Setting the global standard for investment professionals

1 July 2011

Attention: ICGN Shareholder Responsibilities Committee
c/o ICGN Secretariat
16 Park Crescent
London, W1B 1AH,
United Kingdom

Re: Model contract terms between asset owners and their fund managers

Dear Shareholder Responsibilities Committee:

CFA Institute[1[1]]is pleased to comment on the consultation paper: *Model contract terms between asset owners and their fund managers* (the "Model Contract") issued by the International Corporate Governance Network (ICGN). CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency and integrity of global financial markets.

Executive Summary

CFA Institute supports the ICGN's focus on developing best practices in the agreements between asset owners and their fund managers, with the aim of facilitating more long-term behavior in the capital markets and a greater focus on key risks. We commend the ICGN for focusing on contract terms that can help guide the asset owner/fund manager relationship towards engaging in investing and oversight practices that are in the best interests of the asset owner client.

CFA Institute has written often on many of the subjects addressed in the ICGN's consolation paper, including but not limited to; *Breaking the Short-Term Cycle (2006), Code of Conduct for Members of a Pension Scheme Governing Body (2008), Environmental, Social, and Governance Factors at Listed Companies (2009), Asset Manager Code of Professional Conduct (2009,2010),* and *Elements of Investment Policy Statements for Individual Investors (2010).*

Comments on Specific Proposals

<u>Standards and high-level commitment</u>

Issues to be considered in fund manager contracts:

[1[1]] CFA Institute is a global, not-for-profit professional association of over 105,000 investment analysts, advisers, portfolio managers, and other investment professionals in 137 countries, of whom more than 93,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

Charlottesville Hong Kong London
560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

CFA Institute agrees that in order for asset owners to know what they are seeking by way of long-term thinking in the investment process, it is helpful for them to agree on a high-level commitment to such thinking. This can be in the form of an established statement of commitment from the fund manager; in other cases, asset owners will have established a set of principles to which they expect the investment process will conform.

Within the proposal for the Model Contract, ICGN recognizes the *Asset Manager Code of Professional Conduct* (the "AMC") created by CFA Institute. We see the AMC as a best-practice standard for the ethical and professional responsibilities and accountabilities of firms that manage assets on behalf of clients. Consequently, we support the ICGN's citing of the disclosure standards within the AMC as issues included in the Model Contract.

We agree with the ICGN's proposed subject matters for Model Contract terms concerning standards and a high-level commitment, including;

- a high-level commitment to a set of principles agreed to by asset owners and fund managers covering a long-term philosophy and approach
- adherence to disclosure standards within CFA Institute's Asset Manager Code of Professional Conduct or equivalent
- integration of this approach into the investment and risk management processes and adherence to agreed principles on a transparent basis

Risk management

Issues to be considered in fund manager contracts:

CFA Institute agrees that asset owners should consider risk-adjusted returns when evaluating a potential or current fund manager. We also concur with the ICGN's proposal that any written representations about risk management capabilities and practices that are presented during the marketing and due diligence process should also be attached to and incorporated into the management contract. Asset owners should also seek to include contract terms on risk management reporting and transparency, along with continuing rights to assess ongoing risk controls as a means to ensure that the quality of risk management seen during due diligence is maintained while a fund manager is managing a client's assets.

We agree with the ICGN's proposed subject matters for Model Contract terms concerning risk management, including:

- ensuring that clients can gain effective insight into the manager's risk management strategy
- an alignment of fund manager and client investment time horizons
- ensuring that a fund manager supports the integrity of the marketplace and does not engage in activities that may lead to systemic market failure.

<u>Integration of long-term focus</u>

Issues to be considered in fund manager contracts:

The ICGN is correct in stating that the time horizons of most asset owners are considerably longer than those of most fund managers. Therefore, asset owners need to ensure that asset managers understand the long-term factors and risks that asset owners want included in the investment process. Asset owners may want to establish standards in their contracts with either a select group or all fund managers that require fund managers to:

- establish an effective process for monitoring such factors, whether using internal staff and systems or by employing external providers;
- effectively integrate such analyses into investment decisions and risk management; and
- allow asset owners to make ongoing assessments of how effectively both monitoring and integration are carried out.

