

A Guide to Performance Appraisals for Non-Executive Directors of Investment Trust Companies

IN RESPONSE TO THE RECOMMENDATIONS OF THE HIGGS REVIEW,
AS INCORPORATED INTO THE COMBINED CODE IN JULY 2003



THE ASSOCIATION OF
INVESTMENT TRUST COMPANIES

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Appraisals for Non-Executive
Directors of Investment
Trust Companies

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Foreword by Daniel Godfrey

In 2003, a number of new corporate governance initiatives were introduced which, collectively, introduce a number of new responsibilities which Boards must seek to fulfil.

The AITC has been involved in these initiatives and, broadly, we believe that they can be implemented in such a way as to help, rather than hinder, Boards and Directors in the exercise of their responsibilities to shareholders.

The AITC Code, the new Combined Code and changes to the listing rules relating to investment trust companies all have implications for the work of Boards.

Some of the new requirements may well represent completely new ground for some Boards and some individual Directors. The AITC is determined that Boards should not be abandoned to invent the wheel on their own, each in their own way.

One of the new requirements which may well be causing concern is that Boards should conduct an evaluation of their performance as a Board and of the individual Directors.

Our research (amongst 40 directors of investment trusts, 8 directors of other quoted companies, 10 institutional investors, 6 private client advisors, 6 IFAs, 10 private investors, 10 managers, 6 brokers, 3 company secretaries, 2 regulators and 1 journalist) indicates that the conduct of the exercise can indeed be valuable in a process of constant improvement of the way in which the Board of an investment trust company can contribute to the successful attainment of the shareholders' objectives.

This guide, produced for the AITC by Trust Associates, provides some background to the requirement and desirability of conducting a formal Board evaluation. It proposes a variety of practical steps that Boards could take both to fulfil the requirements and to make sure that the exercise really does bring out any areas which could be improved.



Daniel Godfrey
Director General

Executive summary

The Higgs Review recommended that the board of a company should:

“...undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors”.

The Higgs prescription is for a combination of self-assessment, peer assessment and (only sometimes, we think) third-party facilitation, all under the direction of the Chairman.

We recommend that investment trust boards should:

- Adhere to the spirit of the Combined Code guidance on appraisals;
- Follow the broad Higgs guidelines on method;
- Adapt the method to suit the circumstances and particular characteristics of the trust;
- Consider using third-party facilitation from time to time or in particular circumstances;
- Act on the findings as soon as is practicable, and take note of longer-term implications for board composition etc.;
- Be as open and positive as possible about the process.

We recommend that boards should appraise their skills and procedures in:

- Monitoring and, where appropriate, guiding investment activity;
- Performance measurement;
- Evaluating the manager’s stated investment strategy and portfolio management method;
- Understanding the macroeconomic environment in which the trust operates;
- Understanding the particular country, geographical region or industry sector in which specialist trusts operate;

- Understanding and monitoring investment risk;
- Overseeing both the implementation of gearing and its financing;
- Maintaining an appropriate perspective with regard to strategic issues and implementing fundamental changes where needed;
- The management of costs and the negotiation of management and other fees;
- The management of any discount to net asset value that may arise;
- Ensuring that there is sufficient liquidity in the market for the company's shares;
- Ensuring the company's compliance with company and tax laws, accounting, reporting and other regulations and the Combined Code;
- Communicating with the particular mix of shareholders which they represent and directing the promotion of the company to potential shareholders;
- Managing their own meetings and procedures;
- Planning board succession;
- Dealing with the various service suppliers.

And, separately,

- The skill and independence of the Chairman.

Preferred approaches to the task may vary but some combination of questionnaire/checklist and interviews is likely to be the most efficient option.

Whatever method is used, it should:

- Cover the ground;
- Elicit as candid responses as possible;
- Be easy to analyse and act on.

We outline three possible approaches to evaluation (on p.23):

1. DIY1: Self appraisal by interview only (For those boards which prefer to avoid committing any part of the appraisal process to paper and therefore to conduct the whole process verbally)
2. DIY2: Self appraisal using questionnaire and interview
3. Appraisal using Third Party Facilitation

There is no point in conducting an appraisal unless you are prepared to act on the findings where necessary or appropriate.

Well conducted appraisals have the potential to achieve various benefits, helping the board to:

- Confirm that the board has a suitable balance of skills and other attributes and focusing attention on the attributes required in any new director;
- Focus on any inadequacies;
- Identify strategic priorities;
- Develop skills, knowledge and understanding in the individual directors;
- Review its practices and procedures and thus to become more efficient and effective;
- Justify recommending the three yearly re-election of each Director (where appropriate).

The fact that an appraisal has been conducted should be reported in the Annual Report and Accounts, together with details of the method used, as appropriate. There is no requirement to report or comment on any findings of the review, although the Directors may wish to do so in some circumstances.

General guidance for questions to be addressed in an appraisal can be found after page 113 of the Higgs Review, which can be downloaded from: www.dti.gov.uk/cld/non_exec_review/

A practical appraisal questionnaire template for investment trusts, with guidance notes, can be found on the Trust Associates website: www.trustassociates.co.uk ; alternatively, a hard copy may be obtained from Lori Fox at the AITC.

Introduction

There has been a steady procession, in response to the various corporate scandals of the last decade or so, of officially appointed individuals and committees who have sought to delineate the path of corporate righteousness and to exhort, cajole or even compel the boards of listed companies to tread it. The name of Higgs has recently been added to the lengthening list of those, including Cadbury, Greenbury, Hampel, Turnbull and Smith, whose various prescriptions have shaped the Combined Code - that rubric which defines the standards of corporate governance to which UK listed companies are expected to adhere (unless they can show good reason why they should not or do not).

One recommendation of the January 2003 Higgs Review (Review of the role and effectiveness of non-executive directors), and one that was duly incorporated into the Combined Code when it was updated in July 2003, suggests that the board of a company should "...undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors".

In this regard, the Code is now arguably the most explicitly prescriptive rulebook of its kind in the world. We have surveyed the corporate governance frameworks and the prescriptions for board appraisals elsewhere in the world and have included our findings, which provide an interesting backdrop to developments here, in an appendix to this report.

So, Higgs breaks new ground and, given the regularity with which new corporate governance requirements have been heaped on boards of late, it was perhaps inevitable that the recommendation for board appraisals would evoke among the non-executive directors of investment trusts a variety of responses. These range from enthusiasm in principle, through resigned acceptance, mild bewilderment and exasperation, to outright hostility. Simply speaking, some accept the recommendation as meaningful and valuable; others, to one degree or another, do not.

The purpose of this paper is to provide some guidance to the membership of the Association of Investment Trust Companies regarding the implications and the value of the Code. It is designed to help boards comply with the requirements of the Code in an efficient and constructive manner.

Comply or die?

On the face of it, it might be thought that the Combined Code gives sufficient scope to companies to deviate from its provisions (provided that they state that they are doing so) and to make compliance with any of them essentially voluntary. Such an interpretation would be, at best, simplistic but the fact that the Code lives in the no man's land between recommended practice, quasi-legal regulation and company law makes the perception of ambiguity understandable.

The response from the International Corporate Governance Network (ICGN) to the Higgs Review, however, displays a commendable clarity of thought on the matter:

"...it is critical that shareholders and their agents should not treat compliance with every element of the code as compulsory, and that 'comply or explain' should not become 'comply or you die'... There have been many cases where companies have received letters from institutional investors implying that they have not 'complied with the Code'. Of course, companies comply with the existing Code if they explain why they choose not to apply every provision. Shareholders must make a reasoned judgement about how much non-application of these principles is acceptable. With the substantial increase in the size of the Code suggested by the Review, this becomes ever more important..."

