Our Ref ID

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Fund Management Company Effectiveness
– Delegate Oversight Consultation
Markets Policy Division
Central Bank of Ireland
Block D
Iveagh Court
Harcourt Road
Dublin 2

Sent by email to fundspolicy@centralbank.ie

CP86 – Consultation on Fund Management Company Effectiveness – Delegate Oversight ("CP86" or "Consultation Paper")

Dear Sir/Madam

We welcome the opportunity to provide our thoughts on the Consultation Paper regarding Fund Management Company Effectiveness – Delegate Oversight, and we do so from a position in the Irish market as a substantial, independent law firm whose funds industry practice focusses very specifically on the provision of legal, regulatory and company secretarial services and advice to our fund clients. We do not market or provide the related services of administration, fiduciary services or other activities. As such, we provide our comments in a context that seeks to address the implications of CP86 for our clients from a purely legal perspective.

William Fry is one of Ireland's largest law firms with a market leading asset management and investment funds practice which has held this position since the beginnings of the industry in the early 1990s.

We have set out below our answers to the specific questions asked in the Consultation Paper which questions we agree, for the most part, address the most pertinent issues raised by the consultation. From a general perspective, we would comment that the absence of a clearly defined deficiency sought

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to be addressed in the consultation does limit our ability to suggest solutions where we did not agree, either partly or entirely, with the proposed regime changes. It was not entirely clear to us what end result the Central Bank of Ireland (the "Central Bank") seeks to achieve. Having said that, we have provided our commentary in as much as we could understand what the Central Bank's objectives might be.

Addressing the questions as follows:

Q 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?*

Publishing a delegate oversight good practice document is a constructive approach to encouraging the development of sound supervision of delegates practices, thereby, hopefully contributing to fund management company effectiveness. However, we have some reservations in relation to the document attached to the Consultation Paper, which, unless modified, would not, in our view, form a good basis for the appropriate development of practices in this area.

Specific areas of concern include:

(a) the prescriptive nature of some of the matters set out in the document may generate significant litigation risk for boards which is not necessarily present otherwise, including for boards conducting their operations in an effective and prudent manner;

(b) there is a significant risk that setting out a step by step process to the manner in which boards should exercise delegate oversight would lead to a "*check the box"* approach in terms of addressing issues (whereby form overtakes substance). For example, some questions set out in the document do not apply in all cases, and indeed in other cases there are questions which should be asked, yet which are not listed. Providing a list of questions for boards to raise which appear *"regulator approved"* may not encourage directors to make due enquiry outside of the parameters set by the regulator and may lead directors to ask questions not particularly relevant to the particular circumstances in order to meet what are perceived as "regulator requirements";

(c) some of the practices proposed in the document would appear to us to suggest executive management functionality which is not the legal role of a board. Oversight and the monitoring of delegates is still, and should remain, an oversight and directing function exercised in a controlled and robust manner. There is a clear division of responsibilities between those parties responsible for executive functionality and those parties who have no such responsibility but who have ultimate management responsibility. The challenge is to ensure a controlled environment resulting in the effectiveness of oversight.

In our view a delegate oversight good practice document should be far less prescriptive in nature and provide guidance only to boards of the sort of activities the Central Bank expects them to undertake.

We would also point out that fund management companies (as that term is used in the Consultation Paper) are companies incorporated under and subject to the Irish Companies Acts 1963 – 2013 (as amended or consolidated from time to time), which, together with common law, set out well established rules regarding the duties and responsibilities of directors. We would stress that it is essential to avoid a situation whereby any document published by a regulator such as delegate oversight good practice document could be contrary to the statutory and common law duties and responsibilities of directors, and accordingly it should be made clear that any such guidance is strictly only guidance

Q2. 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[1] effectiveness function?

Any breakdown of managerial functions should first and foremost be dictated by organisational and operational processes that seek to achieve a high level or control over all areas of the business and the risks of that business. Preferably, those breakdowns of managerial functions prescribed by law and regulation should show a high level of correlation. Unfortunately, previous breakdowns were dictated by regulatory prescription. For example not all functions are relevant

[1] In relation to the two questions regarding *"operational"* effectiveness, we understand that the word *"operational"* should be replaced with *"organisational"* and our response is on that basis

to UCITS Management Companies as opposed to AIFMs. From a business and risk management perspective, why should there by a difference? Consequently, a streamlining is welcome. The suggested breakdown does appear to cover the necessary areas. The clarity provided by the new breakdown seems positive and indeed logical and could be adopted as the base requirements for management companies in their approach to regulatory compliance.

