CITY OF LONDON
Investment Group PLC

# 2003 Statement on Corporate Governance and Voting Policy for Closed-End Funds

# Contents

# I. Introduction

## 1. About this Update

*City of London stands by these guiding principles and is pleased to see that corporate governance issues are receiving renewed focus and attention.*

This statement is the fourth annual update to City of London's Statement on Corporate Governance and Voting Policy for Closed-End Funds. Since the first statement was published in 1999 there have been a number of important developments within the closed-end fund industry. Most prominent among these events have been the recent corporate governance scandals in the US as well as the split-capital trust problems in the UK. These events have put Shareholders rights and corporate governance in the spotlight, and have triggered many corporate governance initiatives including significant legislative and regulatory activity in the US. Financial Services Authority (FSA), the UK regulatory authority has also accelerated the process to set new legislation on the matter.

On July 31, 2002, the US Congress approved into law the Sarbanes-Oxley Act of 2002, which contains far-reaching reforms in the corporate governance and disclosure rules applicable to public companies. A number of the Act's provisions became effective immediately, while other provisions will be implemented over the course of the next twelve months through rulemaking by the SEC, stock exchanges, Nasdaq and other regulatory bodies. The Act is a significant component of a broad series of corporate governance and disclosure reforms.

The SEC has also adopted a new rule and rule amendments under the Investment Advisers Act of 1940 that address an investment adviser's fiduciary obligation to its clients when the adviser has authority to vote their proxies. The new rule requires an investment adviser to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, and to make available to clients information about how their proxies are voted.

In the UK, whilst the conventional fund sector did not suffer from similar problems to split-capital trusts, the FSA announced a number of proposed amendments to the Listings Rules governing Investment Companies. These include rules on the independence of Boards, a limit on the percentage of assets invested in other Funds and annual reviews of investment management contracts. Whilst the proposals are not final, City of London has responded to try and ensure that any changes that take place are for the benefit of Shareholders. Annex 1 on pages 16 and 17 of this report, shows a comparative synthesis of the AITC (Association of Investment Trust Companies) and FSA views on corporate governance issues, and City of London's position regarding the proposed amendments to the Listing Rules governing Investment Companies.

City of London welcomes the initiatives put forward by the SEC regarding voting and holding disclosures in addition to the FSA initiatives separating the Investment Manager from effective ownership of the investment management contract. We believe that these measures will contribute transparency to the Closed-End Fund industry. We also believe that a clear definition of independence of a Fund's Board Members from its Management Company, a key element in the search for transparency, still has not been fully addressed by the regulatory authorities. City of London's view is that in order to properly serve Shareholder's best interests, a Fund's Board should be fully independent from the Fund's Manager. Any management

representation on a Fund's Board can only dilute the effectiveness of the Board decision making process when considering many sensitive matters, for example investment performance and the management contract.

The implications for corporate governance as a result of these developments are expected to be significant. Honest, transparent, accountable and independent Boards will continue to be rewarded; non-independent Boards that do not respond to Shareholder concerns may attract greater (uninvited) attention from arbitrageurs as well as traditional institutional fund investors. In our opinion, in the UK managers that use group or affiliate votes to frustrate the wishes of independent Shareholders will come under increasing public pressure to refrain from such practices. Similarly, we expect the same public pressure to be applied to Boards in the US that make an inappropriate use of the Broker non-vote.

In this update to the Corporate Governance Statement we have added a number of new points and best practice targets for Boards of Directors and Managers. The most important addition to this update is the introduction of the Management Engagement Committee. It is our belief that the creation of this committee at Board level will bring closed-end funds into the 21st century in terms of Manager accountability and will reverse the feeling of entrapment felt by many institutional and retail investors.

Regarding City of London Ranking System, the importance of recent events and City of London's participation in the development of new corporate governance initiatives in the UK have caused its completion to be delayed. This project encompasses the universe of closed-end funds that we monitor and invest in. Boards of Directors will be ranked according to their commitment to and handling of corporate governance issues.

In light of the development of new and, in some cases diverging, corporate governance initiatives in the US and in the UK, City of London will perform an in-depth re-evaluation of this document in order to give specific consideration to securities listed in countries where different corporate rules apply. Examples of different approaches to corporate governance issues in the US and the UK include the concept of independence of Board members, the voting process and the use of Broker non-vote.

City of London will continue to stress the importance of corporate governance to Boards of Directors who refuse to adopt what we believe to be best practice in the closed-end fund sector. It continues to be demonstrated that poor corporate governance results in Fund price underperformance via the widening of the discount to Net Asset Value. We believe adoption of these standards will result in a better-supported and ultimately larger closed-end fund industry with greater global respect and support.