The ICGN thus clearly and correctly identifies the shareholders as the front-line troops in enforcing compliance with the Code and places the first responsibility for interpretation of compliance or non-compliance with them, and not with any external regulator. It also points out that the necessary scope of such judgements has greatly increased. It cautions, however, that over-zealous policing of compliance should be discouraged because:

"The alternative will be that companies will either be forced into a straightjacket of applying every provision for fear of the 'box tickers' voting against them, or, perhaps worse, will increasingly ignore the provisions of the Code and bring the whole exercise into disrepute."

The crux of the matter, then, is whether, in the "reasoned judgement" of the shareholders, compliance with any particular provision of the

Code (and, for our purposes here, compliance with the performance appraisal provision) is deemed to be essential, “nice to have” or wholly irrelevant. More immediately, however, it is for boards to interpret this provision of the Code in the light of their perceptions of their shareholders’ responses.

The correctness or otherwise of boards’ perceptions is only likely to undergo any acid test as and when some choose not to comply with the provision and thus invite a reaction from shareholders. Some insights into likely shareholder reactions and, thus, guidance on policy can, however, be derived from the record of public utterances of some of the bodies which purport to represent shareholder thinking on corporate governance issues.

PIRC, in its response to the Higgs Review states:

“We consider that there should be transparent and systematic processes in place both for [the appraisal of] boards as a whole and for individual directors.”

The ICGN, its above-quoted comments notwithstanding, states unequivocally in its statement of corporate governance principles:

“Every board of directors should evaluate its performance and the performance of individual directors on a regular basis and should disclose the basis for such evaluation.”

Unqualified support for this provision might have been expected from PIRC, which has taken a consistently hard line on corporate governance issues and, further, states that outright regulation might be preferable to mere inclusion of provisions in the Code. It is, however, significant that even the comparatively dovish ICGN, which publicly stated that it thought Higgs to be overly prescriptive, did not demur with regard to the specific provision for board performance appraisals.

It might be thought that such bodies, in their blanket prescriptions for corporate governance, in some way fail to take account of the particular circumstances of investment companies and it is undoubtedly true that they are not the principal focus of attention when these are being considered. Nor was performance appraisal for

boards a major topic of debate in the wake of the split-capital crisis, when the FSA's Consultation Paper 164 was being discussed. Any debate about boards around that time tended to focus on the relationship between the board and the manager and potential conflicts of interest - on the potential for collusion rather than on perceived incompetence.

However, the problems of split-capital trusts have highlighted both the increasingly complex and demanding nature of the non-executive director's role in the investment company sector and the necessity for properly constituted boards which possess an appropriate mix of skills. At a recent investment trust round table forum, John Tiner, Chief Executive of the FSA said:

"I would say that the investment trust industry needs to show in a very tangible way that the split capital investment trust problem was an isolated one, that it was not something that was typical of the industry as a whole. It may be that the industry at the moment does need to go that extra mile to justify to investors that it is a safe place to put money."

Commenting on the roles of investment trust board directors, he added:

"There has to be a sea-change in the way that investment trust board directors and boards themselves behave, and actually hold the investment manager to account, rather than the investment manager being an 'insider'. Directors will need to take their responsibilities as independent directors more seriously, and not feel that it is something they can delegate to the manager most of the time."

Recognising that successive re-drafts of the Review's provisions may have misrepresented or partially obscured its original intent, the authors of this report enquired directly of Higgs how he envisaged board reviews might be conducted by companies, such as the smaller investment trusts, that are less able than the FTSE 100 constituents to afford the kind of rigorous, third-party-facilitated appraisal which seems to be called for. We also asked whether we were correct in assuming that it was not the intention that the provisions should in any way be relaxed for investment trusts. Although, in the course of our conversation, he emphasised that it was the intention of the

Review to give its guidance with as light a touch as possible, his response on this point was very clear:

“There is no case for excluding investment trusts. Although there is a case for minimising costs, it would be perverse to come to the conclusion that it does not apply to them.”

In this light, it seems that there is no case for excluding the sector at large from the board appraisal provision and very particular circumstances would need to obtain if any individual trust were to make a case for non-compliance.

The role of a company’s auditors in enforcing the Combined Code deserves a brief description here. Auditors are required to read the directors’ report and to comment with regard to compliance with certain provisions of the Code. As regards other provisions, including the appraisal provision, any failure to comply or to explain might be the subject of quite robust conversations with the board, but auditors are not required to comment on any explanation for non-compliance, although they undoubtedly would do so were they to consider the explanation to be disingenuous or clearly unreasonable.

In summary, it can be said that performance appraisals for boards are now an integral part of the Combined Code and that, although it is not a question of “comply or die”, non-compliance with this provision is not, in our opinion, a sensible option and would be unlikely to be seen as a trivial matter by shareholders, auditors or, in extremis, the FSA. In any event, we believe that the directors should comply, as far as possible, with both the letter and the spirit of this provision and use the appraisal process as an aid to planning their affairs and, over time, enhancing their effectiveness.

The virtue in the necessity

Directors should be aware of the political undertones of the Higgs report and earlier versions of the Combined Code. It is widely believed by politicians, policy makers, individual and institutional investors alike that many investment trust boards embody a 'clubbiness', which is both anachronistic and contrary to shareholders' interests.

Defenders of the *status quo* might regard these calls to formalise what has hitherto been an informal aspect of board activity as little more than expressions of a rather facile political correctness, believing that the "organic" culture that has characterised many investment trust boards until now has functioned well because it has depended on the organisational abilities of talented and experienced people. The processes may have been informal and intuitive but they were, nevertheless, effective. In many cases this is undeniably true; where it works, it works. The purely organic approach to board composition and self-appraisal does, however, have its drawbacks, as most directors will recognise, and if assiduous compliance with the Code only serves to remove suspicions which investors might otherwise harbour about a board's culture, it might give them more confidence in board decisions about more important issues.

Further, most investment trust boards can claim that they have been properly constituted and have performed their duties conscientiously, without recourse to a formal or rigorous process of recruitment or performance appraisal. However, this does not mean that such procedures could not improve boards and their performance.

Even supporters of the formal recruitment and appraisal methods should accept that some important aspects, such as integrity and judgement, are not easily assessed in these ways. Fellow directors would be understandably reluctant to comment on such aspects (especially if they harboured doubts in either regard) and a third party would not know the individuals well enough to do so.

It is not surprising that directors have tended to recruit people whom they know well in appropriate professional contexts or whose public profile is such that their integrity and judgement might be regarded

as beyond question. Such methods have, however, increasingly come to be regarded as manifestations of “old boy networks” or as mindlessly mechanistic appointments of the “great and the good”. The pressures for transparency and objectivity in the recruitment process have increased and chairmen and boards now appoint directors whom they do not know personally and of whose professional performance they have little direct knowledge. At this stage, the quality of their individual and collective assessments of the integrity and judgement of the candidates is crucial. As such, these elements are more important in the recruitment process than they are in the periodic/annual appraisals required in the new Combined Code.

