

Consultation on Fund Management Company Effectiveness – Delegate Oversight Consultation Paper CP 86 (the “Paper”)

I welcome the opportunity to respond to the Paper. The following views are personal to the author and are not the views of any other person.

Introduction

Having regard to the interests¹ of investors, one should not lose sight of the commercial objective of a collective investment scheme and its adjunct management company. Such a scheme is a pooling vehicle and a means by which investors can gain access to the expertise of investment managers. Traditionally many investors because of their limited financial resources would not be able to access such expertise but by pooling their assets they can so do. A fund is a product but this seems to be lost sight of. In many cases the most convenient means of packaging the product is through corporate vehicles. A fund as a corporate vehicle is uniquely different from corporate boards. If I might quote from a passage of the Investment Company Institute statement on “*Overview of Mutual Fund Governance*”.

“Directors of mutual fund boards and corporate boards both oversee management and operations and have a fiduciary duty to protect the interests of shareholders. The focus of fund directors, however, is different, due to the unique structure of mutual funds. Because a fund has no employees and relies on the advisor and other service providers to carry out the fund’s day-to-day operations, the board focuses on the performance of these entities under their respective contracts and monitors the potential conflicts of interest that can arise between them and the fund.”

Further the management company is only an element of the jigsaw of the fund structure and it is dangerous to only look at this element in isolation. At the end of the day surely the issue is one of what is in the best interests of investors and in particular investor protection. The role of “Independent Oversight Entities” are key participants in providing an additional layer of oversight and are a key element in the framework and organisation of funds. IOSCO in its report “*Examination of Governance for Collective Investment Schemes*” February 2007, places great emphasis on the role of such entities. In this jurisdiction the depositary fulfils this role.

In a fund structure you have the additional oversight functions of the depositary and the administrator. Similar products from insurance companies and banks do not normally have these Independent Oversight Entities.

Before we consider the impact on regulation of this simple yet effective model, in the light of the fact that the focus of the Paper is on management companies, including self-managed funds, the question must be posed does the addition of a management company fundamentally alter this model? In my opinion, no. Historically the use of management companies was necessitated by the fact that many of the collective investment vehicles, such as trusts, had no legal personality, hence the necessity to establish a management company. Management companies in their early days were also seen as an effective means

of sheltering certain income at an attractive corporation tax rate of 12.5%. Did management companies provide an additional means of oversight, probably yes but even the Central Bank saw it as limited and this is seen in the fact that they did not permit management companies to perform operational functions in particular investment management functions. As a result you had this anomalous situation that the Central Bank would allow the management company to delegate investment management functions but not perform such functions.

Another important feature of the role of the board of a fund and a management company is the fundamental distinction between the role of a non-executive director and an executive director. This distinction is lost in the Paper and as a result some of the propositions maybe starting from a flawed premise.

There has been little legal jurisprudence on the distinction between an executive and a non-executive director. Some cases from Australia, which is a common law jurisdiction just like Ireland, provide useful guidance. The following definition was given by Rogers CJ in the case of *AWA Ltd v Daniels t/as Deloitte Haskins & Sells & Ors [1992] 7ACSR 759* (cited with approval in the recent case of *Jacques v AIG Australia Ltd [2014] VSC 269*):

*“Another division of function is between the non-executive directors and the chief executive officer or managing director. Generally a chief executive is a director to whom the board of directors has delegated its powers of management of the corporation’s business. Usually the chief executive is employed under a contract of service which will either include an express term or, in the absence of an express term, an implied term, that the chief executive will exercise the care and skill to expected of a person in that position. The degree of skill required of an executive director is measured objectively. In contrast to the managing director, **non-executive directors are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board meetings, and at meetings of any committee of the board upon which the director happens to be placed**”* (emphasis added)

A non-executive director does not have continuous or day-to-day functions yet the Paper would appear to propose otherwise.

There is no doubt that European regulation has altered the traditional domestic role of management companies. This in part maybe due to the fact that under certain continental European fund platform models it is not uncommon they may have an integrated management company with substantive operations including employees who are investment managers. Under the UCITS regime for the first time in 2009 under directive 2009/65/EC (“UCITS IV”) and directive 2010/43/EU the activity of a management company was seen as separate and distinct from the fund. In imposing obligations on the management company the directives recognised the adoption of a proportionate approach taking into account the nature scale and complexity of the funds it might manage. The directives recognise the ability to delegate to third parties and this is reflected inter alia in the Central Bank’s Guidance Note 4/07. In particular at page 11 of the Guidance Note, the Central Bank acknowledges the ability to delegate all functions with the exception of

decision taking. Further under paragraph 9 "Reports" the Central Bank acknowledges that effective supervision of delegates can be achieved by having adequate reporting procedures in place. Only on an exceptions basis does daily reporting arise and this aside designated persons do not perform their functions on a "day-to-day basis". The Paper would seem to suggest otherwise going forward.