## 2. 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.

## 3. 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 and China 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.

## 4. 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. Because City of London does not generally seek a direct role in Fund affairs, the starting point for its voting policy is to vote 'For' Board proposals. That said, City of London will nevertheless generally vote 'Against' proposals that conflict with 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 we should deviate from our normal voting policy.

A shareholder's vote is his voice. It is one of the few times of 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 uses shareholder voting rights accordingly.

## 5. 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, best practice in corporate governance 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.

## 6. 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 does not, as a general matter, proactively involve itself in the governance of Funds in which its clients are invested. Involvement in corporate governance issues is generally limited to those situations in which City of London perceives there to be the 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 the Investment Management Teams in City of London's three offices. Exceptions to a policy or changes to a decision are always considered on a case by case basis with a collegiate approach.

# II. The Board

## 1. Role of the Board

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

### Physical Safeguarding

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 two principal options: the removal of the Manager; or the liquidation of the Fund.

## 2. Composition of the Board

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

### 2.1 Structure

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. 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's 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.

*A Director should serve no longer than three years without there being a vote by Shareholders for his re-election. A Director should serve for no longer than three full terms subsequent to his initial election.*

### 2.2 Period of Tenure

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.

*As a general rule, Directors should not start a new term in office beyond the age of 70 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.*

### 2.3 Age/Experience

As a general rule, City of London believes that the skills and contribution of a Director outside this criterion 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.

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

### 2.4 Remuneration

City of London believes the best way of achieving this is by remunerating Directors, to the extent permitted by applicable law, 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.

*City of London believes that current or former Directors, officers and other personnel of the Manager or its affiliates, and their relatives, are not independent.*

## 3. Definition of Independence

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.

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 directors, officers and other personnel of the Manager or its affiliates, and their relatives;
- Former directors, officers and other personnel of the Manager or its affiliates (within the previous 5 years);
- Individuals with an on-going financial link to the Manager or its affiliates or the Fund;
- Representatives of a Shareholder with a significant holding in the Fund;
- Any individual currently or previously associated with a firm that currently has, or has during the past five years has had a material business or other financial relationship with services to the Fund, the Manager or an affiliate of the Manager group that was material to the individual;
- Individuals whose independence may be compromised by service on multiple Boards of funds with the same Manager or its affiliates. In our view, such a Director has a potential conflict of interests arising from his relationship with the Manager and, as stated above, conflicts of interest pose a threat to the Board's role of ensuring that the best interest of shareholders is pursued. In fact, by being an appointed Director by the Manager to several funds, this person gets a stipend per fund that, when accumulated, ends up being a potentially significant source of income. With this in mind such a Director could be, not necessarily but possibly, inclined to vote in favour of the Manager's interests, even if they were against the best interests of shareholders; or
- Individuals with cross-directorships with executives of the Fund, the Manager or Manager affiliates, 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.

## 4. Ranking of Boards of Directors

City of London is developing a Ranking System to rank the Boards of Directors in the universe of closed-end funds that we monitor and invest in. In the Ranking System, City of London will review a number of issues, which it is believed are relevant for good Corporate Governance as it relates to closed-end funds. Boards of Directors will be assessed according to their handling of these issues.

City of London's Statement on Corporate Governance and Voting Policy will form the basis of the review. The approach will be to start with the Prospectus or Offering Memorandum of a Fund, analyse what commitments were contained within it and consider the extent to which the Directors have kept to these commitments. City of London will also look at the history of the Fund and review the extent to which errors or omissions have been made with respect to such things as errors in the Fund's execution of our recommended practices such as daily calculation of NAV or the use of a benchmark (as discussed below).

Another area of Corporate Governance that City of London will address in the Ranking System is the extent to which Directors communicate effectively with Shareholders, after all, they are representatives of the Shareholders and not Management.

In our opinion, the Manager (or another employee of the Manager) should not become involved in Corporate Governance issues; this is the sole responsibility of the Board. City of London have encountered situations where, for example, the Chief Executive Officer of the Manager has taken on responsibility for issues that the Chairman of the closed-end fund is responsible. Invariably this level of involvement by the Investment Manager leads to the appearance of conflicts of interest and is presumably demotivating for the Chairman of the Board, who effectively becomes a mouthpiece of the Chief Executive Officer.