Where the composition of boards may be given less rigorous scrutiny, through the more traditional methods of selection, they may become excessively consensual, since the tendency has been to appoint individuals with similar outlooks and experience. An overly consensual board may unwittingly become complacent. A regular and objective evaluation of board performance should provide an opportunity for the chairman to conduct an audit of the skills the board possesses and, more importantly in this context, those which it may lack. This, in turn, may assist in the process of recruiting new directors.

Chairmen sometimes find it difficult to deal with situations in which, for example, one or more directors might be deemed not to be pulling their weight (or conversely, to be inordinately assertive or disruptive). The formal review should not only encourage chairmen to confront such issues but should give them a well-defined and relatively impersonal mechanism through which to bring such problems to the attention of the directors in question or to replace them.

Board effectiveness, of course, is not just about individual and collective skills and experience. Some boards may fail to function well because of difficult inter-personal dynamics (and this should not be read simply as a euphemism for vendettas or personality clashes) or may become over-zealous in dealing with some issues (riding personal or collective hobby horses, perhaps), at the expense of others. Here again, regular appraisals might encourage a rounded assessment of what has been discussed and topics that may have been neglected and why, and enable imbalances more readily to be

addressed. It should also be possible to address in a formal appraisal process some of the problems of inter-personal dynamics, such as personal differences of approach which can render board proceedings inefficient and which might otherwise be overlooked.

The Higgs prescriptions included in the Code contain useful guidelines as to how, and in what spirit, the task might be approached.

In addition to prescribing that a board should “...undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors”, the relevant section of the Code further states:

“It is the responsibility of the chairman to select an effective process and to act on its outcome. The use of an external third party to conduct the evaluation will bring objectivity to the process.

The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.”

The Code then goes on to outline questions that should be considered in performance evaluation with the caveat that companies “...will wish to tailor the questions to suit their own needs and circumstances”.

The prescription, then, is for a combination of self-assessment, peer assessment and third-party facilitation, all under the direction of the chairman (and the senior independent director as regards appraisal of the chairman), with the specifics of the evaluation being tailored to suit the nature of the company.

Board appraisal for investment trusts

What to look at

The Code exhorts the board to appraise: “...its own performance and that of its committees and individual directors”.

Although performance measurement for fund managers is an increasingly sophisticated, scientific discipline, it is unusual in this regard. Performance measurement in most business disciplines is notoriously difficult and, in most cases, the lack of realistic quantitative or other objective measures means that it is at best quasi-objective. This is undoubtedly the case for non-executive directors, even those of investment trusts, whose success or failure might to some extent be seen in terms of the asset performance of the trusts. Evaluations of non-executive boards have hitherto usually been public, retrospective and condemnatory. This is because non-executive success is usually perceived to be the absence of obvious failure. Boards may sometimes be thought to succeed because the trusts are well-run by the managers but, if things do go wrong, boards are quickly blamed. In this context, the Higgs proposals might be seen as an attempt to encourage boards to avoid failure by a process of rigorous self-examination.

Board evaluation can also be seen as part of the process of providing newly appointed board members with the understanding of investment trusts and their operations. Increasingly, non-executive directors come from outside the investment trust industry and even from outside fund management. The induction process should equip directors with the knowledge and understanding of the special status of investment trusts and the issues with which they should be concerned, including legal and regulatory issues, accounting, the regulation and function of fund managers. Such knowledge and understanding should be kept up-to-date and skills and experience developed, even for directors with long-established roots in the industry. The regulatory, legal, accountancy and tax rules are constantly changing and the approach to fund management evolves in response to changing economic circumstances, developments in management theory and the emergence of new instruments. Board evaluation, both of individuals and of the effectiveness of the board as

a whole, may well identify training and development needs.

So, what should be the focus of an investment trust board's appraisal? Except in the cases of the relatively small number of self-managed trusts, investment trust boards are explicitly non-executive in nature and they seldom have significant influence on investment performance (except in the matter of gearing) in any direct way. Nor is it the case that boards are expected to change the investment manager with such frequency that they could be credited with a "manager of managers" role. Rather, the typical role of the board is primarily one of guardianship of shareholders' interests and any appraisal of a board, its committees and its individual members must therefore focus on the skill and effectiveness with which they safeguard shareholder interests in a number of areas.

Investment matters

In investment trusts, the success of the business is, in most circumstances, seen to be overwhelmingly about investment performance. Boards should therefore do all that they can to ensure that investment performance is satisfactory and that it is delivered while a reasonable risk profile is maintained. For most boards, this is the most important object of their deliberations and it is therefore important, in any self-appraisal, that a board should assess the skill and efficiency with which it monitors and, where appropriate, guides investment activity.

As noted above, **performance measurement** in the investment world is an increasingly sophisticated, technical discipline and it is therefore necessary that a board's membership should possess sufficient specialist knowledge in this area. If a board is not possessed of reasonably up-to-date skills in performance measurement, it is unlikely that it will be able adequately to interrogate the manager's representations of investment performance without calling upon external professional support.

The board also has an important role in providing a "sanity check" for the manager's stated **investment strategy and portfolio management method**. Here again, a significant degree of specialist knowledge, and

preferably of relevant hands-on experience, is necessary and, as the investment environment changes and portfolio management techniques develop, it is important that one or more members of the board should have relevant and up-to-date knowledge.

It is also important to recognise that all investment takes place in a **macroeconomic environment** and that an investment trust board should possess skills and current knowledge of this subject.

In addition, for those specialist trusts that focus on a particular country, geographical region or industry sector, it is important that boards should know something about these **specialist aspects**.

Finally, boards need to be able to understand and monitor investment risk. This is particularly important because **risk management**, more than any other aspect of the investment process, is about protection of investors' assets. They should have the knowledge and skills necessary to monitor whatever risk management procedures the manager uses, to curb excessive enthusiasm in overbought markets (or panic selling in oversold markets) and to influence the use of gearing. **Gearing** is the one aspect of investment and risk over which non-executive boards do normally have a significant influence and it is therefore important that they have the expertise to oversee the management of both the implementation of gearing and its financing. Informed oversight of gearing policy thus requires two quite separate skill sets: an understanding of investment volatility and timing and specialist knowledge of the wide range of possible methods of financing and their implications for risk.

Overall strategy and corporate issues

Once they are established, investment trusts tend to take on a degree of inertia. Unless the board and/or the manager receives some clear message to the contrary, they usually assume that the originally stated **investment objectives** of the trust are still valid and that its continued existence is justified. Similarly, it is likely to be assumed, unless they say otherwise, that the shareholders support the **continued employment of the incumbent manager**. The same is true of the trust's continued **closed-end status, domicile etc.**

These are all, in other words, strategic issues which are not subject to constant change but which rather require periodic, formal review and a continuous consciousness on the part of the board that they are not immutable. It is often the case that change in these strategic areas comes as a result of expressions of shareholder dissatisfaction and boards are sometimes criticised for failing to take action earlier.

For this reason, boards should, in the appraisal process, ask themselves how effectively they consider such issues and should perhaps review their general preparedness and more routine procedures for doing so.

Shareholder Value

Issues over which an investment trust board does exercise direct control and which have a bearing on shareholder value include the management of costs, the negotiation of **management and other fees**, including performance fees, the management of any **discount to net asset value** that may arise and control of the board's own fees and associated costs.

It is also very important to investors that the board should make efforts to ensure that there is **sufficient liquidity in the market** for the company's shares. As well as giving investors comfort that they will be able to realise their investments at a time of their choosing, this is likely to have an important bearing on the level and volatility of the discount.