We agree with ICGN's proposed subject matters for Model Contract terms concerning the potential integration of long-term factors, assuming these are consistent with the investment strategy and service the client is seeking, including:

- monitoring environmental, social and governance (ESG) factors, including appropriate measurement and reporting;
- permitting due diligence by the client into the processes of integrating a long-term focus into the investment process; and
- ensuring that the fund manager establishes and adheres to relevant guidelines on the manner in which the investor and the client agree on whether and how ESG factors are effectively integrated into investment decision-making process.

<u>Stewardship activities</u>

Issues to be considered in fund manager contracts:

CFA Institute agrees that, in essence, stewardship entails working with the underlying assets to ensure that they focus on delivery of risk-adjusted value over the time horizons that matter to owners and taking into account risks and other issues that matter to those owners. Therefore, there is a need for clients to have effective oversight of the stewardship of their assets.

We agree with the ICGN's proposed subject matters for Model Contract terms concerning stewardship activities, assuming these are consistent with the investment strategy and service the client is seeking, including:

- adequate reporting on ownership rights and powers being exercised by the fund manager and which retained by the client;
- permitting clients to direct the voting of the underlying shares in respect of their separate account investments, or alternatively executing votes according to guidelines set by the client; and
- initial agreement and reporting on stock lending practices.and any lent positions at a given time, and who will have scope to recall lent securities.

Long-termism and alignment

Issues to be considered in fund manager contracts:

Asset owners seek to encourage their fund managers to act fully in their interests by setting fee structures that appropriately align the interests of fund management firms with their own – and encourage fund management firms to align their remuneration structures and cultures with the long-term perspectives which will generate returns over the time-horizon those asset owners find relevant. CFA Institute agrees with the ICGN that the measurement of fund manager performance over longer periods is desirable, and that high water mark structures are desirable. We agree with the ICGN's proposed subject matters for Model Contract terms concerning long-termism and alignment, including:

- requiring that fee and remuneration structures appropriately align the interests of fund managers with those of the proposed investment strategy and client expectations;
- appropriate and agreed upon annual portfolio turnover rates;
- prompt and full disclosure of any departures from agreed-upon terms including changes in fund manager, governance, portfolio manager remuneration scheme, investment approach, or risk/leverage levels during the mandate period; and
- an effective conflicts of interest policy and procedures with prompt reporting of any material changes or waivers.

Commission& counterparties

Issues to be considered in fund manager contracts:

The ICGN is correct in stating that one of the key frictional costs which clients face and which are seldom transparent relate to execution and commission costs. While such costs are ultimately reflected in the returns to an investor, CFA Institute agrees that given the prevalence of practices like soft dollar commissions and commission rebate schemes, fund managers can face conflicts of interest about using client assets to support manager operating costs. It is an area where greater transparency is needed so that clients can have full confidence that the costs they are paying are fully disclosed.

We agree with the ICGN's proposed subject matters for Model Contract terms concerning commissions and counterparties, including:

- requiring that commission payments and structures paid for from client funds are (a) made solely in clients' interests; (b) reflect an appropriate balance between short- and long-term client interests; and (c) are fully disclosed; and
- requiring that counterparty risks are managed effectively and properly identified are transparent to the client.

Concluding Comments

CFA Institute is pleased to submit its views on the ICGN's *Model contract terms between asset owners and their fund managers.* If you or your staff have questions or seek clarification of our views, please feel free to contact either Nitin Mehta, CFA, at +44.0207.330.9595 (Ext. 595) nitin.mehta@cfainstitute.org, or James Allen, CFA, at +1.434.951.5558 or james.allen@cfainstitute.org Matthew Orsagh, CFA, CIPM at +1.212.756.7108 or matt.orsagh@cfainstitute.org.

Sincerely,

/s/Nitin Mehta
Nitin Mehta
Managing Director, EMEA
CFA Institute

/s/ James Allen
James Allen, CFA
Head, Capital Markets Policy
CFA Institute

/s/ Matthew M. Orsagh
Matthew M. Orsagh, CFA, CIPM
Director, Capital Markets Policy
CFA Institute