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Promoting Excellence in Corporate Governance in Ireland

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Mr Martin Moloney
Head of Markets Policy
Central Bank of Ireland
Iveagh Court
Harcourt Road
Dublin 2

**Consultation Paper CP 86:
Fund Management Company Effectiveness – Delegate Oversight**

Dear Mr Moloney,

We welcome the Central Bank's consultation paper, Fund Management Company Effectiveness – Delegate Oversight ("CP86") published on the Central Bank's website on 19th September 2014.

The UCD Centre for Corporate Governance ("the Centre") welcomes the opportunity to comment on CP86. The comments and recommendations contained in this submission reflect the output of four years of doctoral research conducted by Dr Margaret Cullen under the supervision of Prof Niamh Brennan, at the Centre on investment fund governance¹. Our research has highlighted the considerable differences between the roles of traditional boards of directors and the much more limited roles possible for investment company and fund

¹ Cullen, Margaret M. [2011] *Towards a Grounded Theory of the Role and Effectiveness of Boards of Directors in Investment Fund Governance*. PhD Dissertation, University College Dublin.

management company boards. Unless these differences are factored into regulatory guidelines, there will be a mismatch between regulatory expectations and the implementation of fund governance in practice.

Your consultation requests responses to six specific questions, while encouraging comments on the entire document. It is not our intention to address the six questions directly. Rather, our response addresses what we believe to be gaps and anomalies in regulatory policy on fund management company governance. In doing so, however, we indirectly address questions 1 and 2. We include 14 recommendations in our commentary.

1. OBJECTIVES OF THE CENTRAL BANK GUIDELINES

The regulatory expectations of investment company boards and governance frameworks at a macro level can be understood by exploring regulatory expectations through the lens of the International Organisation of Securities Commissions (IOSCO)). Investment fund governance is defined by IOSCO as "*a framework for the organization and operation of CIS [collective investment schemes] that seeks to ensure that CIS are organized and operated efficiently and exclusively in the interests of CIS Investors², and not in the interests of CIS insiders*" (IOSCO, 2006, p. 3). The ultimate goal of the governance framework should, therefore, be investor protection. This does not equate to protecting investors from market-related losses. Rather, the objective is (i) to enable investors to understand the risks attached to investment fund products; (ii) to prevent misleading or fraudulent practices; (iii) to prevent investor loss due to the malfeasance or negligence of fund promoter organisations; and (iv) to minimise conflicts of interest.

The objectives of CP86 are unclear. An omission from the paper is any reference to investor protection. The overriding objective of the guidelines (the "what") should be to promote strong governance in the investment fund sector in Ireland with the ultimate aim of investor protection. The phrase, "investor protection", is frequently used by fund directors to describe their role. Identifying what this actually means in practice can be a remarkably subtle and uncertain process in many situations. The core features of what constitutes protecting investors' interest is an important platform from which to build principles of good governance. Central Bank guidance should reflect how investor protection objectives should be met by investment company boards and fund management companies (the "how"). This is addressed further under point 9.

Recommendation 1: Objectives of the Central Bank consultation paper

We recommend that the Central Bank clearly articulates the overall objectives of the document (the "what"). The guidance provided should reflect how these objectives should be met by investment company (fund) and/or fund management company boards (the "how").

² This includes both current and potential investors.

Recommendation 2: Defining investor protection

We recommend that the Central Bank clearly articulates what constitutes investor protection from a regulatory perspective. Investment company and/or fund management company boards should act in the best interests of investors. We believe the Central Bank recommendations would be strengthened by providing regulatory interpretation of “investors’ best interests”.

2. SCOPE OF THE GUIDANCE

The preamble to CP86 (pages 1 to 8) focuses on fund management company effectiveness and includes within its scope UCITS management companies, self-managed UCITS investment companies, authorised Alternative Investment Fund Managers (AIFMs) and internally managed Alternative Investment Funds authorised as AIFMs. Appendix 1 (Appendix on Collective Investment Scheme Governance Report) sets out good practice “for boards of directors of investment funds and their managers in the supervision of delegates”. However, we believe CP86 is virtually silent on the role of the investment fund (or company) board. Anecdotally, there is considerable ambiguity in the role of the investment company board versus the role of the fund management company, particularly in a post Alternative Investment Fund Management Directive (AIFMD) world which needs to be resolved.

