IoD POLICY PAPER

Funds Governance in the UK:

Strengthening the Role of Independent Directors

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Introduction

Independent directors have a crucial role to play in the governance of UK investment funds. However, this potential has yet to be realised – due to weaknesses and limitations in the way that the role is currently defined.

In the light of recent scandals affecting the asset management industry – such as the collapse of the Woodford funds – there is a pressing need to rebuild trust in the sector amongst ordinary investors.

The UK asset management industry has an immense role to play in financing the green transition to a net zero economy. Independent fund directors with the appropriate expertise, training and experience are ideally placed to help guide this transformation.

Background

Bringing independent directors into UK fund governance

The UK's asset management sector is one of the crown jewels of the UK economy – second only to that of the United States in terms of its global significance. From a societal perspective, the sector plays an important role by increasing the access of retail investors to capital markets and enabling them to benefit from economies of scale in the management of their savings.

However, investors typically exert little direct governance discipline over the management of the funds they participate in[1]. Most of the time, they rely on the relevant financial regulatory authorities to monitor compliance with regulatory obligations, or alternatively utilise their ability to exit as the main means of protecting their interests.

In the US, mandatory appointment of independent directors to the boards of mutual funds has been a feature of the landscape since the early 1940s. Independent mutual fund directors are intended to act as investor watchdogs. From their location within the fund organisational structure, they are well-placed to identify and mitigate management excesses or conflicts of interest – in particular, the risk of excessive fee extraction by those who control the management of funds.

The oversight of investment funds in the UK has historically taken a different path – largely being industry-led. However, in recent years, significant regulatory harmonisation has taken place at the EU level – first for retail collective investment schemes, and then subsequently for alternative investment funds after the global financial crisis.

In 2018, the UK's Financial Conduct Authority (FCA) decided to adopt elements of the US approach by introducing an independent director requirement for all authorised investment funds. The entity within the investment chain with legal responsibility for funds – known as the Authorised Fund Manager (or Authorised Corporate Director) – is now required to have at least one quarter independent directors on its board, or a minimum of two independent directors where the board is less than eight in number.

This initiative was catalysed by the FCA's findings in its Asset Management Market Study (2017)[2], which assessed price competition and conduct in the asset management industry. The Study found that market discipline was failing to sufficiently drive down fee levels charged by UK asset managers. This was reflected in their finding that the UK asset management sector enjoyed one of the highest profit margins (in excess of 34%) of any UK economic sector.

As a result, the FCA introduced a new mandatory duty for the independent directors of Authorised Fund Managers (AFMs) to assess the 'value for money' of their funds. Through this requirement, it was hoped that independent directors would exert critical scrutiny and constructive challenge over the appropriateness of management fees, and thereby serve to champion the interests of the end investor.

The Study found that market discipline was failing to sufficiently drive down fee levels charged by UK asset managers.

[1] This policy paper is concerned with open-ended fund products, such as mutual funds or unit trusts, which represent the vast majority of funds in the UK.
[2] Financial Conduct Authority. Asset Management Market Study: Final Report. MS15/2.3. June 2017.

The performance of independent directors so far – could do much better!

In 2021, the FCA conducted an initial audit of the effectiveness of these reforms and presented a somewhat negative scorecard[3]. **It expressed disappointment with the capacity of independent directors to implement robust oversight of the practices of investment managers.**

Some directors were criticised for being insufficiently aware of their regulatory-defined duties in terms of assessing value for money. Others were seen as having insufficient expertise for the task or being unwilling to address conflicts of interest. These factors limited their capacity to probe or adequately challenge the investment manager.

From an IoD perspective, it is regrettable that independent directors are not yet seen as fulfilling a meaningful role in fund governance. However, these shortcomings are perhaps not unsurprising given how the FCA has sought to include them within the UK's fund governance framework.

Rather than positioning them directly on the boards of individual funds, as in the US, **independent directors in the UK have been required to sit on the boards of the AFM – which is a service provider firm selected by the investment manager.**

The FCA review details a number of failings on behalf of AFMs and their boards, including:

- "We found a number of the AFMs were unable to provide evidence of robust governance procedures.
- We saw a wide difference in the quality of contribution from the independent non-executive directors.
- Minutes of board meetings and discussions did not show effective challenge by independent non-executive directors of, among other things, potential conflicts and their management.
- We observed a number of board discussions which happened outside board meetings, with limited attendance, which questions whether all Board members were given an opportunity to provide challenge and means decisions are not appropriately documented.
- We saw evidence that risk and conflicts of interest registers were static, standalone documents, and, in some cases, there was little or no board discussion about them."

Source: https://www.fca.org.uk/publications/multi-firm-reviews/host-authorised-fund-management-firms

As a result, the ability of independent directors to act as impartial champions of investor interests seems likely to conflict with their fiduciary duty to promote the business interests of the AFM – given that the latter will be entwined with the retention of good relations with the investment management community.

