UKLA Technical Note

Investment management agreements and independence of the board

Ref: UKLA / TN / 405.1 Guidance Consultation

LR 15.2.19R and LR 15.4.7AR

In CP12/25 we consulted on amending LR 15 and subsequently introduced rules which state that the board of a premium listed closed-ended investment fund must be able to effectively monitor and manage the performance of its key service providers, such as the investment manager, both at admission and on an ongoing basis (LR 15.2.19R and LR 15.4.7AR).

In CP12/25, we highlighted our continued belief that it is important that the board acts as an important counterbalance to the investment manager (paragraphs 8.5 and 8.6). Specifically, we stated that we expected boards to ensure that appropriate contracts with key service providers are in place at admission and to ensure that they are in a position to take action if the contractual provisions are breached or they are no longer in the best interests of shareholders (see paragraphs 1.34 and 8.14 of CP12/25 and Handbook Notice No 4, July 2013). Whilst this issue was highlighted in the context of the AIFMD, the new rules built on an existing concept articulated as part of previous Financial Services Authority (FSA) policy work (the Investment Entities Listing Review1).

The purpose of an independent board is to offer challenge, including to key service providers such as the investment manager, and to safeguard shareholders' interests. Traditionally, the board ultimately had the ability to terminate the management agreement and appoint a new manager if the performance of the existing manager was found to be unacceptable. Of course, such a termination may be at a cost and, depending upon the nature of the fund's investments, there may commonly be a period of initial investment during which the ability to cancel any agreement would be very limited.

However, we have seen new applicants with investment management agreements that only allow the fund's board to terminate the agreement if the fund is wound up at the same time, or that continue in perpetuity or for an exceptionally long period of time, with termination costs that are essentially prohibitive or where termination is only permitted following a shareholder vote.

Clearly the challenge provided by an independent board will only lead to the dismissal of an investment manager in the most extreme cases. In addition, an investment manager will normally be subject to a number of regulatory and fiduciary duties that will govern its relationship with the fund. It is unclear to what extent the ultimate ability to cancel an agreement affects discussions between the fund's board and its investment manager.

LR 15 does not prescribe specific provisions for investment management agreements and generally we would not seek to involve ourselves in what we regard essentially as a commercial contract that needs to be appropriate for a particular fund.

1 CP 06/4, CP 06/27 and CP 07/12.

However, boards should be mindful of whether the terms of an agreement are such that their ability to act independently and provide appropriate challenge could be fettered. In the case of a new applicant, we would expect the fund's sponsor to be able to articulate how the board is able to meet the requirements of LR 15.2.19R (and in due course LR 15.4.7AR) in light of particularly onerous or unusual terms in the investment management agreement.