

Heightened focus on governance in the year to come

Sound corporate governance has been one of the issues at the forefront of everyone's mind for some time, fund managers and investors alike, with increased regulation around improving governance and transparency.

For example, within real estate fund management, the Association of Real Estate Funds (AREF) has led the industry in providing a framework with its Code of Practice and is now widely acknowledged as the gold standard for fund corporate governance and transparency. Developing this further, in 2018, AREF launched its Quality Mark, awarded to funds that comply with the Code. This should make it easier for investors and their advisers to discern which funds have made such demonstrable commitments to the highest standards in governance.

The year ahead will no doubt bring many challenges for fund managers, not least of which will be ensuring compliance with the new FCA regulation regarding fund boards, following their Asset Management Market Study. Indeed, this affects not just real estate funds but all UK authorised open-ended funds, across all asset classes. In the following article, Melville Rodrigues, partner at international law firm Charles Russell Speechlys, considers for us the implications of these important corporate governance reforms being introduced by the UK regulator.

Adrian Benedict, Chair, AREF Corporate Governance Committee

Prepare for Independence

Uncertainty clouds the regulatory landscape for real estate and other UK fund managers and the investors in their funds following Brexit. However, whatever the Brexit scenario, this year will bring another significant date for the managers of authorised open-ended UK funds and their investors.

By 30 September 2019, the managers must comply with new corporate governance requirements¹ of the regulator, the Financial Conduct Authority (FCA), which include a requirement for:

- a minimum of two independent directors on the fund management board (or other 'governing body', which includes a similar governance body in entities that do not have boards of directors); or

¹ <https://www.fca.org.uk/publication/policy/ps18-08.pdf>

- if the board has more than 8 members, the independent directors must comprise at least 25% of the total board membership.

These requirements apply to all managers of authorised open-ended UK funds, irrespective of a fund's assets under management, and are being implemented together with new rules on assessing and reporting on funds' value for money to investors.

The FCA is concerned that management boards should balance the interests of fund investors as against the interests of shareholders: their Market Study evidence indicates that management boards have been generally staffed exclusively by executives of the management houses which the FCA feel has led to weak competition in the investment funds sector due to the relative inability of investors to find better value products. The regulator wants to ensure that the best interests of investors are better represented and that there is sufficiently robust and independent challenge within management boards. The FCA's intention is that the introduction of an independent perspective to support executive directors will lead to fund governance bodies focusing more on delivering better outcomes for investors and ultimately in delivering better value for money.

Implementing Board Membership Reforms

On the assumption that boards currently do not comply with the FCA's new requirements, fund managers must start preparing to change board membership – and take steps to appoint the requisite number of independent directors. Managers may need to identify suitable candidates for independent director roles as well as review the fund's conflicts of interest and other corporate governance arrangements. Managers may also need to involve their investors in approving candidates.

FCA Guidance

The FCA offers guidance for independent directors, for example they:

- need to have enough experience and expertise to fulfil their role albeit financial services expertise is not compulsory.
- can serve a term of up to 5 years (renewed once to a maximum of 10 years and eligible for re-appointment after a further 5 years if they meet the other criteria) within one group.
- can sit on more than one management board within a group (with the length of tenure calculated on a cumulative basis across all such appointments, but discounting overlapping periods to avoid double counting).

The guidance also indicates:

- Independence refers to no monetary link to or employment with the management house for a minimum of 5 years, and no material business interest with the management house for a minimum of 3 years. Managers with independent directors in place prior to 30 September 2019 can retain those directors on their boards on the basis of them meeting the independence requirements; the clock starts running on the maximum length of their tenure from 1 October 2019.
- Independent directors should have a role providing input and challenge to the manager's assessment of the value to investors of each fund. This assessment of value is to focus on whether the payments out of fund property are justified in the context of the overall value delivered to investors and such an assessment is to be undertaken at least annually for each fund (and for each class of units in the fund). The board of an authorised fund manager must take "sufficient steps" to address "any instance" where charges are not justified. In carrying out this assessment, as a minimum, the board should consider: the quality of service provided to investors, fund performance, the general costs of the authorised fund manager, sharing economies of scale, comparable market rates, comparable services and classes of units. The independent directors may be tasked with additional responsibilities subject to remuneration and conflict of interest rules.
- Management boards should decide whether or not to have independent chairs, though the FCA will monitor the situation and propose further reforms if necessary.
- The FCA will not be involved in the recruitment process, nor with approving candidates, albeit the FCA encourages managers to look outside the pool of usual candidates in their search of independent directors and refers to the Investment Association's initiative to increase diversity in the boardroom: see Investment 20/20.²

Harmonisation?

The FCA reforms relate only to managers of authorised open-ended UK funds, though it will continue to consider whether to extend the governance proposals. The reforms more closely match the current mutual fund regulatory practice in the US where the majority of directors are independent.³ The FCA reforms may lead to a market reassessment: investors expect governance provisions in other funds - including those funds which are closed, unauthorised and those that are structured outside the UK - to be harmonised with the FCA reforms and US practice.

² <https://investment2020.org.uk/>

³ https://www.idc.org/pdf/pub_17_fund_governance.pdf

Fund investors may also look to apply requirements for independence to investor advisory committees (IACs) or equivalent investor consultative bodies. Significant investors can dominate IACs, with minority investors concerned about IAC transparency and being treated fairly with other investors. Independent representation solutions within the IAC may assist in addressing these concerns.

The FCA considers that its reforms will make the UK asset management industry more competitive: a silver lining perspective in the midst of the uncertain clouds of Brexit. Our real estate funds industry, indeed the whole fund management industry, needs to review regularly fund corporate governance best practice to ensure the funds are attractive for investors.

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