Standards of Corporate Governance vary enormously across the various markets in which City of London invests. Careful consideration will be given to the strengths and weaknesses of each of these markets. For example, in the US, City of London will review the use of the "Broker Non Vote" when it is used in a manner contrary to what we believe to be the best interests of Shareholders. In the UK however, there is no equivalent of the Broker Non Vote; votes have to be cast by Shareholders to be counted. In the US, a fund's charter may include provisions that can frustrate attempts by Shareholders to influence fund policy or achieve board representation.

When considered individually, some of these examples may appear trivial but taken collectively they provide a valuable insight into the standard of Corporate Governance within a Fund. City of London believe that the level of adherence to the points made in our Statement on Corporate Governance and Voting Policy will show the extent to which the Directors of a closed-end fund are undertaking their responsibilities on behalf of Shareholders and more importantly, in the interests of Shareholders.

# 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 principal 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

A Director 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. the Non Broker votes, as occurs in the US) is a questionable practice. Boards should not allow such votes to thwart the intent of Shareholders who are interested enough in their investment to register their vote. The use of the Broker Non-vote was created to facilitate a quorum for Ordinary business, it seems however that it can be also used against the wishes of voting shareholders. There have over the past few years been examples of Boards using the Broker non-vote against those that have taken the time to vote. In the end, Boards who undertake this type of "Protectionism" invariably fail. In the end they are held accountable by shareholders.

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.

To the extent possible, 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

To the extent permitted by applicable law, Boards should take responsibility for ensuring that major Shareholders automatically receive all annual and interim reports and copies of other major announcements directly.

In most jurisdictions the Board is required to notify Shareholders and the market of significant events, such as when a company repurchases its own shares. However, the US only requires 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.

City of London believes that Boards should inform Shareholders as soon as practicable of any material change in any relevant aspect related to the Investment Manager, such as resignations, change of fund manager, etc. To the extent permitted by applicable law, Boards should also contact Shareholders to gather their opinions with regards to sensitive issues like change of Investment Manager and change or granting of sub-advisory contracts in advance of presenting the facts in the proxy forms to be voted at annual or extraordinary Shareholders meetings. Clear explanation of the benefits for Shareholders should also be disclosed.

### 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 into a contract with Shareholders*

A Board in promoting a new Fund enters into a contract with Shareholders, the terms of which are both explicitly stated in the prospectus and implied through asking Shareholders to acquire shares initially at net asset value (in reality, a premium after including transaction costs).

### 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 at a significant level 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 the rarest of 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 other than to existing Shareholders at not less than net asset value in proportion to their existing holding.*

New share issues, other than pro rata to Shareholders at not less than net asset value, 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 shares 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 has been 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

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

## 1. The Board's Relationship with 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 that 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.

*The Management Engagement Committee should assess the Manager's performance and its contribution to the best interests of shareholders.*

### 1.1 The Management Engagement Committee

We believe that a Management Engagement Committee should be created in order to assess the Manager's performance and its contribution to the best interests of Shareholders.

This committee should:

- Meet quarterly and be comprised only of Directors who are independent (to the extent the entire Board is not independent) and who do not accept any direct or indirect consulting, advisory or other compensatory fee from the Fund, the Manager or any affiliate of the Manager other than in the Director's capacity as a Board member;
- Agree in advance a relevant benchmark against which the Manager will be assessed;
- Specify a period over which the Manager's performance will be assessed;
- Specify the level of volatility that is acceptable in achieving out-performance of the benchmark;
- Specify that NAVs will be released to investors on a daily basis and the methodology for calculation of NAVs;
- Monitor and assess the Manager's use of gearing/leverage;
- Specify and assess the Manager's fulfillment of its marketing obligation;
- Closely monitor the Manager's expenses and those which are passed to the investment company.

The Manager's performance should be critically assessed against the Fund's benchmark and consistent underperformance should result in the board selecting and recommending to Shareholders a new Manager.

*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.*

## 2. Investment Policy

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.

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

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

*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.*

## 3. Ancillary Services

### 3.1 Value and Quality

When support services are provided by subsidiaries of the Manager these issues are especially sensitive. 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. This should be a transparent and reported process to Shareholders.

### 3.2 Control and Supervision

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) to develop this point.

This principle can equally be applied to closed-end fund Boards. One example of where it could be applied, in the UK, 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.

### 3.3 Calculation and Dissemination of Net Asset Value

City of London considers that the NAV should be calculated and published on a daily basis, preferably on the Fund's web site. Alternatively, dissemination of NAV information via Bloomberg ar AMEX is welcomed. Dissemination should take place at a specific time each day and, where applicable, include the relevant currency rate(s) used in the calculation. The Board should ensure that strict management controls are in place to insure that the NAV is calculated accurately, and that it is published in a timely manner.