The **marketing** of the wrappers in which the trust's shares are typically bought by retail shareholders has a bearing on the magnitude and the volatility of the discount. This is another activity in which a board should be able to direct the managers' efforts.

To sum up, the appraisal process should include an evaluation of the trust's ability to maximise shareholder value and the skill and efficiency with which the board's procedures enable it to do that.

Corporate governance

Directors typically depend on their company secretaries to guide them in most corporate governance areas and are entitled to do so. The board, however, has ultimate responsibility for the trust's **compliance** with the various laws, regulations, listing requirements and codes of practice which apply. These cover a wide range of issues, including tax, accounting, reporting and compliance and the knowledge required to ensure that the trust is compliant is both extensive and specialised. Boards should evaluate whether they have **the right people, with the right skills, efficiently and effectively implementing appropriate procedures** to meet these manifold requirements.

Shareholder relations and communications

The patterns of share ownership vary widely among investment trusts. Some are generalist trusts with a predominantly retail ownership, others are specialist vehicles with a preponderance of institutional holders. Most trusts have some combination of both. The requirements for shareholder communication therefore vary from trust to trust and directors should assess whether they are efficiently communicating with the particular mix of shareholders which they represent. Where the balance of ownership has shifted significantly, it may be that the process and style of communication needs to be changed accordingly. In any event, good shareholder communications are not only an essential aid to investor decision-making but also a safeguard against inflexible board thinking and strategic inertia.

Process and Style

Board meetings constitute the single most important part of the non-executive director's work and boards should therefore review whether their focus is appropriate and whether they are conducted efficiently. Boards should consider whether meetings are of an appropriate frequency and duration, whether the agendas and board papers are efficiently compiled and followed and whether the chairman and the individual directors discharge their responsibilities

diligently and efficiently. Some consideration might also be given to the “group dynamics” of the board (whether some directors are excessively assertive, while others are too passive etc.).

Support and relationships with suppliers

Non-executive directors, by their nature, are very dependent on the support of the various executive functions in discharging their duties. Board deliberations typically require substantial inputs from the manager, the company secretary, the company broker, the auditors and other specialist advisers. Boards typically manage their relationships with these supporting functions on a continuing basis but it is nonetheless a useful part of a periodical review process to review the overall efficiency of these service providers and the nature of the relationships with them.

Appraising the chairman

A strong chairman plays a very important role in the composition and conduct of any board and is therefore in a position to exert a powerful influence for good or ill. A weak chairman, on the other hand, may exert little or no influence, abdicating *de facto* authority to others or simply allowing the board’s strategy to drift. The chairman takes the lead in board meetings and requires particular intellectual and inter-personal skills in this connection. It is therefore important that the chairman, whose character and conduct are likely to be a major determinant of the way in which the board operates, should be subject to scrutiny as part of the appraisal process.

In most respects, the chairman should be appraised in the same terms as are the other directors and, indeed, as a director. Some aspects of the role, however, require that some additional questions should be asked.

Since board independence is such a crucial issue, it is important to ask how independent-minded the chairman really is. Does he have any potential or actual conflicts of interest? Is he too dependent on the manager for support and advice? Is he, on the other hand, too

antagonistic to the manager or some other provider of services to the company? Has he been in the post for so long that he has lost his real independence of mind or become susceptible to inertia?

It is also important to assess his skills as a chairman. Does he manage agendas and scheduled or unscheduled meetings and discussions well? Does he use time efficiently? Does he handle the various personalities involved well? Does he respond quickly and appropriately to changing circumstances or problems that arise?

In order that these questions may be asked, the Combined Code stipulates that a board should meet at least once a year without the chairman being present and that a Senior Independent Director (SID) should be charged with overseeing the appraisal of the chairman and discussing with him its findings.

It should perhaps also be mentioned here that this appraisal of the chairman by the other directors serves an important secondary function in that it largely avoids any perceived shift in the power relationship between the chairman and the rest of the board which might otherwise arise as a result of the appraisal process.

The chairman's relationship with the others should merely be one of *primus inter pares* and it is important that his central role in the appraisal process should not give rise to any perception that this has shifted towards a superior/subordinate or even employer/employee relationship. Such an outcome could have deleterious consequences for the future functioning of the board and, as such, be counter-productive.

How to look at it

If all of the above is, to one degree or another, motherhood and apple pie, it does represent a basic check-list of the subjects which a periodical review of board efficiency should cover. Some would say, and perhaps with justification, that they review all of these things on a continuous basis. There is no denying, however, that a periodical, formal review can provoke useful self-criticism that would not arise through any continuing and, in some aspects, probably largely subliminal process. It seems to be the case, anyway, that objections

to board appraisals focus less on their potential value than on the difficulty of their implementation.

Among those who have been vocal in their opposition to the introduction of appraisal for non-executive boards there are some who protest that their limited exposure to their board colleagues makes it impossible for them to make fair judgements of their abilities and attitudes.

Our soundings suggest that most objections stem from the fact that many directors and, more pertinently, chairmen, simply see the nature of their relationships with fellow directors as rendering mutual appraisal difficult or, in the words of some, actually “impossible”. What they really mean, we suggest, is that they believe such a process, however conducted, would be deemed to be threatening (and unlikely to be wholly positive) and hence embarrassing and socially inappropriate.

This perception, in turn, translates into a belief that, if it is necessary to conduct an appraisal process, it should be done as informally as possible and with the lightest possible touch. Many chairmen believe that this is the only way it can be done and that any chairman worthy of the name should be able to give and receive objective feedback in the course of fairly brief, individual conversations. If this is likely to be the most popular appraisal method, its merits and demerits warrant examination. Is this method likely to be effective in the following ways?:

1. Will it cover the ground?
 2. Will it elicit candid responses?
 3. Will the findings be easy to analyse and act on?
- 1) The answer to this question is likely to be influenced by what the chairman considers “the ground” to be. The main weakness of the informal, conversational approach is that it is unlikely to cover the full range of topics which would be covered in a formal, methodical process. It is easy to deride any structured approach as “box-ticking” but the use of checklists can give rise to useful conversations that might not otherwise take place. The converse advantage of the informal approach is that it might result in

conversations about topics which would not naturally have arisen within a more (perhaps excessively) structured conversation.

- 2) Candour in an appraisal process cannot be guaranteed, no matter what method is used. If there are no defined “rules of engagement” for the informal conversation, directors are likely to be reluctant in any way to be critical of one another, regarding such criticism as potentially, or even necessarily, personal. In these circumstances, therefore, candour or otherwise is likely to be a function of personalities and of the relationship between the chairman and the individual director.
- 3) It may be that a series of informal, individual conversations with directors will enable a chairman to identify areas of weakness in the board and to address them. He may, on the other hand, decide that no action is required. The danger here is that, where the feedback received is unstructured, wholly private and subject only to the chairman’s judgement, inaction may be a more tempting option than it would be where the feedback is more structured and where there is an audit trail (albeit one held in confidence) to indicate that problems have been raised.

In all, this suggests that informal, purely conversational appraisals might work well in some circumstances and can be very effective, if conducted with a high degree of determination and skill, but that they are not easy to conduct well. Ironically, it may be that the informal approach which many chairmen intuitively favour, on the grounds that they feel that it would make it easier for them to deal with potentially sensitive issues, actually makes it more difficult to do so. Chairmen might also ask themselves whether their preference for this approach might not sometimes reflect a subliminal desire for a mechanism which allows them to avoid awkward or embarrassing situations.

