Fund governance in focus

An industry expert roundtable discussion

INDOSFINANCIAL
INDEPENDENT FUND OVERSIGHT

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Introduction

On May 21 a group of leading players from across the fund business, each from different industry sectors, came together to debate what is happening in fund governance. Following is a summary of what was discussed, with background to put the discussion into context.

By comparison with many other areas of the asset management industry fund governance has received relatively little attention over the years. It only tends to come to the fore when something goes badly wrong. There was a flurry of interest in fund governance in the wake of the 2008 financial crisis but that soon dissipated once markets resumed their upward trajectory.

However, a number of factors have come together recently that suggest that fund governance will climb up the industry's agenda, on a more permanent basis. The growing institutionalisation of the alternative fund industry's investor base, the rapid rise of ESG and the ever-greater interest in fund governance matters taken by regulators are three reasons why this is likely to be the case.

Whilst issues surrounding the governance of funds have not received as much attention as many would claim that they deserve there have nonetheless been significant improvements in the levels of professionalism by those involved in this sector over the last decade.

For example, independent directors serving on fund boards today are often highly experienced, capable individuals who are able to bring invaluable perspectives to boardroom discussions. That wasn't always the case.

IFI Global's fund governance publication, The NED, has analysed the composition of 1,018 funds of 50 the largest, and mainly alternative, managers. Its analysis shows that there is much variability in standards. This includes: fund board size, use of independents (and how 'independent' they actually are) and gender diversity.

How many consider this variability to be a problem is unclear. But what is clear is that the investors that The NED has surveyed on fund governance matters over the years are resolutely in favour of more transparency, which would help expose the problem. The desire to see more transparency in fund governance practices appears to be getting even stronger today, according to the latest research that The NED has undertaken with investors this year.

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This may have something to do with the rise of ESG. ESG could well become a dominant factor in fund governance in the coming years.

Transparency in the director selection process and fund board composition are likely to become much more commonplace, as a result of the asset management industry adopting business practices which conform to investors' expectations in ESG standards. The days when private funds, including those domiciled in offshore jurisdictions, could get way with saying that this is a confidential matter may be coming to an end.

> There is likely to be more change in the next few years than there has been in the last decade

For all these reasons this is an interesting time to following what is going on in fund governance. There is likely to be more change in the next few years than there has been in the last decade.

As a result, INDOS Financial, a JTC Group company and specialist fund oversight and governance service provider, and IFI Global decided to host a roundtable to discuss what is happening in fund governance at the moment. Speaking at the roundtable were:

Anna Colombatti (AC)
Head of Operational Due Diligence, Architas Multi Managers (AXA Group)

Max Hilton (MH)
Managing Director, Clarus Risk

Mike Jones (MJ)
Managing Director, Mourant Consulting

Greg Kok (GK)
Group Head Management Company, JTC

James Newman (JN)
Co-Head & Co-Founder perfORM Due Diligence Services

Bill Prew (BP)
Founder & CEO, INDOS Financial

Rebecca Walters (RW)
COO, Vor Capital

What is fund governance?

BP: Fund governance is about the checks and balances that ensure a fund operates in the best interests of its investors. I believe that there is not enough focus on fund governance across the industry as a whole and there are still too many examples of 'tick the box' compliance rather than effective oversight on which investors can genuinely rely to protect their interests.

> There is not enough focus on fund governance across the industry

JN: Fund directors should act as watchdogs for investors, though their responsibilities extend to all the stakeholders – and this includes the service providers. The investment manager should be viewed as one of those service providers.

MJ: There are different drivers for improvements in fund governance, such as crises and investor driven initiatives. But there are also regulatory requirements that come in to enhance it as well. Outside inspections of international jurisdictions, for example, mean that regulators have to be on top of their game.

An example of that is the recent FATF assessment of Cayman. It resulted in Cayman being placed on the FATF grey list. From a regulatory perspective, the bar has been raised spectacularly over the last few years. This is not going to stop; it is only going in one direction. Regulatory standards have changed fund governance from being a tick box function to more of a focus on effectiveness. For instance, there have been some recent sanctions in Jersey which were done pre-emptively. Although nothing had gone wrong, up to that point, they could have done in the future.

> The bar has been raised spectacularly over the last few years

GK: Fund governance is about a lot more than what happens at the board meeting. It has to be a shared burden between a number of different parties including the board, the ManCo and the service providers. Expecting the directors of the fund to be all seeing and knowing is impractical.

Much of the ability of a director to do his or her job properly depends upon the quality of information that he or she gets. It has less to do with the information quantity. It more often has to do with how this information is presented to the directors. ManCos have come under pressure to produce more detailed reports for the directors, for example.

And there is more focus on the skill sets of directors than there used to be. This has become much more specific. There are now detailed questions as to how much time is spent in board meetings discussing matters like AML compliance. It is likely that the same thing will apply to ESG in the future too.

A definition of bad fund governance would be directors just rubber-stamping decisions made by the management.

The evolution of fund governance

AC: Things are very different today than they

> Things are very different today than they were back in the Madoff era

were back in the Madoff era. There is more transparency, and reporting is much better. But there are still matters that happen today which investors need to focus on, things that could create issues if they do not do that.

