Investment funds are lacking independent governance

LCP fund governance survey report

May 2017

Introduction - why fund governance matters

When deciding which companies to invest in, many investment managers take into account the strength of the corporate governance at the company. Many investors, however, take little account of the governance of the investment funds they use.

In companies, it is widely seen as good practice to have separation of executive control (the Chief Executive) from oversight and senior remuneration policy (typically the responsibility of the company Chairman). But this separation of executive and oversight is rarely considered in relation to investment funds.

Many pension schemes invest their money in a range of investment funds that pool their assets with those of other investors. These funds are provided by investment managers, and trustees may think of these funds as being part of the investment manager's business. However, investment funds are often separate legal entities from the investment manager, with their own board and management structure. Strictly, the investment manager is employed by the fund to provide a service. Hence corporate governance considerations apply to investment funds, in a similar way to companies.

We recently conducted a survey of the governance arrangements for the investment funds used by our clients. In this context, by "governance" we mean the arrangements to ensure that investment funds are managed in a way that is aligned with investors' interests. Our survey focused on the fund's legal structure, the composition of its board of directors (or equivalent) and how the fund is regulated. We wanted to see how well these governance arrangements are aligned with the fund's responsibilities to act in the interests of its investors.

Although fund governance rarely hits the headlines, it is now receiving more attention due to the Financial Conduct Authority (FCA) review of the asset management market. The FCA has raised concerns that investors may not be receiving value for money and are not well placed to assess or address this. It identified changes to fund governance as a potential remedy for these concerns.

We wanted to see how well governance arrangements are aligned with the fund's responsibilities to act in the interests of its investors.

Matt Gibson
Partner

The role of the investment fund director

+ Funds can take many different forms, including companies, trusts and unit-linked life insurance policies. We use “fund director” and “fund board” as a general term for the individuals and the group that is ultimately responsible for the fund.

The directors responsible for investment funds are often affiliated to the investment manager and this can cause conflicts that disadvantage investors.

The directors appoint a number of service providers for the fund including:

The investment manager

Responsible for making investment decisions such as which stocks to hold

The administrator

Responsible for record-keeping and the mechanics of buying and selling units

The custodian

Responsible for the safe-keeping of assets

If the fund board is affiliated to any of these service providers, there is a clear conflict of interest in making these appointments and in negotiating fees for these services. In some cases, many of the service providers and the fund board are all part of the same financial services company.

In extreme circumstances, the board may have to make some dramatic decisions about the fund, such as deciding to suspend redemptions. They’ll do so under the advice of the investment manager, but ultimately it’s their decision. This is a very rare occurrence, but when that decision has to be made, the board needs to act on behalf of the investors, even if it could severely damage the investment manager’s business.

In brief

Investment managers have tended to charge large institutional clients, who employ the investment manager directly for managing segregated accounts, lower fees than pooled funds. In the US though, there is a duty on fund boards to consider the investment manager fees that are being charged to other clients. The board must show that it has negotiated the investment fee at “arm’s length” and taken into account a range of information in doing so. An independent fund board is much better-placed to negotiate the fee objectively than a board that is closely affiliated with the investment manager.

About the survey

290

investment funds used by UK pension schemes surveyed about their governance structure

50%

of the funds domiciled in the UK (significant numbers in Luxembourg and Ireland too)