But does a more structured approach, based perhaps on some kind of check-list or questionnaire, really offer advantages? If tested against the previous questions, how does it stand up?

- 1) It should at least cover the ground well because it should be possible to discuss and agree in advance what the scope should be and it should be possible to include a sufficient number of open

questions (or simply space for free-form comments) so that directors can raise issues not directly addressed in the more closed questions which the “box-ticking” element requires.

- 2) Candour may suffer if directors feel more reluctant to commit their views (especially their criticisms) to paper in any form whatsoever, than they would to air them in a private conversation. Those who have prior experience of, for example, 360-degree appraisals that have been badly mismanaged may have such sensitivities. Guaranteed anonymity and clear rules of engagement, however, should enable respondents to be more candid than they might be in conversation, the more so if the content of the questionnaire can be regarded as quasi-objective and impersonal. It should be understood, however, that, if anonymity in responses is really important (and there may be occasions on which it is) it would be very unlikely to be achieved unless a skilled third-party facilitator was employed. This is true whether questionnaires or interviews are used.
- 3) A well structured questionnaire, with carefully crafted guidance notes, should provide a chairman with a relatively objective view of a board’s mutual/self assessment. Where such a process throws up issues, it would be more difficult to ignore and it might be easier to address them.

The two approaches are not, of course, mutually exclusive. A chairman may use a preliminary questionnaire as the basis for a series of conversations, an approach which might combine the best features of both techniques. Even the most skilfully composed questionnaires often contain ambiguous questions or, for one reason or another, elicit ambiguous responses. It is therefore essential to be able to follow up any paper-based enquiry in person.

Who should do what?

Whatever approach is taken, questions arise as to who should do what, who should have access to what information and so on. Higgs recommends that a senior independent director be charged with overseeing the process of appraising the chairman and it follows, to

that extent, that two more or less separate appraisal processes need to take place. Apart from the chairman and the directors themselves, it might be possible to involve the company secretary and/or some independent third party.

Although Higgs suggests that the appraisal of the chairman might take into account the views of executive directors, this would need to be handled with extreme care in the case of an investment trust. The portfolio manager (whether a director of the trust or not) may well have clear and potentially useful opinions regarding the board's activities and the abilities of all or some directors. However, as an interested party, and one over whose employment the board has discretion, the manager should not be in a position, directly or indirectly, to exert undue influence over its activities or its composition.

The company secretary, whose position ought to be disinterested even if the secretarial function is performed by the management group, might be considered to be an obvious choice for the role of administrator of any paper-based part of an appraisal process. Such a role would, after all, dovetail neatly with the secretary's corporate governance advisory function and most secretaries should have sound instincts regarding the conduct and style of an appraisal process. There are, however, three drawbacks to the use of the secretary which ought to be considered :

- 1) Where the company secretary is an employee of the manager, a potential conflict of interest might be perceived.
- 2) Some directors are likely to feel uncomfortable if the company secretary knows more about the various personal views of the board than does any individual member including, possibly, the chairman. (As one director put it: *"I don't think I'd like the company secretary to know what other directors thought of me."*) As such, they might be less than candid in their responses if the secretary is centrally involved in the process.
- 3) As an investment trust professional who deals with all of the directors on a regular basis and yet remains apart from, and independent of, them, the secretary is potentially one of the more

useful “witnesses” whose views might be sought by the chairman or a third party. (This is also true of the more senior “client directors” who take charge of liaison with trust boards for some management groups.) This value might be lost if the secretary (or client director) is also involved in the process.

These problems could be avoided if the secretary/client director were to assist in the preparation stages but was explicitly excluded from any role in the collection or processing of the responses.

The use of third parties

The Higgs assertion that : *“The use of an external third party to conduct the evaluation will (our underlining) bring objectivity to the process”*, if taken literally, probably overstates the case for third-party involvement. The idea that it is so unlikely that the chairman and senior non-executive director would be unable to conduct an appraisal on a sufficiently objective basis in most circumstances that third-party involvement should be regarded as best practice in all cases, does not seem supportable. For all practical purposes, boards should be capable of conducting a reasonably rigorous and objective self-appraisal most of the time and would reasonably resist the costs of involving third parties unnecessarily. If, however, the word “may” were substituted for “will”, it would be difficult to disagree .

Third-party involvement in the appraisal process can undoubtedly be useful in some circumstances and it is for the chairman to decide when such circumstances obtain. One chairman interviewed said: *“Things would have to reach a pretty pass before I would consider using third-party facilitation”*. Others consider the use of such facilitation on a fairly regular basis to be sufficiently useful as to justify the costs involved.

So, when might third-party involvement be useful?

- **For new chairmen:** Incoming chairmen, especially if they have only been members of a board for a short time prior to their appointment, may find it useful to commission third-party facilitation of an appraisal in order to accelerate and render more objective their own assessments of the boards' capabilities and to plan future changes of their membership where this is envisaged.
- **For old boards:** Conversely, chairmen of boards which have operated with the same membership over a long period might consider an element of third-party appraisal as a safeguard against inertia or complacency.
- **When challenged:** Some shareholder lobby groups routinely criticise or challenge the tenure of certain directors on the basis of judgements which might be regarded as mechanistic (as per the ICGN reference to "box tickers"). Such challenges are often ignored, and often with good reason. The occurrence of such criticism, however, might encourage periodic third-party appraisal, which might, in turn, provide clear legitimisation of the decision to ignore it.
- **Every so often:** Although most boards might regard annual third party appraisal to be unnecessary, it may be that such involvement every three or four years might enhance the value of the regular, annual process. This, as can be seen from the Appendix, is the current recommended practice in France. It should also be noted that occasional third-party facilitation makes it easier to solicit the views of the company secretary, client director, manager or other relevant parties whose inputs would be compromised should they be involved in conducting the process. Such individuals would also, in any event, be understandably reluctant directly to criticise directors who are their employers and would be much more likely to be candid in speaking with a third party facilitator on a confidential basis.
- **When you know you have a problem ...** that will require tactful, impartial handling.

How to report and use the findings

There would be little point in conducting an appraisal of board effectiveness unless there was a clear intention to benefit from any lessons that it might provide. As Higgs puts it:

“The evaluation process will be used constructively as a mechanism to improve board effectiveness, maximise strengths and tackle weaknesses. The results of board evaluation should be shared with the board as a whole while the results of individual assessments should remain confidential between the chairman and the non-executive director concerned.”

It might also usefully be added that the fact that the appraisal has taken place should be recorded in the annual report, together with whatever details of the process the board sees fit to make known. Compliance with the Code will clearly be reassuring to investors.

In contemplating the ways in which the findings of the appraisal might be reported and acted upon, there is perhaps a tendency to dwell on the reporting of the “individual assessments”, with all the potential embarrassment that this may imply. In reality, most of the useful findings are likely to be concerned with gaps in the board’s skill-set: (“We should consider appointing an (economist/accountant/compliance specialist) next time”) or process: (“We have too (few/many/long/short/ill-focused) board meetings”; “The performance data in the board papers is badly organised”; or “We really do need to have a regular, formal discussion of whether or not we have the right manager”).

Individual assessments are seldom likely to be significantly negative and may, of course, be entirely positive. The recognition of particular strengths may encourage directors to contribute more to the board’s work by concentrating on their areas of strength, furthering the development of useful role differentiation. In the comparatively rare instances where an individual director is subjected to serious criticism, it is for the chairman to attempt remedial action or, maybe, to encourage the individual to resign or not to stand for re-election. (Conversely, the appraisal process gives increased legitimacy to each director’s standing for re-election by rotation).