For example, it is important that there is good due diligence of the documentation; that helps you make sure that you know what is going on. Investors in Europe tend to do a lot of due diligence on alternatives but not so much on UCITS funds. However, Woodford and H2O were UCITS funds and more due diligence should have been done on them by investors.

BP: Despite improvements in governance since the financial crisis, high profile issues such as these still come along. Regulators appear to get involved once the horse has bolted and questions are raised about how governance and oversight fell short. Strong governance should raise alarms and ensure issues are addressed at a much earlier stage.

Regulation has played a role and the building blocks of good fund governance are in place. For example, the role of the depositary under AIFMD, but often they are seen as a compliance necessity rather than a key component of good fund governance, performing oversight of fund operations throughout the year. Depositary is also a good example of where conflicts of interest exist – since often the depositary is affiliated to the fund administrator that performs processes the depositary has responsibility for overseeing – a genuine case of marking your own homework. These and other conflicts need to be appropriately managed.

MH: I notice an increasing concern with the level of responsibility and quantity of information that boards are required to deal with. One has to take a view of how much information is reasonable in order to make an informed and measured decision.

Pre-Madoff and 2008, the consensus was that investors in, say, Cayman hedge funds didn't need an independent assessment on risk. Back then the industry culture was that it was sufficient to rely upon the risk information provided by the fund's portfolio manager. By contrast today boards are typically presented with independent leverage, liquidity, credit and counterparty risk metrics. Directors now have the responsibility to address and evaluate these reporting sets.

RW: Directors have often been chosen because of their connection or friendship with the fund manager. Managers have tended to want to have someone on the board who they know. Whist this dynamic has some benefits, is it really the right one for the fund's board?

As the COO of a fund, I like to have directors who I can use as an independent sounding board. In particular, to ask them what they think

The evolution of fund governance

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is in the best interests of the funds' investors. I go to them to get a fresh, experienced and independent perspective. This is different from prior experiences earlier in my career where I've seen instances of portfolio managers treating the role of an independent board with suspicion or as a possible threat. In my opinion these have been missed opportunities to utilise the depth of knowledge of independent boards.

The better your directors and service providers are the better you are as a manager.

BP: Running a depositary you want to see directors on the board who have teeth and will act on issues which are escalated to them. When they don't it can be a problem and the only recourse can be to escalate the issue with the regulator.

AC: In continental Europe many managers don't want external directors. They think that they create difficulties. Often when I bring up the lack of independents on UCITS boards I am told by the manager that I am the first person to have brought this matter up. Until there is a blow-up these managers will keep on doing what they have been doing. They are not challenged enough.

Listed boards have a lot of transparency. So there already standards out there. It would be great if these standards were adopted more broadly, including by UCITS funds

The interest of investors in fund governance

JN: For many investors fund governance is an important string in the 'due diligence bow'; they believe that good fund governance can lead to better investment outcomes through better risk management and oversight. However, there are investors who take the view that the directors play too passive a role – that they ultimately fall short of providing independent oversight of, and robust challenge to, the fund and service providers. Similar to Bill's point, you could say that for some their bite does not match their bark.

> There are investors who take the view that the directors play too passive a role

As a result, it is not a surprise that investors may look elsewhere in their operational due diligence programme to get to a point where they have, what I call, 'operational conviction' – that the sum of all fund governance constituents (the fund governing documents, the investment terms, the investment manager, the administrator, the custodian, the depositary and other stakeholders) are evaluated together to form an overall opinion.

One way to enhance the role of independent directors in the eyes of investors would be to create a 'disclosure of information' to shareholders that they could give to investors regarding the activities of the board in the year.

At the moment directors will say what they are responsible for, and what they have observed, to those that ask, but it is typically a generic statement and is not available to all investors. It is not an attestation of activities related to the fund, which might include how many board meetings took place during the year and the type of items discussed on the standing agenda, whether there were any board resignations, whether all administrator reports were received and reviewed in the year, etc.

If there was a requirement to include such information in the directors' report of the fund financial statements, it might focus the attention of all board members; boards that have been active would be able to demonstrate this, increasing investor confidence. The report