Recommendation 3: Enabling investor protection

Drawing on Recommendation 2, we further recommend that the Central Bank enable investor protection by both investment company and fund management company boards via:

- (i) guidelines on the establishment and composition of investment company boards;
- (ii) clarity on the respective responsibilities and accountabilities of fund management company boards, investment company boards and service providers within the overall governance framework;
- (iii) clarity on the most appropriate contractual arrangements to serve the interests of investors where an investment company has appointed a fund management company which, in turn, outsources key functions to specialist service providers (the rationale being to facilitate the exercise by investment company boards and fund management companies of their respective duties and responsibilities, taking into account the various regulatory forms);
- (iv) an accurate reflection of the role of fund promoter organisations in the governance of their investment products and particularly the interdependencies between fund promoter organisations, fund management companies and investment company boards (see points 5 and 6 below).

CP86 states that the Central Bank is separately reviewing the impact of the Irish Funds Industry Association (IFIA) Corporate Governance Code “which tackles the question of the standards applying to the allocation of responsibilities at board level in investment funds and their fund management companies”. We consider CP86 and the IFIA Code to be inextricably linked. We are concerned that producing two separate stand-alone documents could confuse fund promoters and asset managers and indeed investment company and fund management company directors. It would be a lost opportunity not to put together a single integrated, cohesive and unambiguous governance framework that could set the standard for fund governance in Europe.

Recommendation 4: Overarching set of integrated guidelines

We recommend that a single, integrated, cohesive document be produced, the objectives of which are clearly stated. As noted above, we anticipate that investor protection would be the core objective of such a document.

3. CORPORATE GOVERNANCE VERSUS FUND GOVERNANCE

Throughout the paper we believe that corporate governance and investment fund governance are consistently confused. Corporate governance is the process by which companies are directed and controlled. Fund management companies are corporate vehicles that manage investment funds established as unit trusts or VCCs. Fund management companies must of course be regulatory compliant and there is an expectation from the shareholders (fund promoter organisations) that they be viable, profitable entities. Boards of directors' role is to maximise performance and ensure conformance of fund management companies with the relevant regulatory framework (including measures to preserve the integrity of the markets). At the heart of the performance agenda is the maximisation of management fees, the sole source of revenue, and minimising costs relating to the outsourcing of services to third party and related party service providers. This is corporate governance.

Focusing on AIFMs, Chapter 1, Section 13 (1) of the AIFM Regulations 2013, requires an AIFM to at all time "act in the best interest of each AIF or the investors of each AIF it manages". How the board executes this responsibility to investors is investment fund governance. Critically, the corporate governance agenda of fund management companies might conflict with the investment fund governance agenda. In short, the fund management company can have more than one master. The focus of the board of the AIFM at the level of the investment company (or fund) is different to the focus of the board of the AIFM at the level of the AIFM itself. This is a distinction that is critical to regulatory policy and one that is absent from CP86. Investment company boards, in contrast, who have appointed AIFMs have a fund governance role pure and simple.

Recognising the singular governance role of the investment company board versus the dual (and inherently conflicted) governance role of the fund management company board will assist the Central Bank in implementing policy aimed at minimising potential conflicts of interest and protecting investors' interests. The regulatory framework needs to acknowledge this critical distinction to fully appreciate the potential for conflicts of interest, the relevance of board composition and the vital role of the investment company board.

Recommendation 5: Corporate versus fund governance

We recommend that the Central Bank acknowledges the distinction between investment fund governance and corporate governance and the implication of this distinction on best practice investment fund governance (in particular the relevance of board composition, contractual arrangements and the critical role of the investment company board).