Directive 2011/61/EU further develops the role of the management company or "AIFM" and places limits on the delegation model of operational functions. In particular under Article 4 (w) the extended definition of "managing AIFs", (defined as "**performing at least investment management function referred to in point 1(a)[portfolio management] or (b)[risk management] for one or more AIFs**"), when read with Article 82 of Commission Delegated Regulation (EU) No 231/2013 does not permit the delegation of such functions "*to an extent that exceeds by a substantial margin in the investment management functions performed by AIFM itself*". Such a requirement does pose a challenge to the traditional structure of Irish management companies. It clearly requires the performance of these functions in an executive capacity beyond the supervisory role assumed by directors in particular non-executive directors. In so as the Paper expresses a desire to extend the broad range of skills of directors such as in the area of risk management, it would be unreasonable to expect directors to take on this operational role which would require a daily commitment. Directors would be performing executive functions and if such a commitment is required it would come at a cost and expense to the investors. As regards non investment management functions which can be delegated the requirement of involvement "on a day-to-day basis" as stated in the Paper, this is not prescribed by AIFMD and regular reporting along the lines of the UCITS model, with daily reporting on an exceptions basis should be sufficient.

The suggested and extended role of a Chairman goes against recommended practice in most jurisdictions in that it appears that the Chairman would be performing certain executive functions. The separation of executive functions from the office of Chairman is fundamental to good corporate governance. It is a main principle of the UK Corporate Governance Code that there should be such a clear division and this is also reflected in the IFIA's "*Corporate Governance Code for Collective Investment Schemes and Management Companies*".

Finally there is a certain degree of confusion in my mind when reading the Paper as to whether the issues at times relate to management companies or investment companies.

Responses to "Questions for Consideration"

1. Is publishing a delegate oversight good practice document along the attached lines a good approach to encouraging the development of the supervision of delegates by fund management companies?

Generally yes. However what is lacking from the document is the acknowledgement that in many cases, the product, the investment manager and the distribution channels are predetermined by the promoter. The impression maybe given is that directors of funds have a greater say in the shaping and distribution of the product.

2. Is the breakdown of revised managerial functions correct? Should other managerial functions be provided for? What are your observations about what the operational effectiveness function might entail and how this might be performed? Do you see any obstacles to the Chairperson performing the operational effectiveness function?

I would refer you to my comments in the Introduction. Subject to the limitations imposed by Article 82 of the Commission Delegation Regulation, in Ireland, generally funds and management companies, delegate the day to day operational functions to third parties while designating a designated director having oversight responsibilities. The designated director monitors the performance of such functions through receipt of periodic reports. There are escalation procedures for immediate reporting to the designated director in exceptional circumstances. This position is consistent with the section on Delegated Tasks in Appendix 1 yet the description of the functions in Appendix 2 and the use of the expression “on a day-to-day” seems to suggest a more active involvement. This should be clarified. If it is the intention to prescribe for more active involvement I believe it is unnecessary. When you consider the framework of funds, including the participation of Independent Oversight Entities, investors are adequately protected.

Complaints Handling is more appropriately dealt with by Compliance and not distribution.

I refer to the Introduction section of this response and would not be happy with the change in role of the Chairman which runs contrary to conventional wisdom. Traditionally Chairmen would not be prepared to take on day-to-day involvement through what appears to be executive functions. If the Central Bank is to proceed on the basis of the Paper it would limit the pool of persons willing to act as Chairman.

3. Is relaxing the two Irish resident director requirement the correct approach? Will relaxing this requirement have an adverse impact on the ability of the Central Bank to have issues with distressed investment funds resolved? If so, how could this be addressed?

I do not have very strong views on this. In distressed investment funds situations it has been of benefit to the Irish director to meet and consult with his fellow Irish co-director. Where the second independent director is resident abroad, in a distressed situation he may be less responsive to meeting with his co-director or the Central Bank.

Tax residency and attendant risk is a factor which I believe may necessitate the composition of boards still having Irish resident directors and accordingly in practice there may not be major changes to the composition of boards.

4. What are your views on the proposed approach to measuring time spent in Ireland? Can you suggest any alternatives or any enhancements to the definition proposed by the Central Bank?

I do not have any strong views on this save to say at least some certainty would be provided as to meaning of “Irish resident director”.

5. Is there a downside to requiring fund management companies to document the rationale for the board composition? Will fund management companies require a transitional period during which they can alter their board composition to ensure they have sufficient expertise and how long do you consider would be a reasonable timeframe for such adjustments?

In many cases the rationale of documenting board composition could become a fictional exercise. The imposition of this practice fails to recognise the factual situation that when management companies and funds are initially constituted, the composition of the board is determined in many cases by the promoter.

The Paper fails to identify where the range of skills are lacking. The fund and the management company are merely the means of facilitating investors access to third party investment managers who have the skills and expertise that they so desire. One of the key roles of the vehicle and its adjunct the management company and their respective boards is to supervise and ensure the investment manager operates within its mandate as prescribed by the prospectus and investment management agreement and to call him to account for its performance where appropriate. Subject to the foregoing it is not the role to interfere with the investment decisions of the investment manager. The requirements of Article 82 of the Commission Delegation Regulation, which is specific to non-UCITS funds, does not fundamentally undermine this model although it is recognised in the area of risk management and to some degree portfolio management additional expertise maybe required to perform an operational executive functions, which are quite separate and distinct from the role of a director.

6. Are there any other elements which should be included by the Central Bank in a Fund Management Company Effectiveness – Delegate Oversight initiative?

Please see my comments and observations in the Introduction section

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