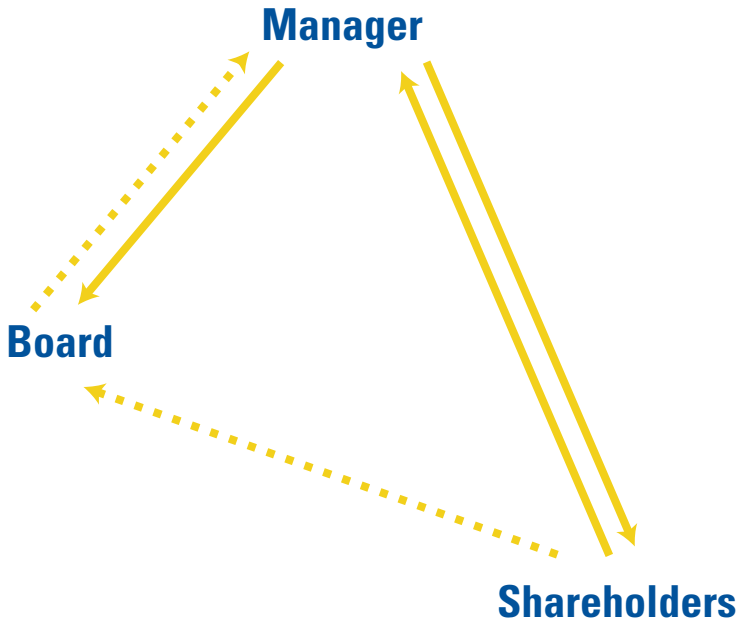
Too often Funds exhibit features of poor Corporate Governance, best illustrated by:

## Historic Relationship

### The Eternal Triangle – 2

Such features include:

- Manager ownership of the Fund implied
- Manager's name often prefixes Fund
- Manager's representatives are generally on the Board
- Manager's representative is generally Chairman
- Manager implicitly controls the future of the Fund



CITY OF LONDON
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## Important Notice




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