4. ONE SIZE DOES NOT FIT ALL

As already noted, CP86 focuses on fund management company effectiveness and includes in its scope UCITS management companies, self-managed UCITS investment companies, authorised Alternative Investment Fund Managers (AIFMs) and internally managed Alternative Investment Funds authorised as AIFMs. In doing so, the Central Bank adopts a one-size fits all

approach to regulating fund management companies. Further, the Central Bank makes no distinction between external AIFMs and internal AIFMS.

AIFMD seeks, inter alia, to enhance the governance of alternative asset managers with a particular emphasis on risk management capabilities and the separation of responsibilities. It is a directive at the level of the asset manager and imposes very specific requirements on entities authorised as AIFMs. UCITS management companies have, to date, been part of the regulation of the UCITS product. The UCITS management company is almost a conduit facilitating the management of investment funds with no legal identity of their own in addition to investment funds structured as investment companies. UCITS management companies and AIFMS are distinct. Therefore, by necessity, the governance model for each has to be different. The objective of UCITS V might be to move the UCITS industry closer to an AIFMD world. This is a concern as the underlying regulatory objectives behind AIFMD (protection against systemic risk) may not be applicable to UCITS.

Recommendation 6: Recognising regulatory form

We recommend that the Central Bank re-consider the appropriateness of producing a one-size-fits-all set of guidance. Rather, the Central Bank should recognise the unique characteristics of the different regulatory forms, namely:

- UCITS Management Companies that manage Unit Trusts;
- UCITS Management Companies that manage Unit Trusts and/or investment companies;
- Self-managed UCITS investment companies
- External AIFMs (i.e. that provide AIFM services to third party asset managers)
- Internal AIFMs
- Internally managed AIFs authorised as AIFs

The Central Bank should, in turn, provide guidance specific to each form or provide overriding principles that be contextualised to each regulatory form on a comply-or-explain basis.

5. PIVOTAL ROLE OF THE FUND PROMOTER ORGANISATION

The content of CP86 is restricted to fund management companies, as defined. Fund management companies are one element of the investment fund governance framework. Other key parties in investment fund governance include (i) fund promoter organisations (directly and through fund promoter representation on fund boards), (ii) investors (specifically institutional investors), (iii) service providers to whom fund management companies outsource functions and, in a large number of instances, (v) investment company boards. Fund management company effectiveness cannot be looked at in isolation given the unique context in which they operate. Rather, their effectiveness needs to be viewed in the context of the overall framework and the critical interdependencies that exist between the various parties.

In the introduction to CP86, the Central Bank notes that the guidance contained in CP86 is “more important than ever...because the Central Bank no longer makes use of a promoter regime”. Part of the difficulty with CP86 is that it is written on the premise that investment funds and indeed management companies are the initiators of strategy. Through this regulatory lens, the board of the investment company or fund management company appoints the investment manager. The practical reality is very different and the steps are typically as follows:

- Fund promoter / investment manager engages with their client/prospect base on a potential new investment fund product;

- If the clients positively respond to this engagement, the fund promoter / investment manager decides to launch the investment fund;
- The fund promoter / investment manager engages legal counsel to commence working on the fund prospectus;
- Service providers, to whom fund activities will be outsourced, are identified and engaged. Typically the core fund activity of investment manager will be provided by the investment manager itself;
- The board of the investment company (or fund management company for unit trusts) appoints the investment manager (related party service provider) and the third party service providers.

The essence of the above is that control is significantly vested within the fund promoter / investment manager. Once the fund is launched, while legal responsibility for the investment fund product is firmly with the investment company board, significant day-to-day control is exerted by the entities to whom fund activities have been outsourced, with the investment manager / fund promoter playing a significant on-going control role. It is critical when considering governance frameworks for investment funds not to divorce the fund promoter from its own product.

Recommendation 7: Fund promoter approval regime

We recommend that the Central Bank revisits its decision in relation to the promoter regime. While we acknowledge that in its previous guise the fund promoter regime had no legal or regulatory footing, it was purposeful in that it connected the investment fund product to its originator (fund promoter organisation) from a regulatory perspective.

