

January 2022

Thought Leadership Contribution: Why Independent Directors?

With ESG (Environment, Social & Governance) having become such a significant focus in the Asset Management world, and in many cases the main driver for change and challenge, are Funds and IFMs (ManCos and AIFMs) paying enough attention to their own Governance structures?

Board members will increasingly be expected to challenge the Governance of the companies into which their Funds invest, and indeed in some cases may require dis-investment from those who do not, for example, demonstrate sufficient Diversity and Independence on their Boards or perhaps do not adequately disclose sufficient and accurate Information to their shareholders.

Can we honestly say that, to date, the Governance applied to the Boards of Funds and IFMs would pass the same level of examination in all cases?

The Bi-annual PwC Luxembourg/ILA Fund Governance Survey, last published in 2020, does indicate a slow improvement in the Diversity, specifically gender, seen on Boards, but at the same time shows a fairly glacial move towards the routine use of Independent Directors on Boards, and in particular on the Boards of ManCos and AIFMs.

Why should this be and how can the benefits of enhancing Governance, including Independent Directors on a Board, be better explained to what appear to be, in many cases, reluctant Fund Promoters?

Let's start with a tentative approach to the definition of what an Independent Director is:

According to the CFI (Corporate Finance Institute), "an Independent Director is a member of the Board of Directors who does not have a material relationship with the company, is not part of the company's executive team, and is not involved with the day-to-day operations of the company."

The NYSE further states that: "no Director qualifies as 'Independent' unless the Board of Directors affirmatively determines that the Director has 'no material relationship' with the listed company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the company."

The European Commission (recommendation 2005/162/EC) indicates that: "A director should be considered to be independent only if he/she is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement."

How the "no material relationship" criteria are understood may leave room for interpretation or vary from one jurisdiction to the next but at the end of the day it is the Board of Directors' respon-

sibility to ensure there is no problem and to be accountable for it.

Another facet of Independence much less discussed to date but undoubtedly of growing importance going forward is the diversity and freedom of opinions of the Directors. Thinking outside of the box and avoiding cognitive biases can be very useful when the Board is faced with crisis and difficult situations to address specially under time pressure as is often the case in financial services.

The case for strong Governance on a Fund and/or IFM Board

It is acknowledged that investors in funds, and especially retail clients, are not active investors in the same way that a large Institutional shareholder in a commercial company may be. They do not, as a rule, attend AGMs or vote on corporate actions undertaken by Funds when given the opportunity. They will often have (very) limited understanding of financial instruments and markets and therefore the associated potential risks.

The understanding of how a Fund is managed to meet its investment objectives, by both the end investor and the financial intermediary who has advised them to purchase, is at best gleaned from a cursory reading of a highly legalistically worded prospectus or the scant information provided in a KIID. A financial intermediary may in addition be provided training by the fund promotor which frequently has an objective of encouraging subscriptions into a specific fund.

The supervisory oversight and challenge of those performing the day-to-day management of a fund therefore, both in practical and regulatory terms, must reside with the experienced and professional Board Directors acting in the best interests of the investors/shareholders of the funds that they have been appointed to supervise.

What does an Independent Director provide to a Board?

A truly Independent Director brings an outside perspective to the oversight and management of a fund while not being subject to the hierarchical structure of the fund provider and therefore being more able to consider, and act on, issues solely with the best interests of the fund investors in mind.

Boards consisting entirely of Directors employed by the fund promotor, or where there is too much commonality of membership between the Fund and IFM Boards, can lack the authority within the group structure of a Fund Promotor to challenge the commercial strategy set by more senior boards and executive committees. The recognition of this potential conflict, and to better meet the interests of fund investors, has seen a steady growth in the appointment of Directors to the Boards of collective investment schemes, that have a corporate structure, who are not directly employed by the fund promotor.

However, for IFMs (ManCos & AIFMs) where the same situation and potential for conflict of interest exists the taking of similar action has been much slower.

Where Non-Executive Directors are sourced from service providers to the fund or affiliated companies of the fund Group, they may bring valuable knowledge and experience to the Board. However careful consideration needs to be given as to whether they can truly be classified as Independent given that decisions made by the Board may directly impact their revenue and potentially their careers. It's a fine line to tread trying to combine technical expertise at the Board level with no conflicting material business relationships as required for "true" Independence.

Do the Regulators Have a View?

The Financial Conduct Authority (FCA) in the UK provides a good example of the thinking of some regulators, and where they see the existing Governance structures potentially failing fund investors.

The FCA has in recent years imposed a mandatory requirement for two Independent Directors to sit on the Boards of Authorised Fund Managers (AFM). When introducing this new regulation, the FCA referred to the asset management market study which they had conducted and their supervisory experience. These raised concerns around examples in a range of funds where the costs and charges investors pay appeared unjustifiably high and where communications with clients were unclear.

They found that AFM boards:

- Generally, do not robustly consider value for money on behalf of fund investors
- Occasionally fail to take appropriate and timely steps to address underperformance
- Can lack the authority within the group structure to challenge the commercial strategy set by more senior boards and executive committees

The FCA recognised, as with most company boards, that there is an inherent tension in the role of the AFM board. The board needs to balance the competing interests of investors and of the AFM and its shareholders. They concluded that on the whole the better competition works in investors' interests, the less reliance is needed on regulation. However, the asset management market study showed that competition was weak in some areas of the market, particularly with respect to value for money.

This led them to propose a package of remedies to make competition work better in the asset management market and to improve protection of the interests of investors. The key elements of the package that relate to fund governance by AFM boards were intended to:

- clarify how we expect the board to act in the best interests of fund investors and explicitly consider value for money
- increase the robustness of scrutiny through the introduction of independent members
- increase the accountability and influence of the board
- allow for greater scrutiny of how boards are discharging these important obligations

While the introduction of UCITS V required the appointment of Independent Directors to IFM Boards, where both IFM and the Depository for a Fund managed are part of the same Group, and several regulations (for example CSSF circular 18/698) stress the need for IFMs to act in the best interest of the shareholders of the funds which they are appointed to manage, there is not, as yet, any regulation in Luxembourg which more broadly requires the appointment of Independent Directors to a Board to address the wider issue of challenging in the best interests of the Fund investors.

Conclusion

Surely this is an area where the Fund Industry should be taking the initiative to positively enhance the Governance of the structure and operation of Funds and IFMs. This can only reinforce the Governance to better service our investors and to meet existing, and potential future, expectations of laws and regulations concerning the Fund Industry in the various jurisdictions where we operate.

That would be a good way to walk the ESG talk for our industry.

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