association of the luxembourg fund industry

Institut Luxembourgeois des Administrateurs

DIRECTOR INDEPENDENCE

Guideline on Director Independence

ALFI Code of Conduct for Luxembourg Investment Funds

Principle II

The Board should have good professional standing and appropriate experience and ensure that it is collectively competent to fulfil its responsibilities

Recommendation 2

Consideration should be given to the inclusion in the Board of one or more members that are, in the opinion of the Board, independent.

Introduction

The question of Director independence has long been at the heart of corporate governance policies as the presence of independent non-executive directors is widely considered as a means of protecting the interests of shareholders and other stakeholders. By ensuring there are Directors on each Board who are free from material conflicts of interest, it is intended that it be easier to ensure appropriate scrutiny and challenge of management recommendations and proposals and, when appropriate, for these Directors to make objective decisions which may be in conflict with the interests of management.

The ALFI Code recommends that consideration be given to the inclusion in the Board of Directors of one or more members who are independent.

Considerations around Director Independence

This paper looks at considerations around definitions of Director independence, in particular by highlighting key guidance derived from the EU Recommendation of 15 February 2005 on the role of Non-Executive directors of listed companies[1], which includes in its Annex II a list of objective criteria to consider when assessing independence. This EU Recommendation has influenced the definition of Director independence in national codes of corporate governance across the EU. In Luxembourg this definition has been incorporated into *The X Principles of Corporate Governance of the Luxembourg Stock Exchange*[2], where it is set out in "*Appendix D: Independence Criteria.*"

Even though funds listed on the Luxembourg Stock Exchange are currently exempted from applying the X Principles of Corporate Governance, Boards of investment funds and fund management companies are encouraged to take into consideration the basic guiding principles of good governance of listed companies[3]. In the context of the Fund industry, such criteria can largely be applied as they stand, but in order to ensure substance over form a wider concept of "the company" needs to be applied to encompass the Promoter group and its employees. Reference to these criteria may assist Boards in their consideration of criteria to adopt for assessing whether Board members are independent.

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[1] Annex II, EU Commission Recommendation of 15 February 2005 on the role of independent non-executive directors of listed companies - http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005H0162&from=EN

[2] Ten Principles of Corporate Governance - Luxembourg Stock Exchange https://www.bourse.lu/csr-corporate-governance

[3] As set out in Luxembourg in the EU recommendation on the role of independent non-executive directors and the Ten Principles of corporate governance of the Luxembourg Stock Exchange

The considerations contained in this paper are without prejudice to any provisions that may apply to particular types of Luxembourg investment funds and/ or their management companies. Reference is made in particular to the specific provisions set out in the Commission Delegated Regulation (EU) 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries, which apply in the context of a group link, as further clarified by the CSSF in its Frequently Asked Questions on UCITS of 6 July 2017.

Executive Directors, NEDs and iNEDs

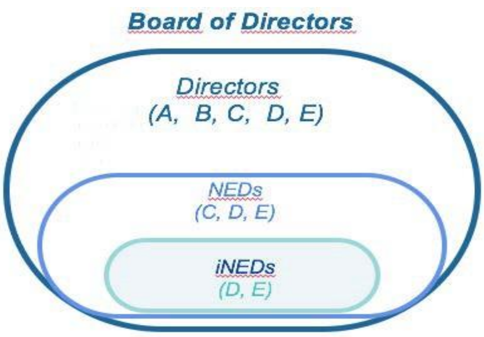
Whilst Luxembourg company law makes no distinction between types of Directors (and therefore all Directors have the same duties and responsibilities), corporate governance practice tends to divide Directors into different groups, usually as follows:

Director - any member of a board of directors of a company

Executive Director – a Director who is also an employee of the company (and in the context of Funds, usually taken to include any persons employed within the promoter group)

*Non-Executive Director ("**NED**")* – a Director who is not an Executive Director

*Independent Non-Executive Director ("**iNEDs**")* – a NED who is also considered independent



Key guidance on Director independence

The EU Recommendation views independence primarily through the lens of absence of any material conflict of interest.