5. FUND MANAGEMENT AND INVESTMENT COMPANY BOARD OF DIRECTORS WITHIN THE OVERALL GOVERNANCE FRAMEWORK

Terminology used in CP86 implies that fund management companies are autonomous entities, capable of operating independently of fund promoter organisations. This is not the case and best practice governance guidance should reflect this. For example, both investment company boards and fund management companies depend significantly on the frameworks within fund promoter organisations (“internal governance frameworks”³) to fulfil their obligations. The fund promoter internal governance framework includes areas such as compliance, risk, internal audit and vendor management from which fund boards can leverage, provided they are facilitated and empowered to do so by fund promoter organisations. For those activities that are outsourced to non-fund promoter related entities (third party service providers), fund promoters have a vested interest in the efficacy of controls and service within these third party service providers. Arising from the interaction between fund promoters and third party service providers, fund promoters are in a strong position to monitor these activities and many invest heavily in so doing. Although in a post AIFMD world fund management companies (AIFMs) de jure contract with third party service providers, the core relationship in practice operates between fund promoters and the service providers. As such, fund promoters have considerably more leverage with third party service providers than fund management companies and fund boards. If the competency or resources (due to size) are not available within fund promoter

³ The concept ‘internal governance framework’ captures support systems within fund promoter organisations such as risk, compliance, and internal audit but also includes the capacity (and willingness) of fund promoters to expend resources on independent oversight of outsourced activities where required by management/investment company boards.

organisations to monitor activities outsourced to third party service providers, the assistance of external specialists should be engaged. Fund management company boards and investment fund boards must oversee that this engagement takes place as and when required. Fund promoter organisations should actively support this engagement by their fund management and investment company boards. The importance of this support and empowerment by fund promoters should be explicitly reflected in any guidance on the operation of fund management companies.

Regarding activities outsourced to entities within fund promoter organisations (related party service providers), it should be acknowledged that fund management companies and investment company boards have to leverage off fund promoters' internal governance frameworks in overseeing these activities. This is not to suggest that fund management companies and investment company boards should accept assurances/reports from internal agents of fund promoter organisations at face value. On the contrary, notwithstanding the reputation of the fund promoter organisation from which such assurances/reports emanate, fund management companies and investment company boards should exercise appropriate levels of professional scepticism in independently reviewing these reports and in assessing the evidence provided to them.

The interdependencies between the execution by fund management company and investment company boards of directors' of their governance role and fund promoter organisations' processes and actions should be acknowledged and addressed in regulation. Governance guidelines for the investment funds industry should explicitly acknowledge and encapsulate these interdependencies.

Recommendation 8: Role of fund promoters in empowering fund governance

We recommend that the guidelines reflect the interdependencies between board of directors' (investment company and fund management company) empowerment in exercising their oversight governance role and fund promoter organisations' control role actions.

Recommendation 9: Leveraging off fund promoter internal governance frameworks

We recommend that the Central Bank recognise the differences in the internal governance frameworks across fund promoter organisations and the extent to which fund management company and investment company boards can leverage off the frameworks within fund promoter organisations in fulfilling their obligations.

7. DELEGATION VERSUS OUTSOURCING

The investment fund sector is characterised by the outsourcing of specialised activities (investment management, distribution, administration, transfer agency) to regulated service providers. These regulated service providers, in turn, have their own corporate governance and internal governance frameworks. CP86, like so many publications, uses the term "delegation" to describe the appointment of specialist service providers by fund management companies and investment companies. The term, "delegation" implies the assignment of responsibility or authority to another person (normally from a manager to a subordinate) to carry out specific activities. We consider that the term "outsourced" rather than "delegated" better reflects the practical realities of investment funds – activities are outsourced to those specialist organisations with the expertise and infrastructure to carry out these activities. Day-to-day

control of the outsourced activities vests with the service providers while the board of the investment company and/or fund management company (depending on the structure) retains ultimate responsibility and executes an oversight role. This distinction between day-to-day control and board oversight is critical and should be reflected in regulatory policy. CP86, as noted earlier, assumes that day-to-day control vests within the investment company or the fund management company. As we have clearly demonstrated in our response, this is not the case.