We would comment that the amalgamation of some of the previously individual functions into a more comprehensive overarching function may lead to certain of the functions being so substantial as to suggest that more than one person could be designated as responsible for it. Clarity as to the Central Bank's position on such a proposal would be welcome.

Having said that however, it should be borne in mind that an unfortunate consequence of this revision in the relevant functions is that clients who have, perhaps even very recently, applied the 16 functions to an AIFM business plan, including all of the effort that was required to prepare and implement such functions, will, if this new breakdown is applied, now have to fully revise their structures, plans or programmes to meet the Central Bank's proposed new requirements. This extensive effort should not be underestimated when the Central Bank is determining the process of implementation, including matters such as timing, forms required and the documentation required. These must all be proportionate to the nature, scale and complexity of the business in question and have regard to the aging of the most recently filed plan. We would strongly recommend the grandfathering of existing business plans until such time as material change requires their updating.

In relation to the question regarding other potential managerial functions being provided for, we do not consider that there are any material functions missing from the proposed list.

In terms of organisational effectiveness, the initial structuring is critical to the creation of an organisational structure which is effective. This involves what we would describe as the "business" (i.e. the promoter – see below) developing out an organisational structure that includes entities and persons/individuals with key roles following defined processes and procedures. This should result in an organisational structure that has regard for the nature, scale and complexity of the promoter's business and the business which it proposes to establish through the fund management company and which, in turn, the promoter believes will result in effective oversight. That party (i.e. the promoter/investment manger) will bring that proposal to the board of the fund management company with a view to demonstrating to the directors how the proposed structure is organisationally effective – again having regard to the nature, scale and complexity of the funds that they will be managing. Critical to this plan will be both the resources which the promoter/investment manager will bring to bear – either directly or indirectly - to support the business and the controls that will be put in place to underpin the structure.

Then there is the task of organisational effectiveness oversight. It is clear that this should be led by the chairman of the board. One then has to consider how the respective roles of the chairman of the board and the chief executive officer/managing director of a traditional operating company might manifest themselves in a management fund company governance structure in the delegated model. It is understood that the chairman of the board carries a greater responsibility (perhaps "role" might be more appropriate) for oversight in this area than the remaining non-executive directors. However, it is critical that in undertaking this oversight task, the chairman of the board maintains a non-executive role – i.e. independent of management and the business. We see challenges in this area – maintaining the difference between oversight and management.

Q. 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?*

As a general observation, we would not agree that there is a shortage of Irish residents suitably qualified to act as directors who have portfolio and risk management experience.

However, in discussing this proposal with our clients, it appears that relaxing the two Irish resident director requirement may provide advantages to some of our clients in terms of ease of board structuring, flexibility of the Irish regulatory environment and other general advantages. This is more likely to be the case where the fund management company has its own physical establishment and personnel in Ireland in contrast to those who may operate on a more delegated basis. That said, our existing clients do not appear to have any desire to change existing structures nor do they express a concern about the availability of required skills in the Irish market.

Nonetheless, we would note some general observations as follows:

(a) the requirements[2] which are set out in the Consultation Paper in respect of the director which fund management companies may substitute for one of the Irish residents are such that they may limit the usefulness of any such relaxation of the current regime. Considering those requirements it would be our expectation that such substitution would only likely occur in limited circumstances as the increased costs of travel for board meetings, the fulfilment by such person of one of the designated tasks etc. will not be desirable for many fund managers. In addition, we understand that your position is that this "substitution" would only be acceptable should it be availed of in limited numbers. Certainty as to (i) the general availability of this "substitution" and (ii) any limits on its use, would be essential;

(b) relaxing the Irish resident director requirement may have the undesirable effect of raising Irish substance questions at a European, and indeed non-European level. Fund management companies which are Irish resident and operating from within Ireland and which are regulated by the Central Bank may, under the suggested new rules, have no Irish resident directors (in the commonly understood definition of residence) and consequently, may be seen to demonstrate a possible disconnect with their home state. The Irish tax residence of such companies may therefore consequently be called into question.

(c) in our experience, non-Irish based fund promoters/investment managers look to their Irish resident directors to be their "eyes and ears" on the ground in Ireland, particularly where they do not have their own physical establishment/personnel in Ireland.