The Board of Directors is ultimately responsible for the implementation of a Net Asset Value calculation methodology that the administrators of the Fund should strictly adhere to. The methodology should include a procedure for the detailed calculation of the NAV, the frequency of NAV calculation and the media via which the NAV is to be disseminated. The detailed methodology should include the time at which stock prices and exchange rates are obtained for NAV calculation purposes. This methodology should be made freely available to all interested parties as well as being disclosed in the Fund's financial statement, website and widely used pricing systems such as Bloomberg.

# V. The Fund and the Manager

## 1. The Manager's Tenure

*After an initial term of two years, a Manager's contract should be subject to annual renewal by Shareholders.*

A management contract longer than 12 months is unreasonably onerous on Shareholders in the event of the need to terminate the Manager.

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.

Shareholders should be given the opportunity annually to re-appoint the Manager. An annual vote can only serve to focus the Manager on the need to provide Shareholders with good performance and value for money with respect to investment management fees. In our opinion the Manager should be appointed on a contract no longer than 12-months and be assessed quarterly by a Management Engagement Committee made up of independent Directors.

## 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. Compensation payable to the Manager should always be calculated on a net-assets basis. Under no circumstances should the Fund pay compensation on geared assets.

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.

*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.*

## 3. The Name of the Fund

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 creates an incentive for 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.

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

## 4. The Manager's Personnel

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.

*The Manager should limit cross investment by Funds under its control.*

## 5. Cross Shareholdings

The use of cross shareholdings to frustrate the wishes of a majority of the Shareholders in a fund has received much attention over the past 12 months. Specifically, in the split capital trust sector it has become apparent that investment decisions which have resulted in a myriad web of cross shareholdings across the sector cannot in most cases be justified on the grounds of prudent investment decisions.

City of London believes that 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, to the extent permitted by applicable law, the indirect voting rights the Manager exercises by virtue of managing another investment vehicle that is a Fund Shareholder. Additionally, care should be taken to ensure there is no double charging of fees by the Manager.

## 6. Portfolio Transparency

The Manager should provide a regular update, at least monthly, detailing the Fund's portfolio, which should include information on the underlying holdings and the level of any gearing. Information on the underlying holdings should include, at the very least the Fund's top ten portfolio investments and their percentage weightings, the amount of any private equity held in the Fund and the level of any investment outside the relevant benchmark index. Information on gearing should include the nature and tenure of any debt. The update should be made freely available, in a timely manner to all interested parties and preferably on the Fund's web site.

# VI. Conclusion

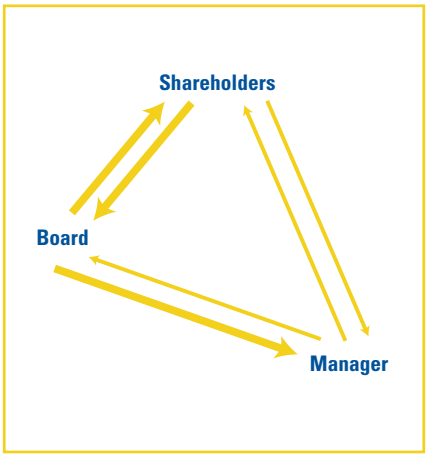
City of London's views upon the key issues of:

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



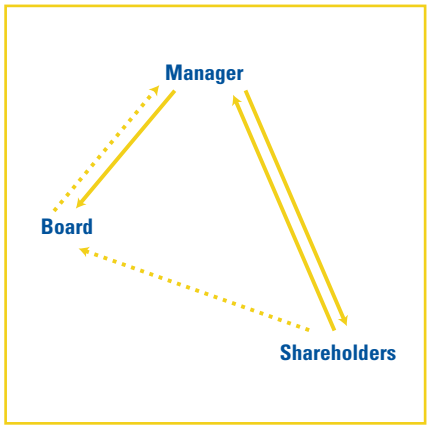

### The Eternal Triangle – 1

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

# Annex 1

| | City of London | FSA |
|---|---|---|
| **Board Structure** | Fully independent from the Manager. | Majority of Board independent. Chairman must be independent. |
| **Definition of Independent** | Excludes current & former employees of the Manager, individuals with financial link to Manager, major Shareholders, representatives of 3rd party providers, individuals who sit on more than 1 Board managed by same Manager | Not clearly stated, however Directors with two Board positions with same group and Directors, employees or advisers all not to be considered independent. |
| **Board Tenure** | Maximum 3 x 3 years | Issue not discussed in paper. |
| **Shareholder Relations** | Independent Director (pref. Chairman) should be main point of contact. | |
| **Discount Awareness** | Board is under obligation to monitor, report on and subsequently address the discount to NAV. | |
| **Evaluation of Manager** | Benchmark should be clearly stated and it should be publicly acknowledged that this is the key criterion for ongoing evaluation of Manager's services. Manager should be evaluated annually – Board should publicly address results of evaluation. Manager should be fired if fails to meet criteria over stated periods. | Directors to explain to Shareholders annually why the continued appointment of Manager on terms agreed is in best interests of Shareholders plus statement of reasons for this decision. |
| **Ancillary Services** | Third party services (excluding IM services, addressed above), should be put out to tender periodically. Expense ratio should be kept under a publicly disclosed, pre-determined level. | |
| **Manager Tenure** | Contract should be no longer than 12 months. | No explicit length – disclosure of terms on which Manager is (re)appointed and costs of early termination to be displayed in annual report. |
| **Portfolio Transparency & Reporting** | Top 10 investments and % weight, level, nature and tenure of gearing, % in private equity, nature and % of ex-benchmark investments should be publicly available at least monthly. | Monthly disclosure of all holdings > 0.5% of assets. |
| **Cross Shareholdings** | Cross shareholdings should be limited to 5% of funds voting equity. No double charging of fees, "contentious" votes should see the Managers vote restricted. | 10% (cost) limit on CEFs investment in other funds (unless other funds explicitly prohibit investment in other funds). |

| AITC | Comment |
|---|---|
| Majority of Board independent. Chairman should be independent. Independent members should lead process of new appointments and disclose procedure. Only independent Directors should vote on new independent appointments. | CoL view would solve quickly many of the issues in both FSA & AITC papers – question needs to be asked would splits debacle actually have occurred if boards were fully independent? Any Manager representation on Board can only dilute the effectiveness of Board decision making process when considering/debating sensitive matters. Representative from the Manager can be called upon as required to provide information or advice to board. |
| Not clearly stated – significant discretion rests with board itself. | CoL's view is that without a clear definition of independence (eg; past employees, 3rd party providers, persons with multiple directorships etc.) will always have question marks over some Boards actual independence. |
| 3-year fixed term – no assumption regarding automatic re-nomination. Total tenure left to Board discretion – tenure policy should be disclosed in annual report. | CoL's view would be that after lengthy period on a Board, views may become entrenched and Director may increasingly become "wedded" to Manager. |
| Contact procedure should be explained in annual report. | It is necessary for an independent point of contact on the Board for Shareholders – Higgs review provides for a model with independent Director being nominated as point of contact. |
| Board should focus on share price and NAV performance – should consider & discuss enhancing share price performance. | CoL's view is that targets should be explicitly stated in prospectus & annual report for discount range and liquidity – if these levels are consistently exceeded over pre determined time period fund should be liquidated. Strong control of the discount to NAV is likely to result in greater issuance and therefore a more vigorous sector |
| Recommendation for Management Engagement Ctte. is excellent however does not propose that any of issues should be anything but "discussed". Specific recommendation regarding fee charge basis is welcome. | AITC proposal to be workable requires more specifics – targets regarding long term performance (for example rolling 24 months should outperform benchmark by at least 500bps) should be in the prospectus and annual report. If the targets are not met, board should put management contract out to tender. Funds that consistently add value will be rewarded – there will be more fund issuance and create a more vigorous CEF sector. |
| Board should establish procedures for the regular monitoring & evaluation of ancillary services including ensuring that auditors do not have any other conflicts. | Acceptable level for expense ratio should be defined in the prospectus. If exceeded over 24-month rolling period, management fee should be cut or fund liquidated. |
| No explicit length, Board could discuss feasibility of regular continuation votes. | A continuation vote every 2 years would ensure the manager took performance responsibility seriously. |
| Annual disclosure of total portfolio, disclosure of material x-holdings and investment companies on monthly basis. | FSA proposal good. Will need clarification on timeliness of this information – i.e. should be published within 5 working days of end of month. Possibly releasing details of holdings >1% would be more workable. Release of details of private equity, ex-benchmark investments and x-shareholdings imperative. |
| Not really addressed – board can agree to discuss identifying circumstances that should be referred to the board for approval. | AITC proposal again too opaque and open different interpretations – a limit of total investment into other companies may be warranted – though 20% would be considered prudent by CoL – perhaps investment in non-independent funds should be prohibited. |

CITY OF LONDON
Investment Group PLC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**Important Notice**



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