From a regulatory perspective, AFMs are supposed to operate the funds and act in the best interests of the funds they manage and those who invest in those funds. **But this is not how most funds operate in practice.** Rather it is the 'delegated' investment managers and sponsors that are in the driving seat – given that they initiate the formation of funds in the first place, which form part of their product portfolio. **The AFM is effectively hired to tick a regulatory box for the investment manager – a power reality that is well understood by the AFMs themselves.**

[3] Financial Conduct Authority. Review of host Authorised Fund Management firms.

One finding in the FCA review was particularly revealing of the nature of the true relationship between the AFM and the investment manager: "We sometimes observed AFMs referring to a third-party investment manager to whom they have delegated functions as their 'client'. This is an incorrect description of the relationship anticipated by the regulatory framework"[4].

Given the reality of the relationship between the AFM and the investment manager, it is therefore unsurprising that some of the independent directors who have been appointed to the boards of AFMs so far have been characterised as being industry insiders with very little incentive to ask the 'difficult questions' of investment managers.

Strengthening the governance role of independent directors – what needs to be done?

Following their review, the FCA have stated that it intends to "ensure that the regulatory framework is in the right place to provide good value for investors balanced by appropriate protections, and we will consider whether we need to make changes to rules to supplement the work of this review and its findings."[5]

This task is particularly pressing as, in recent years, the industry has taken a number of reputational hits. For example, public concerns around fund liquidity and investor redemption were ignited when UK property funds came under pressure after the Brexit referendum. A similar scenario affected money market funds during the height of the Covid-19 pandemic. And a lack of liquidity was a major issue for retail investors in the wake of the Woodford funds collapses.

In the face of fund governance shortcomings, it may be tempting for the FCA to double-down in its direct regulation of investment management – seeing its own supervisory scrutiny as the only effective mechanism through which to protect investor interests.

However, despite the rocky start, **our view is that it is a worthwhile endeavour to persevere with efforts to improve fund governance through the role of independent directors.** Independent directors are well placed to offer a perspective on fund governance that goes well beyond that available to a regulator – potentially drawing on a wealth of high-level expertise and insight, and a uniquely well-informed position as an insider within the fund structure.

The FCA can do this by encouraging greater attention to the robustness of directors' future recruitment, training and board evaluation processes, and the independent resources that are available to them. But there is also a need for the FCA to address the inherent conflict of interest that is faced by independent directors sitting on the board of an AFM and strengthen their position vis-à-vis the investment manager.

A bold solution would be for the FCA to require that independent directors are appointed to the board of the fund entity itself (as in the US), and not just the board of the AFM. Directors could also be required to play a role on a fund entity sub-committee focusing on specific aspects of governance.

[4] https://www.fca.org.uk/publications/multi-firm-reviews/host-authorised-fund-management-firms
[5] https://www.fca.org.uk/publications/multi-firm-reviews/host-authorised-fund-management-firms

The governance of open-ended funds in the UK is unusual relative to the governance of other types of corporate entity, including that of closed-ended funds like investment trusts, in that the board function is effectively 'outsourced' to a service provider. This has proven to be a convenient solution for investment managers setting up multiple funds. They have been able to avoid the costs and accountability of a genuinely independent board consisting of natural persons.

But the downside to this approach has been the trust deficit that has emerged in recent years. Hence, there may be grounds for reconsidering if this outsourced governance approach is still fit for purpose.

It may make sense to re-establish legal accountability for fund entities in the hands of real boards of directors rather than AFMs, just like in any other sector of the economy.

A second, less structurally radical, option would retain the role of the AFM, but enable the FCA to control the appointment process for the independent directors of AFMs. Alternatively, the FCA could choose to establish a right of veto over any attempt to remove an independent director from an AFM board.

Either of these approaches would strengthen the position of independent directors and better position them to independently safeguard the interests of investors.

Within the right structure, and with the right incentives and training, independent directors could play a significant role in rebuilding public trust in asset management – both in the 'assessment of value' process and in other areas of governance oversight.

A key new challenge for independent directors – overcoming the scourge of 'greenwashing'

One pertinent new task for independent fund directors – in the context of the climate crisis - would be the extension of their role to oversee the sustainable investment activities of their funds.

UK retail investors have been pouring money into responsible funds at an accelerating pace during 2021. According to the Investment Association, asset managers drew £4.3bn in retail money into such funds in the three months to the end of September, the highest quarterly total on record. They now account for around 5.5% of the total assets of the UK asset management industry[6].

A recent survey by the Association of Investment Companies found two-thirds of self-directed investors consider environmental, social and governance-related factors before deploying their cash, with climate change ranking first among their concerns[7].

But this massive increase in green investing comes with tangible concerns that many funds do not live up to their responsible branding. There is a substantial risk of 'greenwashing', as investment managers seek to take advantage of this major new investment trend.

