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The Evolution of Independent Governance and Board Diversity

Individuals who serve as independent non-executive directors, like it or not, operate in a role which is constantly evolving. This evolution is not only in parallel with changes in investment funds business but also in terms of regulation and heightened scrutiny on the financial sector generally.

Sean Inggs, a professional fund director at International Management Services Ltd in Grand Cayman and former corporate and funds lawyer, takes a closer look at this evolving role and offers his insights from a slightly different perspective.

What are your thoughts on corporate governance of investment funds in the current climate?

I think that following the events of the recent financial crisis corporate governance is definitely under the microscope, and has been for some time. We are also seeing an increase in the number of fund director service providers in the market and this gives fund managers a wide selection of choice with different providers perhaps offering different levels of service. I think that what we had before the crisis were some pretty standard business practices when it came to corporate governance but now with increased regulation in many jurisdictions there is certainly increased momentum to ensure that regulated funds are genuinely more transparent and accountable to their stakeholders.

When I was in private practice before transitioning to my role as a fund director we certainly noticed an uptick in pressure from investors who sought out board members who could demonstrate leadership and more risk awareness. These are some of the things I focus on, which I think are very important in the current climate.

I think most people in our industry can agree that securities trading and general communications now occur on an almost instant if not continuous cycle. This has many effects, one of which is to force our industry to react quicker to trends and developments. This certainly has its advantages but also brings its own risks and I think that corporate governance needs to catch up to this faster than one may think, but the good news is the ball on this has already started rolling (cyber security being a good example).

Of course I do think that governance should now be more responsive and in fact proactive to market changes and conditions compared to its slightly more static past and here I am mindful of macro shifts, globalization, the recent financial crisis and increased risks and regulation. Being an independent director now demands more time of the individual and while independence is always vital, with that must come the right skills and level of competence in the evolving landscape of alternative investments.

So what other qualities in Independent Directors do you think are desirable in the current market?

The core characteristics of any independent director are those of integrity, courage, independence and impartiality.

The usual suspects in the arena of "which director do I chose" – director capacity, relationship limits and caps, independence, qualifications, experience and insurance – have been covered at length in the industry for some time now. While each has certainly created their own well-trodden path in the forest of literature on the subject of the independent director, and while these qualities are vital for contributing to an effective board, these qualities should be seen as typical, or a bare minimum, when one is looking to appoint a board in the future or replace incumbent directors.

I am certainly not suggesting that one should ignore these factors when considering which director to appoint to a board. But once you have satisfied yourself on these qualities move on to the next level of characteristics which have quietly been gaining momentum with investors and others calling for continuous improvement to governance. This is especially true in the offshore environment where, as I have mentioned, the independent director services market has seen fast growth with a plethora of new start-ups and key players losing staff.

I think that there are more important questions to put to candidate directors and additional factors to take into account when considering potential selections for a board. Does the candidate understand the business of the company? Have the candidate describe their typical preparedness for upcoming meetings. What CDP training (if any) does the candidate participate in? What are the candidate's views on technology and its impact in the boardroom? How effective is the candidate at communication and what is their communication style? Knowledge of relevant risks and financial regulation should now be seen as key factors. A few examples of these in a little more detail are:

Understand the Business of the Company. With many potential candidates to choose from, fund managers should make a point of checking if the persons they are speaking to understand, generally, the business of the company, and more specifically their fund space. This not only means that the director who understands a particular investment strategy or market sector is more effective, but demonstrating an understanding of the business of the specific company they are advising leads to better governance in and of itself. More relevant questions can be asked, challenging fund managers on pertinent operational issues while at the same time being supportive. Gone are the days where the independent fund director could operate at an ultra-high level using light touch governance methods, independent directors need to be more engaged in the business, operational details and accounts of the company. Surely the better independent directors are those who have taken the time to appreciate the culture and service offering of their clients.

Risk, Regulation and Technology. Perhaps the single biggest necessary evolution to the role of the independent director since 2008, risk is an extremely important issue in the current environment. It is crucial that independent directors are able to understand the risks to an alternative investment fund and be absolutely clear about what steps a board may need to take to mitigate those risks. Independent directors, like myself, who bring experience in risk management, are certainly going to contribute to a reduction in risk to an investment fund without impacting overall return.

Can you elaborate on risk mitigation and can you give some examples of the types of risk you see?

I think that risks come in all forms. These are operational and technological, reputational, financial, legal and now more so than before, regulatory. The better independent director is one who is prepared to devote additional time and resources to the board to identify risks and test for these, manage these and set clear boundaries on when to take action. This is especially true in our landscape of increased regulation and oversight which is prominent within the financial sector. I think that even base knowledge of subjects like FATCA, CRS, AIFMD etc. sets independent directors apart. I have been in meetings where directors have demonstrated a lack of sufficient knowledge on these kinds of subjects or others relevant to their industry. My view is that if you are putting yourself forward as a director to the board of a hedge or private equity fund in our current market you need to know what these subjects and others are about.

The impact of technology (and the associated cyber security risks that come with that) should be taken seriously and not underestimated. Tightening up on the use of technology in the board room should be properly considered. Some questions here should be: are mobile devices allowed to be used to record board meetings, how are board packs distributed to directors (is this secure?), are independent directors accessing confidential fund information on web email and mobile phones, if password protected documents are distributed to board members, where is the password being sent to? Also important is where do directors store their funds information, is that secure, what disaster recovery procedure can an independent director rely on in the case of a data breach?

Fund managers would do well to seek out directors with a mindset which has shifted towards being capable of seriously contemplating a worst case scenario so that that risk mitigation strategies can be implemented early on in a funds life. Picking an established fund director services provider with the infrastructure to help mitigate these risks is a big step in the right direction.

What are your views on board diversity and how do you think a board with a diverse set of professional skills may benefit a company or fund?

The short answer is that I think board diversity is a vital component of an effective board generally, and from a funds perspective should be seen as an important consideration.

What we see as a typical structure of a board for a hedge fund would be one of the fund executives acting as a director along with, say, two independents who more often than not have accounting and administration or audit backgrounds, which sees a board more than covered from a financial statement and valuation perspective. But as most professionals in our industry can recognize, corporate governance is more than just valuations.

We have started seeing a shift here, and I would like to see it continue, towards widening the skill set of boards' experience and expertise. For example, diversifying a fund board (be it hedge or private equity) can only benefit from having an experienced lawyer on the board, provided they have the relevant legal expertise. The right lawyer will bring experience on restructuring of funds, will further boost a board's ability to identify and mitigate risks, may be able to assist in avoiding possible litigation by asking relevant questions ahead of time in terms of current contract obligations and would have a good grasp of the regulatory framework for their fund.

I have certainly found that many investors and managers look upon this diversity favourably. All in all I think that having a diverse board means having built a stronger board which plays a significant role in assisting managers with investor confidence in the long run.

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