The evolution of the management company and third-party providers

Jeremy Soutter
Chief Executive Officer
Carne Global Funds (UK)

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The Top 500 global asset management firms manage some US$81.2 trillion[1] in assets worldwide but there are thousands of smaller asset management firms managing another US$3-4 trillion of assets, taking total global assets under management to just shy of US$85 trillion (source below). Smaller asset managers (in relative terms) manage assets in both regulated schemes such as UCITS or 40 Act funds, and semi-regulated funds such as hedge funds, private equity, and infrastructure funds. For decades, a large number of the latter alternative fund managers could manage their assets with relatively little scrutiny or regulation. The bigger, more established firms had in-built governance and oversight functions and for a while, at least, new entrants to the regulated market had to factor the costs of providing that governance framework (including capital requirements) into their startup costs.

Startup costs are prohibitive for smaller firms if all aspects of control are kept in house

We know that since the financial crisis, regulatory frameworks around the world have changed dramatically and, with the introduction of AIFMD and updates to MiFID and the UCITS directive, the world has changed for smaller investment firms. When considered alongside the requirement to create a governance and oversight framework, it is clear that European regulators were paying very close attention to the way this was being provided in practice. In Luxembourg, for example, the concept of having a "self-managed" fund became frowned upon, particularly from the perspective of non-EU countries where the funds could be distributed, such as Switzerland and Hong Kong. In the UK, the Financial Conduct Authority (FCA) struggled to come to terms with investment firms outsourcing their governance framework, particularly in relation to management companies or Authorized Corporate Directors (ACD).

This was highlighted by the FCA in June 2012, in a report entitled Retail Conduct Risk Outlook following a small number of high-profile failures of investment firms, one of which had a third-party management company. However, there was a marked shift in the regulatory view between 2012 and 2017 and it is now perfectly acceptable for managers with assets under management in the tens of billions to outsource the management function to a third party.

It was evident, however, that at the time the FCA felt that investment managers should take full responsibility for the risks they managed including governance and oversight.

1. FCA Market Study Interim Findings 2016 https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

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For large firms this is still the case, and it is unthinkable that a firm with hundreds of billions in assets under management would outsource its main governance and oversight functions, but for small to mid-sized firms things have changed. During a number of the FCA's roundtables following the launch of the FCA's Asset Management Study in 2016, the topic of innovation was often addressed by both the FCA and asset management firms. Neither party wanted to stifle this important part of business growth, as it has positive consequences for managers and clients alike. Naturally, the smaller independent firms and the diversified growth of the larger firms play a significant role in innovative growth, and it is these managers that feel the financial burden of governance and oversight the most. Indeed, large swathes of the industry would disappear overnight if all managers were forced to have their own governance and oversight models. Following some criticism in the FCA's initial report, it was significant that no mention was made of host ACDs in the FCA's final report issued in June 2017. This view was also influenced in part by the globalization of many firms and the diversification of the assets they manage. Product strategy and domiciliation play an important role in getting the right structures to investors in the right format. This has resulted in firms having products in multiple jurisdictions and in multiple structures and as we see growth continuing in the private market space these will become more widespread. Even large firms would struggle to build the necessary regulatory framework around such a diversified product model.

Another area of intense scrutiny globally has been that of independent oversight, particularly in relation to value for money, and costs and charges. Regulators have long been aware that the investment manager ultimately controls every link in the chain, from managing assets to the composition of the independent board responsible for oversight. For UK workplace pension schemes, the pension provider must appoint an Independent Governance Committee (IGC) consisting of a minimum of five members, the majority of whom must be independent, including an independent chair. The IGC must also act solely in the interests of the relevant scheme members and must act independently of the provider. The UK pension fund industry has moved a step further than the US 40 Act mutual fund market where at least 40 percent of the board must be independent, but they too play a vital role as watchdogs and serve as a check on fund management and in safeguarding shareholder interests. Indeed, according to the US Supreme Court, independent directors have "the primary responsibility" for looking after the interests of the fund's shareholders and serve as "independent watchdogs" who "furnish an independent check" upon the management of the fund.

This lack of independence for the UK mutual fund market, particularly in the area of performance monitoring, was also brought up in the FCA's Asset Management Study Interim Report published in November 2016:

5.51 We have found that AFM boards often fail to take appropriate and timely steps to address underperformance. They can also lack the authority within the group structure to challenge the commercial strategy set by more senior boards and executive committees. We found that where AFMs are part of the asset management group's corporate structure, with few or no independent directors, their directors face a significant conflict between their duties to the asset management group and their duties to the funds and their investors. In practice, we have observed that this conflict tends to be resolved in favour of the asset management group.

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The FCA went on to say that outsourcing the regulatory and legal responsibilities of the AFM would result in greater independence as the employees of the company to which responsibilities are outsourced do not work for the manager. They did, however, note that they can be sacked by the manager—so are they really independent?
5.52 Instead of the typical AFM model described above, the asset management group sponsoring a fund range can approach a third party 'host Authorised Corporate Director' firm to perform the regulatory and legal responsibilities of the AFM.
Under this arrangement, AFM board members are unlikely to be employed by the asset management group and so might be expected to act with greater independence. However, the asset management group is clearly the client of the host Authorised Corporate Director firm, with the asset management group deciding on the selection and ongoing appointment of the host Authorised Corporate Director firm. This creates a similar conflict to that in the more typical in-house Authorised Corporate Director model and our supervision work indicates that host Authorised Corporate Directors are no more likely to assess value for money robustly than conventional AFM arrangements.

On 5 April 2018 the FCA issued their long awaited first set of rules and remedies under the Asset Management Market Study. In this the FCA propose that AFMs appoint a minimum of two independent directors and for them to comprise at least 25 percent of the total board membership. Without creating truly independent oversight committees, it is difficult to see how investment managers could lose complete control over all the parties in the chain. However, the practice of outsourcing the governance and oversight framework is now fully acceptable and has matured.

As responsible entities, there is a new breed of firms rigorously challenging investment firms, providing technology solutions that better manage risks, and working more closely alongside them rather than acting as an external provider.

Source: https://uk.reuters.com/article/uk-global-funds-aum/global-assets-under-management-hit-all-time-high-above-80-trillion-idUKKBN1CZ11L

Source: https://press.pwc.com/News-releases/global-assets-under-management-set-to-rise-to--145.4-trillion-by-2025/s/e236a113-5115-4421-9c75-77191733f15f

To the point:

- The era in which it was possible to manage alternative investment funds with little scrutiny or regulation is well behind us.
- The cost of providing governance and oversight can be prohibitive for smaller entities or new entrants.
- Regulators understand that forcing smaller players and new entrants to keep the governance framework in-house would make the market too difficult to operate in and stifle innovation.
- The case for independence within the governance framework is now widely accepted.
- Third-party management companies have evolved to become the accepted model for many small to mid-sized investment firms.

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