Where there are more general implications for change, these should be fed into the board's business agenda in one form or other. Some investment trust boards conduct periodical (often annual) strategy meetings that differ in form and focus from the regular board meetings. For those boards that do so, the findings of an appropriately timed appraisal could form a useful adjunct to this kind of strategic discussion.

Towards a pragmatic solution

At this early stage in the evolution of board appraisals, it would be unrealistic to expect a robust, single method for their implementation to have emerged. Even the largest companies, and those with the most executive or non-executive boards, have made little progress in this direction. It would also be unrealistic to expect investment trust boards, most of which meet five or six times a year and which preside over the management of perhaps £150 million on average, to devote major resources of time and money to the appraisal of their efficiency in doing so. This is not to say that the shareholders of smaller trusts deserve anything less in terms of corporate governance than do the owners of larger companies, but rather that it is important to deal with this issue in an efficient and cost-effective manner.

In pursuit of this objective, we recommend that investment trust boards should:

1. Adhere to the spirit of the Combined Code guidance on appraisals;
2. Follow the broad Higgs guidelines on method;
3. Use some kind of questionnaire or checklist as part of the process, and/or work to a clear agenda in any informal interviews. (It should be possible to combine elements of the "organic" and "mechanistic" approaches in a way the board finds appropriate);
4. Address the range of issues outlined above, whatever method is used;
5. Adapt the method to suit the circumstances and particular characteristics of the trust;

6. Consider using third-party facilitation from time to time or in particular circumstances;
7. Act on the findings as soon as is practicable, and take note of longer-term implications for board composition etc.;
8. Report and, as appropriate, describe the appraisal process in the Report and Accounts;
9. Be as open and positive as possible about the process.

Some suggested methods

Here are three possible ways of going about it, all of which share some common elements (in italics):

1. **DIY1: Self appraisal by interview only** (For those boards which prefer to avoid committing any part of the appraisal process to paper and therefore to conduct the whole process verbally)

***Stage 1:** Agree the scope, “spirit” and method of the appraisal in consultation between directors, perhaps at a board meeting. This is important in order that all directors may understand the purpose of the appraisal and the ground rules.*

***Stage 2:** Agree the “agenda” for the process (i.e. the subjects to be covered in the investigation). The chairman and directors may already have identified some relevant issues which have been the subject of continuing discussion but these should not be investigated to the exclusion of other topics.*

Stage 3: The chairman and the senior Independent director (SID) conduct the initial interviews (probably by telephone).

Stage 4: The chairman and SID review their notes after completing all interviews and, where appropriate...

Stage 5: ...conduct follow-up calls for clarification or further discussion of subjects arising.

Stage 6: The chairman and SID summarise their findings in preparation for reporting and feedback.

Stage 7: *The chairman gives feedback to the board collectively and, where appropriate, to individual directors. The SID gives feedback to the chairman after discussing the general findings with the board, in the absence of the chairman.*

Stage 8: *The board discusses action to be taken in view of the findings and sets this in train.*

Stage 9: *The fact that the appraisal has been conducted, and an outline of the method used, are reported in the Annual Report and Accounts.*

2) DIY2: Self appraisal using questionnaire and interview

Stage 1: *Agree the scope, “spirit” and method of the appraisal in consultation between directors, perhaps at a board meeting. This is important in order that all directors may understand the purpose of the appraisal and the ground rules.*

Stage 2: *Agree the “agenda” for the process (i.e. the subjects to be covered in the investigation). The chairman and directors may already have identified some relevant issues which have been the subjects of continuing discussion but these should not be investigated to the exclusion of other topics.*

Stage 3: The questionnaire is distributed (perhaps by the company secretary), is completed by directors and relevant parts returned to the chairman and the SID. (It is likely that most boards will treat the questionnaires as confidential between the individual directors and the chairman/SID, rather than wholly anonymous).

Stage 4: The chairman and SID analyse the questionnaire responses and, where appropriate...

Stage 5: ...conduct follow-up calls for clarification or further discussion of subjects arising.

Stage 6: The chairman and SID summarise their findings in preparation for reporting and feedback.

Stage 7: *The chairman gives feedback to the board collectively and, where appropriate, to individual directors. The SID gives feedback to the chairman after discussing the general findings with the board, in the absence of the chairman.*

Stage 8: *The board discusses action to be taken in view of the findings and sets this in train.*

Stage 9: *The fact that the appraisal has been conducted, and an outline of the method used, are reported in the Annual Report and Accounts.*

3) Appraisal using Third Party Facilitation

Stage 1: *Agree the scope, “spirit” and method of the appraisal in consultation between directors, perhaps at a board meeting. This is important in order that all directors may understand the purpose of the appraisal and the ground rules.*

Stage 2: *Agree the “agenda” for the process (i.e. the subjects to be covered in the investigation). The chairman and directors may already have identified some relevant issues which have been the subject of continuing discussion but these should not be investigated to the exclusion of other topics.*

Stage 3: The chairman and the senior independent director (SID) brief the third party facilitator and agree the agenda and method (probably some variation on the DIY1 and DIY2 themes).

Stage 4: The third party facilitator solicits the views of the directors, the company secretary, client director and any other relevant parties on the various topics, follows up and discusses where appropriate and prepares separate reports for the chairman and the SID. The feedback from individuals may be attributable or not, provided this is made clear at the outset. Here again, it is likely that most boards will treat the questionnaires as confidential between the individual directors and the chairman/SID (via the third party), rather than wholly anonymous/unattributable, although this practice might be varied in some circumstances.