Earlier, we noted that different regulatory forms exist namely:

- UCITS Management Companies that manage Unit Trusts;
- UCITS Management Companies that manage Unit Trusts and/or investment companies;
- Self-managed UCITS investment companies
- External AIFMs (i.e. that provide AIFM services to third party asset managers)
- Internal AIFMs
- Internally managed AIFs authorised as AIFs

We acknowledge that AIFMD imposes requirements in relation to substance within the AIFMs. It is critical that the Central Bank does not transpose this requirement onto UCIT management companies and self-managed UCITS investment companies.

Recommendation 10: Outsourcing rather than delegation

We recommend that the terms “delegated” and “delegation” be replaced with the terms “outsourced” and “outsourcing” throughout the paper and that the guidelines endeavour to capture the oversight role of the fund management company consistent with its regulatory form.

8. MANAGERIAL FUNCTIONS

Question 2 for consideration in CP86 relates to the breakdown of the revised managerial functions. Drawing on the observations under Section 7, the philosophy behind managerial functions is unclear as it does not reflect the practical reality of how investment funds operate. A detailed discussion of the classification of managerial functions is beyond the scope of this submission. However, we question the rationale for these classifications. CP86 uses the term “Managerial Oversight Task” which is confusing. Is the expectation that the execution of the managerial functions will be one of management (i.e., control) or oversight? CP 86, Appendix 2, refers to the execution of these functions on a “day to day basis” which suggests management (i.e., control). As noted in Section 7, day-to-day control vests with the outsourcees while the investment company and/or fund management company retains ultimate responsibility. Oversight of outsourcees is the essence of the fund governance model.

Recommendation 11: Managerial functions

We recommend that the Central Bank provide a clear, unambiguous rationale for the requirement for managerial functions. We are unconvinced of the benefits of the approach.

It is important that the Central Bank is clear on its expectations regarding the appropriateness and practicalities of independent non-executive fund directors taking on responsibility for managerial functions. We contend that, in doing so, INEDs are taking on a pseudo executive role, comprising the very objectivity they should be bringing to the boardroom.

Recommendation 12: Managerial functions and the INED

If managerial functions remain integral to the Central Bank's regulatory model, we recommend that managerial functions be allocated to individuals within the fund promoter organisation, even if these individuals reside outside the State, but that the Central Bank discourage their allocation to independent non-executive directors.

We are also concerned at the Central Bank's proposals regarding the role of the fund management company chairperson. The Chairperson's role is to lead the fund management company board and we question a regulatory approach that would compromise the Chairperson's ability to be objective in this role. Organisational effectiveness is a matter for the fund management company board as a whole, as is oversight of outsourced functions.

Recommendation 13: Role of Chairperson

We recommend that the Central Bank do not compromise the integrity of the Chairperson's role by allocating executive responsibilities to him/her.

9. RISK-BASED OVERSIGHT APPROACH BY INVESTMENT COMPANY AND FUND MANAGEMENT COMPANY BOARDS: A MODEL REFLECTING THE PRACTICAL REALITY OF INVESTMENT FUNDS

Given the outsourcing model that characterises the investment fund sector, we advocate a risk-based oversight governance approach by investment companies and/or fund management companies boards at the level of the fund with investor protection at its core. This involves a bespoke approach to the governance of each underlying fund, recognising the specific risks associated with each fund. The nature and timing of key performance indicator (KPI) and key risk indicator (KRI) information received and reviewed by the investment company and/or fund management company board is driven by a comprehensive risk analysis at fund level where the control environment within the specialist service providers are assessed and reported on.

Recommendation 14: Risk-based Approach to Investment Fund Governance

We recommend that the Central Bank explore the merits of a risk-based approach to investment fund governance based on an understanding of the risks bespoke to individual investment funds.

We hope our discussion, suggestions and recommendations assist you in developing the Central Bank guidelines further. We wish you good luck in considering and processing feedback on CP 86.

Yours sincerely,

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