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Position Paper

Corporate Governance Practices in Externally Managed Trusts

Institutional investors recognise the value of strong governance structures in protecting their interests as providers of capital. In this context, governance structures that evidence alignment with the interests of unit-holders is a competitive advantage for issuers and managers of listed trusts.

Central to strong governance is the distinction between the interests of management and those of the owners of the capital provided. In the case of externally managed trusts, this requires particular attention to the mechanisms by which investors can be assured that their interests as unit-holders are prioritised ahead of the interests of the manager/responsible entity (RE).

We regard corporate governance principles (for instance those articulated within the ASX Corporate Governance Principles and Recommendations) as applicable to all listed Australian entities including externally managed trusts.

Our objective here is to offer guidance on how to address the specific corporate governance challenges faced by externally managed trusts. For the purposes of illustration, we include examples from the market of structures that apply (or approximate) the relevant principles within the externally managed trust structure.

Board independence

Unit-holders of the externally managed trust need adequate representation by genuinely independent directors and should be able to determine the independent directors on the board of the responsible entity.

Examples include:

- Appointing a genuinely non-affiliated chairman with no relationship to the RE or its parent/s;
- limiting the number of manager-appointed directors proportionate to the manager's holdings in the trust;
- Capping manager appointments at 50% of directors - to protect the interests of minority unit-holders, even when the manager's holding exceeds 50%.
- Requiring directors to stand for election and re-election (e.g. after a three year period on a rotating basis) at which time each unit-holder is able to vote their holdings; or
- At a minimum, providing for unit-holders to ratify the appointment of independent directors (external candidates appointed by the manager) at the annual meeting of unit-holders. Regardless of whether it is binding, this would offer unit-holders a means by which to voice assent or dissent, thereby promoting unit-holder-friendly appointments.

Appropriate fee structure

To enable unit-holders to assess if the fee structure is in their interests, the manager should clearly and transparently explain how the external manager as a whole is rewarded and held accountable for performance. Relevant considerations for both structure and quantum include the cost and complexity of management activities, but also the relative risks borne by the manager versus the providers of capital. Different emphases may be appropriate for trusts with differing objectives (e.g. a highly leveraged trust or one with high deal volume versus a portfolio largely requiring property management) and a discussion of these considerations is worthwhile for unit-holders.

Disclosures of fees should be sufficiently comprehensive to enable institutional investors to compare fee loads among funds and to perform fee analysis across their portfolio.

Examples of good practice could include:

- Clear disclosure in the annual report regarding base fee and performance fee calculations and the reasons for the chosen methodologies;
- Performance fees based on measures of value-add rather than value; the manager should be rewarded for good management and not necessarily for measures of growth per se as these do not always represent value for unit-holders. Potential for upside should be clearly attributable to either management effort or the risk they bear; and
- Using a high watermark structure, so that past negative performance needs to be reversed before positive performance results are recognised in fees.

Entrenchment of management

The freedom of unit-holders to change the manager of the trust is an important principle. There have been cases where an underperforming manager has used undisclosed or poorly disclosed termination provisions to deter investors seeking to replace them and/or to extract high break fees.

Examples of good practice could include:

- Avoidance of high termination/break fees or poison pills. Where any such fees are embedded in the management agreements, they need to be clearly disclosed to investors. This information becomes particularly important if there is speculation around a change of the manager; and
- Avoidance of other mechanisms that penalise unit-holders under change-of-manager circumstances. Where unavoidable, they should be fully disclosed (including continuous disclosure where such arrangements change). The existence of debt covenants triggered by a change in external manager and joint-ownership arrangements or other clauses which may give another party the right to purchase assets upon a change in external manager are examples of this.

Transactions

Transactions between an investment vehicle and its external manager or entities related to the external manager carry the risk that terms may unfairly favour the external manager.

Examples of good practice could include:

- Guaranteeing that any related party transactions (or any above a minimal threshold amount or percentage of the portfolio) will be offered for a shareholder vote;
- Ensuring clear disclosure of:
  - The terms of the transaction (including management agreements); and
  - All related party transactions during the year (including dollar value).
- Providing assurance that related party transactions have been subject to review by a committee consisting solely of independent directors, confirming that the directors were satisfied regarding the fairness of the transaction/s and detailing the methods the committee used to determine this; and
- An independent committee similarly reviewing other (non-related party) transactions that could involve conflicts (for instance where there are deal-related fees paid to the manager).

Asset valuation

The value of long-life assets typically both drives investor value in externally managed trusts and contributes to the determination of management fees. Independence in the asset valuation processes is therefore essential.

Examples of good practice could include:

- Use of an independent third-party asset valuation service and clear disclosure of their identity;
- Rotation of valuation firm to ensure no asset was valued by the same valuation firm for an extended period, e.g. three years; and
- Regardless of whether relying on internal or external valuations, clear disclosure of:
- valuation assumptions used; and
- The dates of the latest valuation.

Audit firm

Employ a different external audit firm to that which is used by the external manager or its related entities for audit or other services, since using the same auditor can risk affecting the independence of the external audit function.

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About Regnan

Regnan – Governance Research & Engagement Pty Ltd was established to investigate and address environmental, social and corporate governance related sources of risk and value for long term shareholders in Australian companies.

Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors with $78 billion invested in S&P/ASX200 companies (at 30 June 2016). This approximates 5.3% of this index. These institutions include Advance Asset Management; Commonwealth Superannuation Corporation; BT Investment Management; Catholic Super; First State Super; HESTA Super Fund; VicSuper; and the Victorian Funds Management Corporation.