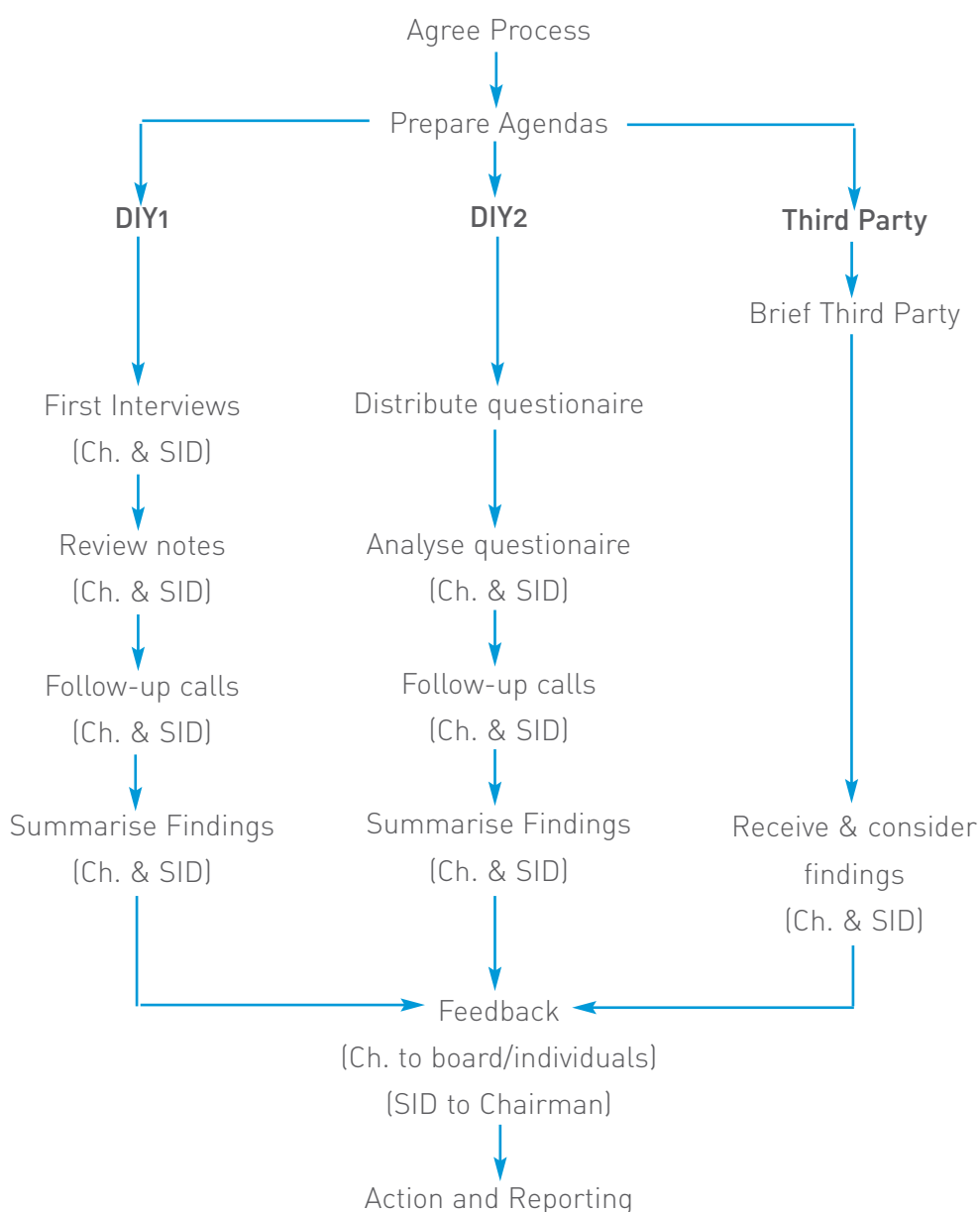
Stage 5: The chairman and SID discuss the findings with the third party facilitator in preparation for reporting and feedback.

Stage 6: *The chairman gives feedback to the board collectively and, where appropriate, to individual directors. The SID gives feedback to the chairman after discussing the general findings with the board, in the absence of the chairman.*

Stage 7: *The board discusses action to be taken in view of the findings and sets this in train.*

Stage 8: *The fact that the appraisal has been conducted, and an outline of the method used, are reported in the Annual Report and Accounts.*

Diagrammatically, the three processes might look as follows:



General guidance for questions to be addressed in an appraisal can be found after page 113 of the Higgs Review, which can be downloaded from:

www.dti.gov.uk/cld/non_exec_review/

A practical appraisal questionnaire template for investment trusts, with guidance notes, can be found on the Trust Associates website: www.trustassociates.co.uk ; alternatively, a hard copy may be obtained from Lori Fox at the AITC.

Appendix

Corporate governance and board appraisals in the United States and Europe

Work on the development of corporate governance codes and principles around the world has developed at a faster pace since 1999, especially following the Enron, Worldcom and Vivendi scandals. The Higgs Review and the Combined Code, as amended, are attempts to resolve issues similar to those arising elsewhere and it is useful to consider them in this wider context.

Prior to the recent scandals, corporate governance in the USA was largely a matter of state corporate law rather than federal securities' legislation, and boards of directors of publicly owned companies had considerable freedom in meeting corporate governance requirements. The scandals revealed a serious lack of oversight of corporate accounting and financial reporting by boards and audit committees as well as damaging management conflicts. In response, Congress passed the Sarbanes-Oxley Act, 2002. As directed by the Act, the Securities and Exchange Commission (SEC) promulgated new listing rules, covering independence standards and the responsibilities of the audit committees, which came into effect in April, 2003.

The model of corporate governance proposed in the Act and subsequent rules follow the 1940 Investment Company Act, which set out the standards for independent directors, who should form at least 40% of the members of the board. These requirements were tightened up in 1970 and again by the SEC in its 2001 rules, which increased the representation of independent directors on the board to over 50%, required new independent directors to be selected by the other independent directors and that any legal counsel to the independent directors should also be independent.

The Investment Company Institute set up an advisory committee, which reported in 1999. That committee set out "best practice" recommendations which include the appointment of a lead independent director, meetings of independent directors separate from management and representation by an experienced independent counsel. A substantial proportion of mutual fund companies have

followed most, if not all, of these recommendations. The corporate governance rules covering investment companies are probably the most relevant to investment trusts.

The same committee recommended that the boards of investment companies should carry out periodic evaluations of the effectiveness of the board, focusing on both the substantive and procedural aspects of the board's operations. The advisory group did not set out any specific criteria against which the board's effectiveness should be measured.

On procedural matters, the board should consider the frequency of its meetings, whether the information provided is 'useful, sufficient and properly focused', whether the board meetings cover all the relevant items and whether the independent directors have enough time to discuss the issues they find important. The independent directors should consider whether they are able to discuss the agenda and other issues separately from the management and also whether the board would handle its work more efficiently through committees as opposed to full board meetings.

Regarding the evaluation of independent directors, the issue is whether board members participate actively, ask pertinent questions and contribute meaningfully to the board's discussions, but the guidance gives no indication as to the method. The board should further consider whether it has 'the right mix of backgrounds, skills and experience', bearing in mind that diversification of experience and professional backgrounds contribute to the board's effectiveness. This guidance was issued in 1999, but stock exchanges will enact self-assessment requirements.

These are best illustrated by the proposed listing requirements of the New York Stock Exchange (NYSE). The NYSE's Corporate Responsibility and Listing Standards Committee made a series of recommendations to the Exchange's board of directors, following the Sarbanes-Oxley Act, which include recommendations for the establishment of nominating/corporate governance, audit and compensation committees, and for an annual performance evaluation for each of these committees. In addition, the Committee recommended that the board should "...conduct a self-examination at

least annually to determine whether it and its committees are functioning effectively". Interestingly enough, the proposed rule changes put before the SEC by the NYSE include provisions for the annual evaluation of the three proposed committees, as well as an annual evaluation of the board in line with the Committee's recommendation. The matter still rests with the SEC and the new rules have not yet received approval.

Almost all of the current member states of **the European Union** (except Austria and Luxembourg) have at least one corporate governance code, most of which have been issued since 1997 and most of which have been issued in the UK. The codes do not all have the same status, being variously issued by governments, governmental commissions, stock exchanges, business, directors' associations and investor-related groups, but all express "best practice". The Codes tend to converge but one significant difference relates to the role of employees in corporate governance.

In Austria, Denmark, Germany, Luxembourg and Sweden, employees of companies of a certain size have the right to elect some members of the supervisory body. In Finland and France, the company's articles may give employees a similar right and in France, when employee shareholding reaches 3%, employees have the right to nominate one or more directors, and in some countries, employees may have the right to attend board meetings but do not have the right to vote. In all other member states, only the shareholders elect all the members of the board. The differences between the two-tier board system and the unitary board system are insignificant, since both the supervisory and the unitary board have similar responsibilities.

