Good fund governance: taking global standards to local lands

Global governance, local considerations

All domiciles have some unique tax, legal and regulatory requirements, but there are common principles of good fund governance that sponsors and directors should consider, regardless of which jurisdiction the fund will be based in, as they are of increasing concern to investors, regulators and courts, writes **ManagementPlus** director **Keith Burman**

Regardless of whether funds are established onshore or offshore, good corporate governance practices are valuable in maintaining appropriate oversight and control of complex investment vehicles. Directors need to keep abreast of increased regulatory requirements such as AIFMD and tax rules such as FATCA, but also respond to escalating questions from legislators and investors about portfolio and risk management, operations, conflicts of interest and independence. Such issues are domicile agnostic, but may need to be resolved in different ways under different jurisdictions, cultures or legal systems.

Below we explore six strategies that fund directors must consider in order to cultivate good corporate governance practices:

1. Achieve appropriate oversight

Regardless of whether funds are established onshore or offshore, good corporate governance matters. Over the past few decades, there have been a number of high profile financial services cases which have highlighted the consequences of not paying attention to these issues (Maxwell, Barings, Socgen, Weavering, Madoff, BNP Paribas, HSBC). Negative consequences have included losses to investors, reputational damage and increasingly severe regulatory fines.

There has also been a growing awareness through the global financial crisis that there has been a wider impact on investors, short of catastrophic failure, which has affected returns and has left investors with less liquidity and more surprises than they bargained for.

2. Be ready for tougher questions from lawmakers and LPs

Institutional investors have come under scrutiny themselves for the investments they have made with investment managers, given the significant losses experienced in 2008-2009, and the surprises delivered when many managers needed to "side-pocket" investments or "gate" funds as markets dried up. In such situations, conflicts of interest abound, and investors have been asking difficult questions about the fiduciary responsibilities of fund directors.

This in turn has brought more focus onto the professional directorship industry, with the *Financial Times* and *New York Times* both publishing widely read articles based on public filings that question the number of mandates and the capacity of directors to genuinely oversee the operations of the funds on whose boards they sit.

3. Keep track of new rulemaking in Europe and the US

As part of reforms brought forward in reaction to the financial crisis, legislators around the world have sought to impose additional obligations on investment managers.

In the US, the Dodd-Frank reforms have also forced significant change in the alternative investment arena, with many formerly exempted investment managers now being subject to SEC oversight and examination.

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In Europe, the AIFMD has shaken up the entire industry, with investment firms being required to make significant and costly changes to their operating practices.

In Ireland specifically, the Irish Central Bank published a consultation paper on on corporate governance aimed at investments firms earlier this year, which proposes *"to develop and ensure adherence to sound corporate governance standards … introducing a number of statutory requirements … [including] minimum board size … composition of the board … role of the chairman … role of the CEO … frequency of board meetings [etc.];"*. It is proposed to make these mandatory for some investment firms and non-retail investment intermediaries and recommended for others, including foreign subsidiaries.

4. Monitor similar developments elsewhere around the world

In 2012, Singapore issued new and revised corporate governance code (CGC) including tighter standards for independent directors, while the Hong Kong Stock Exchange amended the Code of Corporate Governance and Corporate Governance Report with respect to remuneration committees, board independence and pay disclosures. Japan's first standalone Corporate Governance Code came into effect on 1 June 2015.

Elsewhere, in Australia, the government announced reforms in June 2015 to the Superannuation Industry, including that:

- *"all regulated superannuation funds be required to have a minimum of one third independent directors on their trustee board, and an independent chair;*
- *the definition of 'independent' is to include persons who do not have a substantial holding in the trustee or do not have (or have not had within the last three years) a material relationship with the trustee, including through their employer;*
- *trustees of funds that do not have a majority of independent directors be required to report on an 'if not, why not basis'"*

5. Hire the right experts

The questions being asked include oversight of portfolio and risk management, robust operations design and implementation, measures to avoid, reduce and manage conflicts of interest and means to ensure independence of oversight and control functions, including boards of directors and compliance, risk and valuation staff and service providers.

For fund board members to execute these duties, whether they are internal to the sponsoring firm or independent, they increasingly need to have relevant experience both in operational matters and in the relevant investment sectors, as well as being up-to-date on the best corporate governance practices.

6. Consider the legal liabilities of directors

Using the Cayman Islands as a reference point, recall the *Weavering Macro Fixed Income Fund Limited* case, in which the Cayman Court of Appeal overturned the judgement, but only allowed the directors to avail themselves of the indemnity in the fund documents based on a technical judgement around the meaning of "willful neglect". The CICA upheld the finding of the Grand Court that the directors were in breach of their duties to supervise the fund's operations.

A further consequence for fund directors is that the Cayman Islands Monetary Authority has now issued a guidance statement which confirms many of the principles in the original judgement, so any future case will surely be heard with the assumption that fund directors have no excuse if they fail to adopt good corporate governance practices.

Indeed, back in April, the Supreme Court of Gibraltar made a similar judgement in the case of *Compson v FSC & Weal v FSC*, rejecting an appeal against a decision of the Gibraltar Financial Services Commission to take action against two directors of an Expert Investor Fund (EIF).

The Supreme Court noted that *"Deterrence of other directors from failing to monitor the activities of companies on whose board they sit is a justifiable regulatory consideration. …. failure to read the documentation would … have been grossly negligent and a breach of … duties as a director … had a personal responsibility as a director to know the terms of the PPM and … knew … was breaching its terms."*

In the one case, the director was declared *"not fit and proper"* to act as a director, and in the other case, the director was restricted in taking new mandates *"until he has undertaken … continued professional development in relation to the functions, duties and responsibilities of a company director and in particular … financial services … and satisfies the FSC that his corporate governance skills meet the required standards."*

Conclusion

These regulatory changes around the world and significant judgements, while not changing director's duties directly, have put the spotlight on corporate governance in the investment management business and highlights that, regardless of domicile, corporate governance matters. What will differ is the details in each location. ■