These two Irish resident directors:

a. will usually have broad based experience operating as non-executive directors of funds/ fund management companies in the Irish market with the consequent greater understanding of the Central Bank's expectations with regard to governance and

[2] We understand that the Central Bank regards the expression "service provider" (at iii b) on page 6 of the Consultation Paper) to include the investment manager.

greater familiarity with a broader range of service providers and operating standards in the Irish market;

b. will have Ireland as their continuing centre of economic operation and well being;

(d) there is often a reliance on the two Irish resident directors to recognise where Irish legal and/or regulatory issues or concerns may be arising and where appropriate advice ought to be sought in the interests of investors. Having only one Irish resident director concentrates this reliance on one person in place of two. It must be borne in mind that legal and/or regulatory advice is only sought on a consultative basis;

In relation to the question regarding potential adverse impact that such a change may have on the ability of the Central Bank to have issues with distressed investment funds resolved, we believe that it is impossible to say in the abstract how such a change would work in practice. However, our clients' experiences would tell us that, in distressed situations the Central Bank relies very heavily upon the Irish resident directors. These are most commonly professional directors with significant experience in the Irish market. Indeed, in many instances, the Irish resident directors become, and remain throughout distressed situations, the primary points of contact with the Central Bank. Intuitively therefore, it would appear that if the number of such directors were halved, such a change would, by its very nature, result in a significant limitation on the ability of the Central Bank to access the necessary board level assistance.

Further, regardless of any additional requirements put in place by the Central Bank with regard to non-resident directors being available to engage with the Central Bank, logic would dictate that directors not being resident in the jurisdiction could only adversely impact the Central Bank's access to them.

As a practical matter, in a distressed fund situation or where significant issues do arise the potential isolation of a sole Irish resident director could have significant unintended impacts on the organisational effectiveness of the board of directors of the fund management company.

In terms of how any such challenges could be addressed, it is difficult to see how these can be addressed other than by simply not altering the current position.

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

In reviewing the proposal in relation to the measuring of time spent in Ireland, it was difficult to see advantages in separating the current tax definition of residency from the proposed regulatory one.

Although tax residency can be complex, it is commonly understood with well established rules whereas the addition of a further regime to measure residency seems unnecessary and adds complexity.

We note the comment in the Consultation Paper that the Central Bank felt that it was generally undesirable to make financial regulation dependent on tax legislation. We are however unclear as to the rationale for this statement and why it was felt desirable instead to introduce a further, and arguably equally complex, set of measurements to determine residency from a regulatory perspective. Any director will be engaging with tax advisers and will be clear on whether they are Irish tax resident or not and operating to achieve one or the other position. There would be no additional burden on directors in simply being required to review their position under one regime.

In this regard in particular, it would be helpful to understand what the Central Bank's rationale was for proposing the significantly reduced time spent in Ireland to measure residency.

We noted that this proposal could lead to a situation where, from a taxation standpoint, there were no directors of an Irish fund management company who were tax resident in the jurisdiction. This may of course lead to questions being raised by non-Irish tax authorities as to the location of the mind and management of Irish entities, which surely would be undesirable.

It should be noted that any fund management company seeking to avail of revised rules to such an extent that there are no Irish resident directors (from a Revenue/tax residency perspective) would be required to obtain some very specific tax advice to confirm that this position did not have an adverse impact on their Irish tax status. Again, this would seem to add an unnecessary degree of uncertainty and complexity.

Finally, in relation to any individual taking the role of the *"Irish resident director"* in circumstances where a fund manager were to avail of a relaxation of the two Irish resident director requirement, is it proposed that there would be additional criteria applied by the Central Bank to determine that someone was suitable, not only for the role of director but specifically for the role of "Irish resident" director? Clarity as to what is expected of the Irish resident director would be welcome.

In relation to proposing alternatives, again we simply raise the question as to what is the purpose of providing an alternative regime to the well established measure of tax residency.

Q. 5 Is there a downside to requiring fund management companies to document the rationale for 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?

It is not clear to us as to what purpose would be served by requiring a fund management company to document the rationale for its board composition after such board had been formed.

It is a well established principle that the promoter or sponsor of an Irish fund product is the driving force behind its creation. Guidance Note 2/96 (issued in 1996) sets out in detail the Central Bank's requirements for promoters of CIS. As recently as October 2010, the Central Bank provided a definition of the promoter in a revised version of Guidance Note 2/96 as follows:

"*The Notices do not define "promoter" or provide any guidance on the roles and functions of a promoter. The Central Bank considers the promoter to be the entity which is the driving force in establishing and creating a CIS. It decides what legal structure a CIS will take, the proposed investment policy of the CIS, where it invests and in what jurisdictions it will be sold.*

In the context of corporate CIS, the promoter <u>selects the board of directors</u>, chooses the various service providers i.e. the administrator, trustee, investment manager, distributor. In the context of non-corporate CIS, the promoter will also establish or appoint the management company."