The interest of investors in fund governance

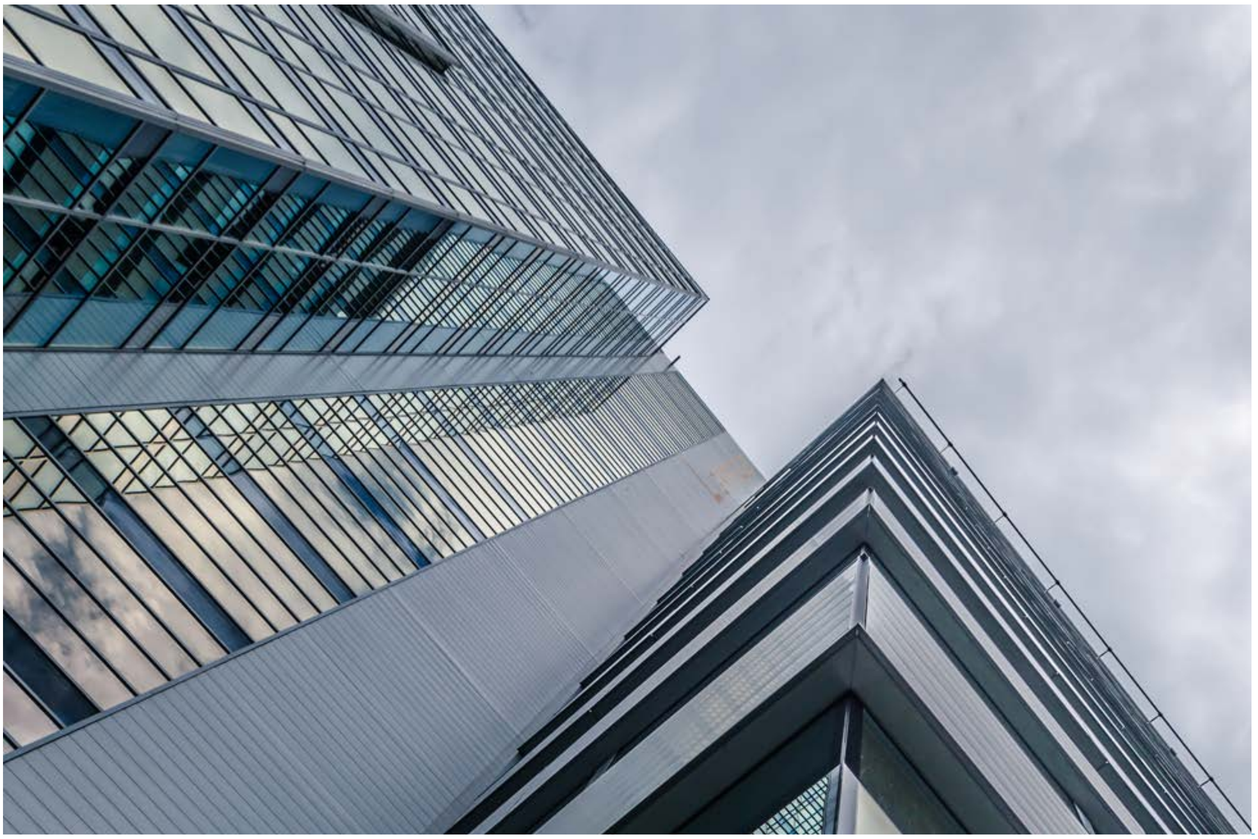
could also explain how the directors define fund governance.

Since the board decides what to include in the directors' report there is no reason why it cannot be expanded and made more useful than it currently is. It offers an opportunity for the directors to explain what they have done, what it is that they are looking at in particular and what their responsibilities are. It could be disclosed alongside the auditor's report, as a regular disclosure of what has happened at the fund year on year for all investors, not just those that ask.

MJ: Such an idea would be of interest to regulators as well as investors. What regulators look at from boards is similar to this anyway.

BP: This is like the disclosure requirements for a UK listed fund. Verification of board meeting attendance and so forth shows a level of engagement. The disclosure could also cover any conflicts that exist within the fund operations and how they are managed.

There is an opportunity for a manager to take the lead here. For someone doing ODD on a manager it would give them an advantage to be able to show the importance they and the funds they manage place on fund governance.



What regulators want

MJ: Regulators are increasingly looking at the culture of the board. For example, they might even use a tool to trawl e-mail traffic at the fund, perhaps to be used after the appointment of a new CEO to look at use of language. If certain words are used more as a result of a new CEO coming in this might signify a change in the culture.

Regulators will ask prospective directors how much time they anticipate giving to any new board role that they are applying for. Then they can use this information to question someone on their overall time commitment – to see if they are exaggerating the amount of time that they say that they are allocating to each directorship. Increasingly, they will add up the quoted individual fund commitments and see how this might impact on the director's overall time allocation.

Regulators also want to see that there is someone on the board with a governance, risk and compliance role.

Risk

> A lot of boards are not forward-looking enough on risk but we see an increasing number of risk committees being formed

MH: A lot of boards are not forward-looking enough on risk but we see an increasing number of risk committees being formed by boards. This is positive as it gives a clearer delineation of responsibilities.

There has been a big increase in reporting requirements to different entities connected to the fund as well as to regulators. The risk committee will tend to receive and consider more detailed risk reporting and provide a summary back to the board.

To have effective risk management you have to be able to demonstrate that changes have been directed and made. Without interventions and changes over time you cannot show that there is real risk oversight.

ESG and fund governance

ESG is becoming the new normal

GK: ESG is becoming the new normal but few people have experience and competency in this area.

BP: Investors are increasingly asking managers to explain how they think about ESG, at both the manager and fund level. Increasingly, 'no ESG means no USD'. I think every single board meeting should have ESG on the agenda, particularly because ESG factors can have a material impact on the risks and opportunities in the investment process. The G in ESG is not just about governance within a portfolio investment company, but governance at the manager and fund level too.

IFI Global