The European Commission has considered producing a European Union-wide code but the attempt to provide such a code would be difficult given the varying legal frameworks and is unlikely to set out "best practice" guidelines as opposed to minimum standards. Indeed, the report commissioned by the European Commission argues that the harmonisation of laws and securities regulations covering disclosure and shareholder participation is much more important than drawing up a Europe-wide Code in bringing about the

single European market. A Europe-wide Code is unlikely to improve on the basic principles of corporate governance set out by the OECD in 1999. However, the report suggests that despite the differences in the institutions of governance, share ownership, capital markets, and business culture across the European Union (and elsewhere), corporate governance requirements are very similar on the surface at least and likely to continue to converge.

Regarding the issue with which we are concerned here, board evaluation, some of the most recent codes do set out such a requirement. Board evaluation is, however, a requirement which has to be seen in the context of the corporate governance requirements in each of the countries concerned.

Significant differences exist in terms of the focus of corporate governance codes, ranging from protecting or promoting shareholder rights, the interests of the shareholders who provide risk capital and other stakeholders, to the interests of the company itself. Disclosure requirements, protection from major shareholders, participation in the AGM and proxy voting all differ and cross-shareholdings with “reciprocal” directorships are still a significant issue in many countries. At the level of the board, there are significant differences in the understanding of the role of the board, but standards for disclosure of the composition of the board and of individual executive and director remuneration are all moving in the same direction, following the UK example.

Other issues such as the size, composition, independence, selection criteria and procedures are also converging. The Codes increasingly emphasise the quality, experience and independence of the board’s membership (although some countries have compulsory representative membership) and relevant qualities such as experience, core competences and availability. Notions of independence vary greatly; for example, in Portugal, independence simply means being separate from dominant shareholders.

France and Germany have both introduced requirements for board evaluation. In **France**, these are part of the Bouton Report (September, 2002), which was produced by the same panel as the Vienot Reports I and II. The panel consisted of the chief executive

officers of 14 major French public companies, chaired by Daniel Bouton, chairman of Société Générale and the reports were produced at the behest of the AFEP (Association Française des Entreprises Privées) and MEDEF (Mouvement des Entreprises de France). The latest report was produced in response to the Enron and Vivendi Universal scandals, but it still proposes non-binding corporate governance principles. The contents of the report cover the same ground as other recent codes, but since the Government did not consider that the report was sufficiently protective of investors, the Minister of the Economy proposed the enactment of new binding corporate governance rules to increase the Statutory Auditors' independence and the role of the Shareholders' Assembly as a counterbalance to the executive management. These rules came into force in 2003. Other proposals in the report are the subject of listing requirements laid down by the Commission des Opérations de Bourse (COB).

In **Germany**, the Cromme Commission was established by the Minister of Justice in September, 2001 to revise corporate governance requirements. The Commission published the Code in February, 2002, but it was revised in May, 2003 to take account of the European Commission's action plan for modernising company law and improving corporate governance in the EU. The amendments are primarily concerned with the issue of executive compensation, covering individualised disclosure of management and supervisory board compensation; a cap on stock option schemes; the disclosure of the value of stock options; and the publication of the compensation system on the Internet and the disclosure of the details of the scheme to the annual general meeting by the chairman of the supervisory board. A survey conducted by the Berlin Centre for Corporate Governance revealed that many companies had adopted the mandatory sections of the Code and published their compliance on the website by February, 2003. The Code Commission remains in existence to observe and assess further developments, in particular the way companies handle these and other issues and to study the European Commission's action plan and incorporate its findings as well as their own into the Code.

The main code produced in **Sweden** is the code produced in 1999 by the Swedish Shareholders' Association, drawing on the work on corporate governance in the UK and the OECD's 'Principles for Corporate Governance'. It should be noted that the composition of the board is quite different from boards in other member states. It normally consists of 6-9 people with management represented by the chief executive, an independent chairman, employee representatives and (sometimes) others serving in a representative capacity, such as a consumer representative. Board members in accordance with the code are nominated to the board by the Nominations Committee.

The Nominations Committee should consist of 3-5 members, appointed by the shareholders at the Annual General Meeting. The committee should reflect the different categories of shareholders of the company, including a representative of the small shareholders (associations of small shareholders exist and are active). They nominate directors and put forward proposals for directors' fees and decide whether or not to re-nominate directors, often after an assessment interview of their performance.

The Code requires the board to draw up an agenda for its work during the year and what reports should be given by the company in the course of the year. It should annually evaluate its work and ensure that the "directives" to the CEO and the reporting instructions have been followed. Again, the nominations committee has to evaluate the work of the board as a whole and ensure that the board's work during the year has followed the guidelines.

The Code sets out the responsibilities of the board. The shareholders should ensure that the board takes the responsibility for ...

"the shaping and development of the strategic management of the company, the business idea, goals, risk policy, budgets and business plans, as well as deciding on major investments, acquisitions and divestitures, the appointment and, if necessary, the replacement of the Managing Director ..." the board shall be responsible for steering and control as well as compensation and reward of the company's management. The board is responsible for ensuring that the company's internal and external accounting fulfils the highest

possible requirements concerned audit, control and risk management and for ensuring that communication with the company's owners and other interested parties is characterised by openness and correctness".

What is actual practice regarding board appraisals elsewhere?

Board appraisals have certainly been the subject of much discussion and even acceptance in principle, especially in **the USA**. According to the survey published in 2001 by the National Association of Corporate Directors, maintaining a process to "evaluate the effectiveness of the board" gained near unanimous support and more than 91% of directors favoured regular board evaluations. Valued it may be, but there is little evidence either in the USA or elsewhere of board evaluations actually being conducted. Advice on the conduct of board evaluations is widely proffered by various consultancies in the USA but its basis is not clear.

The Sarbanes-Oxley Act has provoked widespread discussion about the role of the board in the USA and a few comments are worth attention. For example, one commentator noted that the *"...most significant unintended consequence... is that boards are focusing so much on issues of structure that they are not giving enough attention to their primary responsibilities"*. That is one danger and it applies just as much on this side of the Atlantic just as the issue of board evaluation does.

There is a recognition and, indeed, a requirement that boards should be evaluated, but questions are being raised about the method, including board self-evaluation as opposed to an outsider conducting the review. One commentator added that *"...evaluation is terrific, in theory, but in practice, it's much more difficult. It's very hard to evaluate a fellow director effectively, for many reasons..."* and warned against a paper-based evaluation, which could create difficulties in a litigious context. All such documents are discoverable in the USA and judgements about individual directors would have to be justifiable. It is possible, under the Human Rights Act, that similar problems could occur in the UK.

In France, the Bouton Report does contain more details of self-assessment and the way in which it should be carried out, and are more extensive than the proposals in the previous reports, Vienot I and II. Self-evaluation should have as its focus an assessment of the operations of the board, including checking that important issues are prepared in a suitable manner and that adequate time and opportunity have been given to the discussion of the issues. In addition, the actual contribution of each director should be assessed on the basis of his or her competence and involvement in board discussions. The report proposes a particular approach to the assessment: the board should assess its own operations and discuss this as a board on an annual basis. A more formal evaluation should be conducted every three years under the leadership of an independent director with the help of an external consultant. The independent directors should also conduct an annual evaluation of the performance of the chief executive and the chairman of the board and the future of the company's executive management.

The German Code recommends, but does not require, the supervisory board to examine the efficiency of its activities on a regular basis. However, some German companies have published a full set of principles of corporate governance, including the adoption of the recommendations as well as the mandatory elements of the Code. Deutsche Bank, for example, announced that *'the supervisory board regularly examines the efficiency of its operations'*.

In Sweden there are, despite the role of the nominations committee, no formal procedures for evaluating the board and the directors; although the matter is open for discussion, little progress has been made.



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