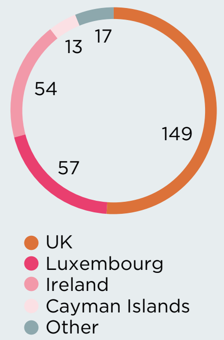
40%

of UK funds are structured as unit-linked life insurance policies

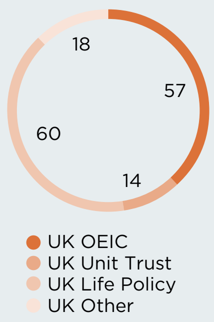
38%

of UK funds are structured as pen-ended investment companies

Funds in the survey



UK funds in the survey



Results of our survey: all funds

56%

of the UK funds did not have any independent directors

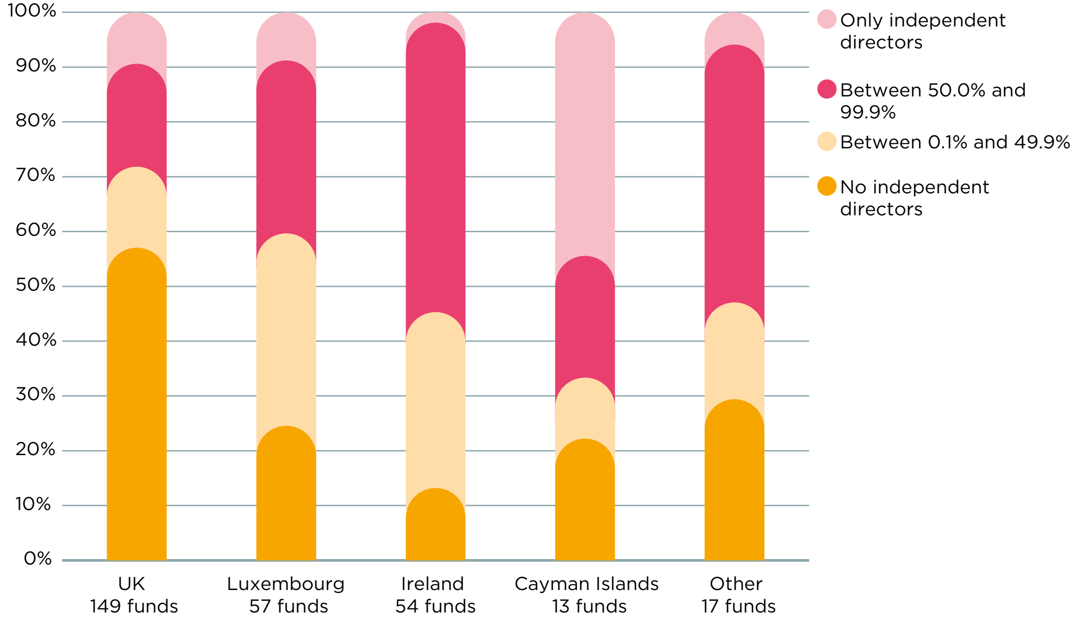
20%

of funds domiciled overseas did not have any independent directors

Our analysis found that, in the UK in particular, the boards of funds tend to be made up of individuals affiliated with the investment manager. Over half of the UK funds did not have any independent directors, compared with only about one-fifth of funds domiciled overseas.

We have less data on funds in the Cayman Islands and other off-shore venues, but the data we do have suggests that independence is far more common in Cayman Island domiciled funds. This finding is consistent with the experience of an independent director of funds in the Cayman Islands we spoke to. He told us that the majority of the fund boards he sits on have more than 50% independent directors. These offshore fund centres are usually regarded as the "wild west" of investment funds, but in respect of fund governance they look ahead of the UK.

Percentage of fund directors independent of the investment manager by fund domicile



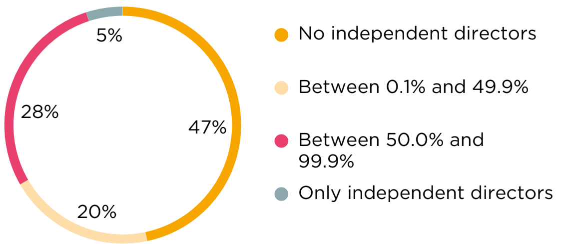
Results of our survey: UK funds

Life funds

The most common legal structure for the UK-domiciled funds we surveyed was unit-linked life insurance policies. These funds differ from many others in the survey, because they aren't strictly funds at all but are insurance contracts. The value of the contract is linked to the value of an underlying pool of assets. The contract is with a life insurance company and the pool of assets is run by the investment manager. The fund is regulated by the Prudential Regulation Authority (PRA) as well as the FCA, whereas most other UK funds are just regulated by the FCA.

Here the responsibility to act in investors' best interests derives from insurance regulations relating to treating customers fairly, rather than company or trust law requirements. Our survey asked whether the directors of the insurance company writing the contract were independent of the investment manager. About one-thirds of these funds had a majority of independent directors.

UK life funds: Proportion of independent directors (60 funds)

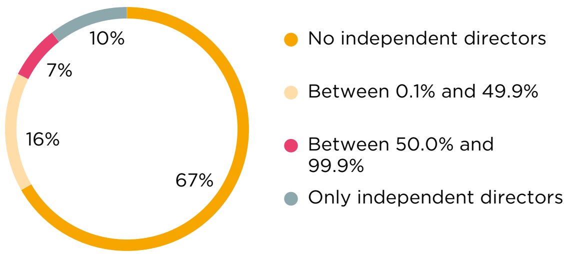


Investment companies

Investment companies are common in many countries with a plethora of different acronyms, but similar structures (eg OEIC, ICVC, SICAV). In the UK, they are known as OEICs, ie open-ended investment companies.