It does, however, leave the determination of what constitutes independence for each Board to determine itself, subject to any compulsory rules of implementation in a member state. The EU Recommendation also stresses that there must be a focus on substance over form when applying criteria for assessing the independence of any individual Director.

In terms of the required number of Independent Non-Executive Directors, the EU Recommendation only states that there should be a "*sufficient number … to ensure that any material conflict of interest involving Directors will be properly dealt with*".

1. **Absence of material conflicts of interest**

   The EU text focuses on the absence of any material conflicts of interest, setting out that a Director should be considered to be independent only if he/she is free of any relationship that creates a conflict of interest such as to impair his/her judgement.

   The OECD Principles of Corporate Governance (2015)[4] also recommend assigning important tasks to independent board members – including taking primary responsibility for the review and management of conflicts of interest. These ideas have also been incorporated into the draft European Model Company Act of 2015.

2. **What criteria to use for assessing independence?**

   It is for the Board to adopt the appropriate criteria for assessment of the independence of its Directors.
   It is not possible to list all threats to a Director's independence, as relevant relationships or circumstances will vary, and best practices evolve over time. However, a number of situations are frequently recognised as relevant in helping Boards determine whether a Non-Executive Director may be regarded as independent. Such criteria are set out in more detail in Appendix D of the X Principles of the Luxembourg Stock Exchange. These criteria include items such as:

   - Not having been employed by the company or by a material service provider for a certain amount of time;
   - Where the Director cannot be considered independent owing to specific circumstances;
   - Not to have served on the Board for more than a certain amount of time.

   When applying such criteria as part of an assessment of the independence of any particular Director, Boards should take care to ensure they are applying substance rather than form.

   In the context of the fund industry, the substance over form requirement would likely result in looking at relevant relationships with the Promoter, the ManCo/AIFM, and/or material service providers and delegates and not only the Fund/ManCo/AIFM itself.

3. **How many iNEDs?**

   One or more members that are in the opinion of the Board, independent should be considered for inclusion in the Board to ensure that any material conflict of interest involving Directors may be properly dealt with, and to protect and prioritize the interests of shareholders and other stakeholders, with each Board needing to consider what number will be sufficient and what number will be optimal in light of their particular situation and objectives.

A recent extensive survey on Luxembourg fund governance indicated that whilst historically there were more Non-Executive Directors at the fund level, the numbers of Non-Executive Directors have continued to increase across all entities surveyed.

[4] http://www.oecd.org/corporate/principles-corporate-governance.htm

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> Recent audit reform also requires that the majority of audit committee members in "public interest entities" must be independent of the audited entity [5]

4. Transparency with shareholders

Proposals for the appointment of Directors should be submitted to the shareholders' general meeting accompanied by relevant information such as their professional qualifications and experience.

Companies may also consider:

- Indicating which candidate(s) they consider as independent according to the independence criteria set by the Company.
- For example, in the governance section of the Directors' Report, disclosing annually which Directors they consider to be independent.

5. Expiration of independent status

The EU Recommendation also refers to term limits, an increasingly important factor in determining Board member independence. Where a Director remains on a Board for a significant period of time they could be assumed to lose their independence as they may be considered to have built up a certain loyalty as a result of the social relationships and interconnections built over the years.

In the context of the fund industry, the substance over form requirement would likely result in looking at all Boards related to a particular Promoter on which the Director has sat, and not only each individual entity.

It is interesting to note that within the ILA Bank Director Guide, it is recommended for bank directors to make a yearly confirmation of independence, and additionally confirming that throughout the financial year:

- in all circumstances, they maintained independence in their analysis, decision, and action;
- they did not seek or accept any unreasonable advantages that could be perceived as compromising their independence;
- they clearly expressed their opposition in the event that they thought a decision by the board or supervisory board would harm the institution; and
- they did not have serious reservations in respect of decisions taken by the Board of Directors during the year.