The EU's Sustainability Disclosure Regulation 2019, inherited by the UK, imposes on all investment entities the obligation to integrate material sustainability considerations into their investment strategies and make appropriate disclosures. The UK is also proposing to make it mandatory for all investment entities to report against the Taskforce for Climate Related Financial Disclosure (TCFD) framework.

But these measures are unlikely to provide sufficient transparency for retail investors to be able to make informed choices around investment funds. Consequently, at the start of November 2021, the FCA launched a process to clean up the labelling and disclosure around sustainable investment products.

One source of investor confusion relates to how investment managers are using their funds to promote environmental objectives. For example, some favour owning oil stocks and using their role as shareholders to push companies for change. Others avoid these shares or express differing perspectives around the climate credentials of different technologies and energy sources.

However, it can be difficult for retail investors to determine which of these approaches are being pursued, and whether investment managers are implementing a consistent strategy. As a consequence, the FCA has called for "initial views" on disclosure and labelling, with the aim of consulting on new rules by mid-2022[8].

£4.3bn

Amount drawn in retail money into funds in the three months to end of September, the highest quarterly total on record.

As part of this review of how investment management implements and discloses on sustainability, **the FCA should consider the role that could be played by independent fund directors. Independent directors with the relevant skills, experience and impartiality could offer robust oversight of sustainability from a key vantage point within the fund entity. and thereby provide much-needed 'green' assurance to investors and wider society.**

Such an enhanced role could be a major step forward towards more sustainable investment once the position of independent directors within the overall framework of funds governance has been addressed and placed on a firmer footing.

[6] https://www.theia.org/media/press-releases/responsible-investment-funds-make-two-thirds-total-fund-inflows-september
[7] https://www.theaic.co.uk/aic/news/press-releases/how-much-does-esg-really-matter-to-investors
[8] Financial Conduct Authority. DP21/4: Sustainability Disclosure Requirements and investment labels. 3 November 2021.

Conclusion

Time for a fresh start for independent directors

The FCA's introduction of independent fund directors as a new mechanism of investor protection is an interesting addition to UK funds governance. **But it may need something of a relaunch.** The challenge for the industry and the FCA is to define a role for independent directors that is trusted by investors and the public – both in terms of director competence and their independent perspective.

If done correctly, the contribution of independent directors to UK funds governance could represent a major step forward – going beyond oversight of 'value for money' and also playing a crucial role in the transition of the sector to a sustainable investment approach.

Such a contribution has the potential to enhance the governance, competitiveness and business prospects of the UK asset management sector over both the short and the longer-term.

IoD Policy recommendations

In order to rebuild trust in the UK's framework of fund governance, the IoD calls on the FCA to:

- **Improve the credibility of independent directors in their oversight of funds on behalf of investors by strengthening their independence from investment managers.**
- **Widen the scope of the oversight role of independent fund directors to encompass issues of key investor concern, such as liquidity and investment sustainability.**
- **Introduce formal training and CPD requirements for independent fund directors, which encompass both sector specific elements and general director training (e.g. as provided by the Chartered Director qualification).**
- **Encourage the undertaking of periodic board performance evaluations by fund boards, which independently assess their performance in championing investor interests.**

The Institute of Directors is a non-party political organisation, founded in 1903, with approximately 20,000 members. Membership includes directors from right across the business spectrum – from media to manufacturing, professional services to the public and voluntary sectors. Members include CEOs of large corporations as well as entrepreneurial directors of start-up companies.

The IoD was granted a Royal Charter in 1906, instructing it to "represent the interests of members and of the business community to government and in the public arena, and to encourage and foster a climate favourable to entrepreneurial activity and wealth creation."

The Charter also tasks the Institute with promoting "for the public benefit high levels of skill, knowledge, professional competence and integrity on the part of directors", which the IoD seeks to achieve through its training courses and publications on corporate governance.

iod.com

About the author

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Dr. Roger Barker is Director of Policy and Corporate Governance at the Institute of Directors (since September 2020) and a member of the IoD Management Team. He is also Honorary Associate at the Centre for Ethics and Law at University College London, and a regular speaker on corporate governance issues at a variety of leading universities and business schools.

Dr. Barker is the author of numerous books and articles on corporate governance and board effectiveness, including a new co-edited volume: 'The Law and Governance of Decentralised Business Models: Between Hierarchies and Markets' (Routledge, 2020). Previous books include: 'Corporate Governance and Investment Management: The Promises and Limitations of the New Financial Economy' (Edward Elgar, 2017), 'The Effective Board: Building Individual and Board Success' (Kogan Page, 2010), and 'Corporate Governance, Competition, and Political Parties: Explaining Corporate Governance Change in Europe' (Oxford University Press, 2010).

A former investment banker, Dr. Barker spent almost 15 years in a variety of equity research and senior management roles at UBS and Bank Vontobel, both in the UK and Switzerland. He has a doctorate from Oxford University and taught Politics at Merton College, Oxford (2005-2008). Until January 2020, he served as a UK Member of the European Economic and Social Committee in Brussels.

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