These funds are themselves companies and require a board and directors to make decisions about how they are run. In the UK, they typically have an Authorised Corporate Director (ACD), rather than a board of individuals. The ACD is usually a company in the same group as the investment manager. Where we have the data, we have looked through the ACD to its directors to see if they, as individuals, are affiliated with the investment manager. Where data on the individuals has not been provided, we have assessed independence based on whether the ACD is in the same group as the investment manager. Our survey found that only about one-fifth of UK OEICs had more than 50% independent directors.

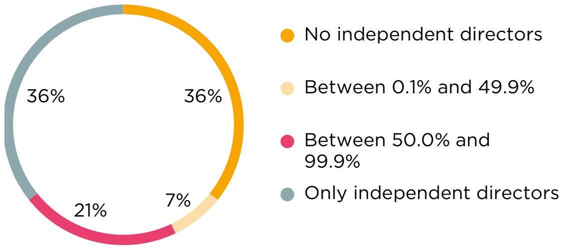
UK OEICs: Proportion of independent directors (57 funds)



Unit trusts

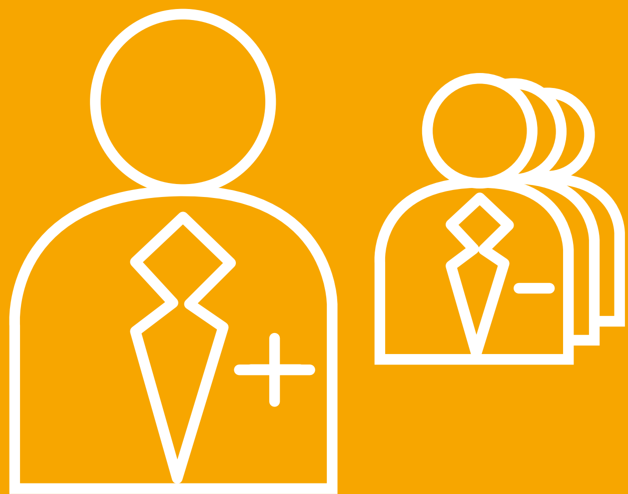
We found that UK unit trusts tend to have a higher degree of independence than either life funds or OEICs. In this structure, the fund is controlled by trustees, rather than directors. Many of the unit trusts in our sample have trustee boards of individuals (rather than a single corporate trustee), making it easier to appoint independent people to the governing body.

UK unit trusts: Proportion of independent directors (14 funds)



Our viewpoint

We would like to see greater independence of fund boards, and fund boards acting in the interests of investors.



Our conclusions

Our survey suggests that the majority of investment funds used by UK pension schemes lack any independent governance arrangements, and UK-domiciled funds tend to score worse in this respect than those located elsewhere.

With this issue now coming under the spotlight due to the FCA's review of the UK asset management industry, we would like to see two changes:

1. We would like to see greater independence of fund boards.

For example, OEICs could appoint individual directors, rather than a corporate director. This approach is commonly used in Ireland, the Cayman Islands and Luxembourg and makes it easier to ensure there is a degree of independence on the fund's board. More generally, we would like funds to appoint a higher proportion of independent directors.

2. We would like to see fund boards acting in the interests of investors.

For example, boards should be assessing whether investors are getting value for money from the management of their investments. In particular, we think that investors would benefit from fund boards undertaking fee comparison exercises and putting pressure on all the service providers to provide better value for money.

We will be encouraging better industry practice in this important area through our ongoing dialogue with investment managers as part of our investment research programme. We will also continue our regular survey of investment management fees and our negotiations with managers to obtain the best fee rates for our clients.

How we can help you

We can help you understand the governance arrangements for your funds and support you in discussing them with your investment managers. We would be pleased to share with you the detailed survey responses for the funds you invest in and help you challenge your managers on the specific issues affecting your scheme. **Get in touch**

Click here to access our latest research on investment management fees

INSIGHT CLARITY ADVICE

Contact us

If you would like more information please contact your usual LCP adviser or one of our specialists below.

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