Such an exercise annually or periodically could also be considered by Funds and Management Companies.

[5] Directive 2014/56/EU of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts - http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32005H0162

6. "Independence of Mind" and resignation of NEDs and iNEDs.

Whilst all Directors must exhibit "independence of mind" when addressing Board matters, the expectations from NEDs and iNEDS are highest. NEDs and iNEDs should undertake to maintain in all circumstances their independence of analysis, decision and action. They should clearly express their opposition in the event that they find that a decision of the Board may harm the company.

When the Board has made decisions about which a Director has serious reservations, they should draw all the appropriate consequences. Should a Director resign, he/she should explain the reasons for resigning in a letter to the Board, and where appropriate also to relevant external bodies. The CSSF may request the reasons for resignations and non-renewals of Directors.

Luxembourg law and regulations impose on all Directors an obligation to act with independence of mind and with integrity, however one might argue that by accepting to be held out as holding independent status, there may be expectations that iNEDs undertake a higher moral obligation to maintain independence in all circumstances. This will include clearly expressing opposition where they believe a Board proposal may harm the company or may not prioritise the interests of shareholders and other stakeholders.

All Boards should carefully consider the criteria they will adopt to assess the independence of their Directors.

about alfi

The Association of the Luxembourg Fund Industry (ALFI), the representative body for the Luxembourg investment fund community, was founded in 1988. Today it represents more than 1,500 Luxembourg-domiciled investment funds, asset management companies and a wide v ariety of service providers including depositary banks, fund administrators, transfer agents, distributors, law firms, consultants, tax advisers, auditors and accountants, specialist IT providers and communications agencies.

Luxembourg is the largest fund domicile in Europe and its investment fund industry is a worldwide leader in cross-border fund distribution. Luxembourg-domiciled investment structures are distributed in more than 70 countries around the globe, with a particular focus on Europe, Asia, Latin America and the Middle East.

ALFI defines its mission as to "Lead industry efforts to make Luxembourg the most attractive international investment fund centre".

Its main objectives are to:

Help members capitalise on industry trends

ALFI's many technical committees and working groups constantly review and analyse developments worldwide, as well as legal and regulatory changes in Luxembourg, the EU and beyond to identify threats and opportunities for the Luxembourg fund industry.

Shape regulation

An up-to-date, innovative legal and fiscal environment is critical to defend and improve Luxembourg's competitive position as a centre for the domiciliation, administration and distribution of investment funds. Strong relationships with regulatory authorities, the government and the legislative body enable ALFI to make an effective contribution to decision-making through relevant input for changes to the regulatory framework, the implementation of European directives and the regulation of new products or services.

Foster dedication to professional standards, integrity and quality

Investor trust is essential for success in collective investment services and ALFI thus does all it can to promote high professional standards, quality products and services, and integrity. Action in this area includes organizing training at all levels, defining codes of conduct, transparency and good corporate governance and supporting initiatives to combat money laundering.

Promote the Luxembourg investment fund industry

ALFI actively promotes the Luxembourg investment fund industry, its products and services. It represents the sector in financial and economic missions organised by the Luxembourg government around the world and takes an active part in meetings of the global fund industry.

ALFI is an active member of the European Fund and Asset Management Association, of the International Investment Funds Association, of Pensions Europe, of the International Association of Pension Funds Administrators and of the Global Impact Investing Network.

For more information, visit our website at www.alfi.lu and follow ALFI on

about ila

The mission of ILA is to promote the profession of Directors by developing its members into highly qualified, effective and respected Directors.

In parallel, it will promote best practices in Luxembourg in the field of Corporate Governance of companies and institutions by actively engaging with those institutions charged with the introduction, application and oversight of those Corporate Governance rules and practices. It will achieve this through high quality training, forum discussions, research, publications and conferences.

ILA aims to be the premier interlocutor in Luxembourg on issues affecting Directors.

For more information, visit our website at www.ila.lu and follow ILA on:

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