Although the Central Bank no longer approves the promoters of Irish AIFs and proposes to do likewise for Irish UCITS, the existence, identity and role of the Promoter in the establishment of, and ongoing connection to, a fund/fund management company, including the supporting of the governance culture, is key. Promoters are usually regulated and/or are part of the same economic group as the fund's investment manager, which must be approved by the Central Bank to act in this capacity. No fund management company board exists as initially composed, other than as proposed and created by the promoter. Consequently, having regard to the requirements of the Fitness and Probity regime and Central Bank's authorisation process, it would appear to add little to require a board, formed by a structuring process in which they will have had a limited say, to then document the rationale for their own composition. Also, whether, and to what extent, a board comprises sufficient expertise to conduct the tasks expected of it should be apparent from the detailed documentation filed with the Central Bank in complying with the Fitness and Probity Regime and the authorisation requirements. In addition, we see additional legal risks in documenting this process which, for the above reasons, appears unnecessary to undertake.

Finally, we would suggest that having to undergo yet a further documentary exercise such as this will add further delay to an already comprehensive process (as well as to cost).

In relation to the question regarding transitional periods, we do not believe, amongst our clients or indeed the industry in general, that there is an acceptance that there would be a significant need to alter board composition following the implementation of any or all of the matters set out in the Consultation Paper.

The revised breakdown of managerial functions would appear to amalgamate many of the functions already in place and, as such, boards and their delegates and designated persons already undertake such functions. Having said that, we do accept that there may be a small number of boards which may require some alteration, perhaps to address areas where board members have responsibility for certain designated functions which have now been amalgamated with functions with which they are not familiar, or in relation to which they do not wish to take responsibility or where the amalgamation results in an unfair and/or unexpected burden on an individual member.

In addition, in relation to the questions raised above in Q.2 regarding the Chairperson undertaking the organisational effectiveness function, it is our view that if the changes proceed as proposed, many chairpersons may not be willing to undertake a role which converges too far with a management company's executive functionality. From a legal perspective, the Board collectively has legal responsibility to review the organisational effectiveness of the entity. In addition, a review of board effectiveness is required under the existing corporate governance code and also offers the additional rigour of an independent review.

Therefore, in a large degree of cases, we do not believe alteration of board composition will be required. Where it is required (as contemplated above) we would recommend that a reasonable transition period to allow such alteration would be 12 months.

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

As noted in our general comments at the start of this response, although we have a very strong desire to assist the Central Bank and the industry and actively engage in this and indeed any other consultation process, we are restricted to some degree in our ability to be constructive by a lack of clarity with regard to the end goal of this consultation.

As mentioned above, it is unclear to us what deficiency the Central Bank seeks to address by the proposed amendments contained in the Consultation Paper. Whilst we would agree that the industry is an ever evolving one, we recognise that structures must be adapted consequent to legal and regulatory changes. Of course generally, improvements are always welcome, but the relatively fundamental nature of the proposed changes raise the question – are there serious concerns perceived by the Central Bank of which the industry is unaware ?

Consequently, at this stage, it is not possible for us to identify other elements which should be included in this review and, indeed, we are not aware of any.

William Fry Credentials

William Fry is one of Ireland's leading corporate law firms with a substantial asset management and investment funds unit which was formed in the early 1990s and, since that time, has been providing expert advice in the area to a broad range of investment managers, fund companies, promoters, custodians and administrators.. We advise some of the largest promoters and investment managers of Irish domiciled funds as well as some of the largest administration and custody organisations operating in this market. William Fry has a team of over 30 professional practitioners working exclusively in the field of asset management and investment funds, including 7 partners who between them have over 110 years of investment funds experience. Our clients include the leading UCITS managers, ETF managers, hedge funds and alternative investment managers, fund service providers, REIT and property funds.

As leading experts in this field, we are keen to provide input in all consultations where we can. We hope that the above comments will be taken in the constructive manner in which they are intended and will be useful.

We remain available to discuss any of the above or indeed any further items which arise. We look forward to hearing from you should you require anything further from us.

Yours faithfully,

William Fry

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