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ADVANCED COMPLIANCE INSIGHTS

THE IMPORTANCE OF GOOD GOVERNANCE PRACTICES FOR FUNDS

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Governance, the G in ESG-based Investing (Environmental and Social being the other aspects), is the practice by which corporations and funds are directed and controlled; it is through effective governance that the interests of all stakeholders and the fund's perception in the financial community can be managed. Governance also provides the structure for accomplishing the fund's objectives. It includes every aspect of management, including the management of the impact that good and bad governance practices may have on the fund's assets and returns, reputation, and the financial industry at large. When good governance practices are implemented in an enterprise, it contributes to the realization of a sustainable fund strategy.

Although short-term investors have traditionally considered sustainability irrelevant, asset owners and asset managers are becoming aware that the importance of understanding and recognizing the ESG risks related to an investment is crucial. According to Miguel Ferreyra de Bone, Head of US Operations at Acrux Partners, an impact investment advisory firm, "these risks can result in a significant loss of value at any moment and it is impossible to know when those risks could turn into a material threat."

Governance can be improved by integrating sustainability. One of the most important reasons to do so comes from a precautionary principle reported by UNEP Finance Initiative in their June 2014 report: "the way to deal with risks whose term is indeterminate is to avoid investing in, or be active in improving, companies that are more prone to a value-destroying event." There have also been noticeable links between corruption at a company/country level and creditworthiness.

At a fund, if sustainability is integrated into the investment process, key points for ensuring successful implementation include:

- appropriate governance processes and practices
- greater investor engagement
- measuring and reporting of ESG performance
- the ability to think and act with a long-term view

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EXTERNAL TRIGGERS CAN CREATE CHANGES IN FUND GOVERNANCE

It is very interesting to highlight that changes in fund governance do not always come from within. Endowments, pension funds, and other investors are in a strong position to apply external pressure to trigger changes to governance practices, and in most cases changes made toward ESG-focused investing have come from mandates or agreements with LPs. “Funds should always consider the advantage of providing ESG integration when courting family offices, HNWI, and institutional investors who would be reluctant to invest in a traditional fund otherwise,” says Ferreyra de Bone, “Especially in times like this when we are experiencing a weak financial environment and fundraising has become increasingly difficult. However, having sound governance practices is part of the GP’s fiduciary duty, and since ESG issues can become financially material at any time, LPs should always take the issue of governance into account prior to committing capital to a fund.”

HOW GOVERNANCE CAN BENEFIT FROM OUTSOURCED EXPERTISE

RIt is possible to embrace ESG in a way that helps fund managers make sounder decisions, and for every step along the investment process there are solutions that can be brought to the table. The growing tendency to include these factors into the investment decision process makes funds take on extra due diligence responsibilities - measuring and reporting activities that usually are outside the expertise of the firm. For these cases, outsourced managed services like ESG impact reporting and ESG metrics collection is crucial to provide investors and managers with the quality in information that they demand when committing and receiving capital in the fund.

There are many other aspects of governance that can also benefit from the expertise that comes from consultants and managed services providers, particularly in the area of compliance. In a post-Dodd Frank world, funds are facing ever increasing compliance requirements from regulatory bodies including the SEC, IRS, BEA, CFTC, NFA, and FINRA, while foreign jurisdictions increase their regulatory requirements in concert. Even with outside service providers, the amount of additional data necessary is growing exponentially and keeping your records in order is a key aspect of good fund governance. Utilizing a single, and secure, data warehouse solution that can handle your SEC Filings, FATCA reporting information, LEI/GMEI registrations, and other legal entity governance is crucial to maintaining compliance without overloading your fund’s limited resources.

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Regulations regarding ESG are still evolving and the current model used in most cases is the “comply or explain” approach, although in other cases, regulation can take the shape of an explicit requirement. For instance, this is the case for pension funds in South Africa and Canada, which have to include ESG issues into their investments as part of their fiduciary duty. Governance researchers and other industry experts are stating that soon we will see governments actively forcing investors and corporations to apply these principles on a normal basis. One such example is how FATCA provisions, which began in the US as a regulatory initiative of the IRS, have continued to expand internationally as other countries require financial institutions to comply with similar disclosure requirements. Additionally, in April, in the United States, the SEC opened public comment on a concept release for changes to their disclosure forms, which included sustainability reporting. “This shows that the SEC is looking to make sustainability disclosure part of an improved framework that meets the governance needs of today’s market as they modernize certain business and financial disclosure requirements in Regulation S-K,” according to Ferreyra de Bone.

In some cases, starting explicit discussions around ESG issues, while possible, can still be difficult in smaller funds due to a lack of resources, lack of consensus and differences in personal values, or lack of expertise in the matter. Even the larger funds struggle to implement committed ESG integration, but although integrating sustainability and good governance practices can involve a transition period that may be difficult in the short run, studies have shown that funds who take ESG factors into consideration in the design of their practices have outperformed their competitors in the long-term.

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IN SUMMARY

As funds review all of the possible areas for investment in the market, internal governance and compliance are moving ever higher on the list of opportunities. Although not always easy, with good partners and tools, the industry is moving toward sustainability and better regulatory compliance. This cycle of improvement and enhancement is not only beneficial for the funds' investors in terms of transparency, but for all parties involved through better financial returns of the funds themselves.

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Learn how CT can help better manage your Compliance and Fund Governance needs.

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