Frequently asked questions in relation to the FCA's Policy Statement (PS18/8)

May 2018

Governance

When should AFM boards begin the recruitment process to ensure that they have the prescribed number of independent directors in place by 30th September 2019?

Ideally, this should happen as soon as possible, given that all AFMs (regardless of size) will be going through the same recruitment exercise. The FCA has previously estimated that their proposals would require the sector to appoint a further 480 independent directors. It therefore makes sense to act quickly to hire the "best" independent directors (although the FCA did not limit the number of AFM boards that each independent director can serve on).

We note that the FCA in its Policy Statement recognised that (in relation to independent directors attending multiple boards across different commercial groups) "legitimate concerns will exist about confidentiality and other conflicts of interest" which "may mean that it does not become common practice for independent directors to serve on the AFM boards of different groups". The FCA indicated that it would monitor this situation (PS18/8, pages 18 – 19).

Can the CEO and Chair of an AFM board be the same person?

The Policy Statement says that the Chair of an AFM board can be either an executive or an independent director but is silent on whether the CEO and Chair can be the same person.

The Governance Code states that for premium listed companies, the CEO and Chair should not be the same person (though a company could explain the non-compliance of wanting the same person to do both roles). There is no governance code published yet for private companies though one is in preparation.

The SM&CR literature does not expressly state whether the same person can be the CEO and Chair; although it does indicate that firms should avoid assigning a wide range of responsibilities to a particular person if that results in the person not being able to carry out those responsibilities effectively.

For purposes of the Policy Statement, if the CEO and Chair were the same person, the AFM would still be subject to the rules on independent directors. With those rules and the SM&CR taken together, we suspect that the spirit of the FCA's regulatory reform is to increase challenge and accountability, and therefore the Chair will likely be a different person from the CEO. This is because it is difficult for one individual to show they have fulfilled their SM&CR prescribed responsibilities for an AFM both as executive and as a supervisor of the executive.

The FCA's requirement for director independence means individual NED candidates cannot serve on the board of an AFM if they have had a 'material business relationship' with the AFM in the past three years.

Does the above requirement apply if the candidate has been or is the independent director for an investment trust whose alternative investment management co (AIFM) or investment manager is the AIFM and the investment trust is independently governed?

Neither the Policy Statement, nor the updated COLL rules, contains a direct answer on this point. However, in our view, it would be reasonable to regard this scenario as equivalent to an independent director sitting on more than one AFM board within a group, which is permitted by the FCA, provided that the time served is calculated on a cumulative group basis. Therefore, provided that the candidate has not exceeded the maximum term across all AFM boards within the group (five years, renewable once to a maximum of ten years), the candidate can still be considered to be independent and cannot be said to have had a "material business relationship" with the AFM.

Could the governance rules be extended even further?

Yes, this is possible. The FCA has said that if the governance measures are not working, they might consider changing the governance composition requirements to require a majority of independent directors on the board of AFM (PS18/8, page 18). This already applies to investment trusts under the AIC Code of Corporate Governance, and the Financial Reporting Council's new Code of Governance (which will apply from the start of 2019) states that Main Market companies should have a majority of independent directors, and the Chairman must also be independent. It can be seen therefore that the broad trend in governance is to require a majority of independent directors on the board.

If a fund manager is set up as an LLP, is there a need for independent board members?

Yes, the updated COLL rules (6.6.26) refer to a "governing body" rather than a board of directors and the FCA has confirmed that the requirements will apply equally to every AFM, regardless of the type of legal entity.

Assessment of value

Are the "assessment of value" criteria prescribed?

The criteria are now expressed as "minimum considerations" (COLL 6.6.21). From the time that this rule comes into force, these are prescribed as the minimum that have to be addressed by the AFM board. It appears you can take other considerations into account, so long as you have at least considered the minimum requirements.

Would you expect AFM boards to practice differently in light of these changes?

While the fundamentals of governance have not changed, it would appear that in light of the "assessment of value" rule and SM&CR, it is now a good time to reflect carefully on adequacy of flow of information up to the AFM board, the AFM board's decision-making process and how these are recorded in board minutes, as no doubt these issues will soon be under increased scrutiny.

It is worth noting that while the Assessment of Value is new, the regulations with regard to provision of value are said to be existing by the FCA (e.g. best interests rule and TCF). The only new thing is the requirement to do the assessment with reference to prescribed criteria and within a particular governance structure, but the underlying obligation is said to be part of the regulatory framework.

Scope

Are UK AIFMs out of scope of the remedies contained within the Policy Statement?

The assessments of value and independent director rules do not apply to UK AIFMs unless and to the extent the UK AIFM is also an AFM of a UK authorised fund (i.e. an authorised UCITS, NURS or QIS). However, this regime may still be of interest to a UK investment manager where it acts as a delegate of an AFM, since the AFM may expect to pass certain of its new duties down to its delegates contractually. We see this as being particularly relevant where a UK investment manager uses the services of a third party AFM and acts as a delegate sub-investment manager on an AIF or UCITS platform.

Could the governance proposals be extended to other investment products?

Part of the original consultation process looked at whether the FCA should extend the governance proposals to other investment products, e.g. unit-linked products, insurance products and other types of investment trusts (see PS18/8, paragraph 1.32 – 1.33). The FCA received mixed feedback in relation to this proposed extension and is continuing to conduct "diagnostic" work to identify whether there is any "harm" in relation to these markets, with a particular focus on with-profit and unit-linked products. It has indicated that it will reach a view by the first half of 2019.

Benchmarking

Under the consultation paper (CP18/9), if those rules go ahead, what will funds do if they do not use a benchmark at all?

The current draft of the proposed FCA rules provides that where no target benchmark, constraining benchmark or comparator benchmark is referred to, a statement to that effect and an explanation describing how investors can assess the performance of the scheme must be included in the prospectus. Given "benchmark" for the purposes of these new rules is widely defined to capture the "value or price of an index or indices or any similar factor" it is difficult to see how an investor could measure the performance of a fund if it is not by reference to a benchmark of some sort. Perhaps absolute return funds may prove to be the exception.

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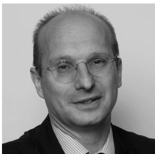

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