



UCD Michael Smurfit
Graduate Business School



UCD Quinn School of Business

100 YEARS
IN BUSINESS EDUCATION

Centre for Corporate Governance at UCD

Website: www.corporategovernance.ie

Promoting Excellence in Corporate Governance in Ireland

Mr Ken Owens
Chairperson
Irish Funds Industry Association
1 Gandon House
Mayor Street
IFSC
Dublin 1

28 June 2011

Irish Funds Industry Association
Draft *Voluntary Corporate Governance Code for the Funds Industry*

Dear Ken,

We refer to IFIA's request for industry feedback and comments on the draft *Voluntary Corporate Governance Code for the Funds Industry* ("the Code") published on the IFIA's website on 13 June 2011.

The Centre for Corporate Governance ("the Centre") welcomes the opportunity to comment on the Code. The comments and recommendations contained in this submission reflect the output of four years of doctoral research conducted by Margaret Cullen, Ad Astra Scholar, under the supervision of Prof Niamh Brennan, at the Centre in the area of investment fund governance¹. Please note that references throughout this document to investment fund boards include boards of management companies.

We set out 33 recommendations on your document below.

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.

1. SCOPE OF THE CODE

The scope of the Code is somewhat ambiguous. Although the title suggests a code for an overall investment fund governance framework, the content of the Code is restricted to a board of director only focus. Investment funds boards 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) the regulator and, in an Irish context, (iv) custodians. A robust governance code for the investment funds industry should reflect the roles and responsibilities of these parties. Anecdotally, there remains confusion in the industry regarding the respective roles and responsibilities of custodians and fund boards, for example. Introducing the designation of independent non-executive directors to fund boards is likely to exacerbate this confusion. The Code would benefit from a clarification on these respective responsibilities from a regulatory perspective.

Recommendation 1: Scope of the Code

It is recommended that the scope of the Code be expanded to incorporate the roles and responsibilities of all key parties in the investment fund governance framework.

Recommendation 2: Scope of the Code

If it is not currently feasible to expand the scope of the Code, it is recommended that the name of the Code be amended to reflect its board of director only focus. Further, it is recommended that the scope of the Code be widened to incorporate Recommendation 1 at the next available opportunity.

3. BOARD OF DIRECTORS WITHIN THE OVERALL GOVERNANCE FRAMEWORK

While investment fund boards have statutory and common law duties to investment funds, the precise objectives and roles enacted by fund boards should reflect the practical realities in which funds operate. Terminology used in the Code implies that fund boards 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, investment fund boards depend significantly on the frameworks within fund promoter organisations (“internal governance frameworks”) 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 investment funds de jure contract with third party service providers, the core relationship operates between fund promoters and the service providers. As such, fund promoters have considerably more leverage with third party service providers than fund boards in relation to the introduction of service level agreements and the use of International Standard on Assurance Engagements ISAE 3402 (formerly Statement on Auditing Standards SAS 70) reviews to provide additional comfort to fund boards on the efficacy of fund promoter internal control environment. If the competency or resources (due to size) are not available within fund promoter organisations to monitor activities outsourced to third party service providers, the

assistance of external specialists should be engaged. Investment fund boards must ensure this engagement takes place as and when required. Fund promoter organisations should actively support this engagement by their fund boards. The importance of this support and empowerment by fund promoters should be explicitly reflected in the Code.

Regarding activities outsourced to entities within fund promoter organisations (fund promoter service providers), it should be acknowledged that fund boards have to leverage off fund promoters' internal governance frameworks in overseeing this activities. This is not to suggest that fund 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 boards should exercise appropriate levels of professional scepticism in independently reviewing these reports and in assessing the evidence provided to them. Investment management is generally outsourced to a subsidiary or division within the fund promoter organisation. The technical knowledge/experience of investment fund directors is critical to effectively monitor this activity and to enable directors to effectively challenge assurances provided (see Recommendation 28).

The interdependencies between board of directors' empowerment in exercising their governance role and fund promoter organisations' processes and actions should be acknowledged and addressed. A robust governance code for the investment funds industry should explicitly acknowledge and encapsulate these interdependencies.

Recommendation 3: Role of fund promoters in empowering fund governance

It is recommended that the Code reflect the interdependencies between board of directors' empowerment in exercising their governance role and fund promoter organisations actions.

Recommendation 4: Leveraging off fund promoter internal governance frameworks

It is recommended that the Code recognise the differences in the internal governance frameworks² across fund promoter organisations and the extent to which investment fund boards can leverage off the frameworks within fund promoter organisations in fulfilling their obligations.

3. OBJECTIVES OF THE CODE

The objectives of the Code could be articulated more strongly. The overriding objective of the Code should be to promote strong governance in the investment fund sector in Ireland. For example, the Code might include the following objectives:

- (i) To provide guidelines on the establishment and composition of investment fund boards;
- (ii) To provide clarity on the objectives of fund boards within the governance framework;
- (iii) To provide clarity on the role and responsibilities of boards;
- (iv) To provide guidelines on the execution by boards of their roles and responsibilities;
- (v) To clarify the respective responsibilities of boards and trustee / custodians;

² 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.

- (vi) To reflect the position of fund promoter organisations in the governance of their investment products and particularly the interdependencies between fund promoter organisations and fund boards;
- (vii) To promote strong governance in the investment fund sector in Ireland and to lead the way in establishing a governance best practice framework in Europe and globally;
- (viii) To provide the framework against which boards of investment funds can be evaluated by its investors and the regulator.

Recommendation 5: Objectives of the Code

It is recommended that the Code clearly articulates the overall objectives of the document. The guidance provided in the Code should reflect how these objectives should be met by fund boards.

4. REFERENCE TO VOLUNTARY CODE

The precise legal basis of the Code is unclear. While Section 2.1 (and the title) of the Code asserts that the Code is voluntary, Section 2.2 states that “*where a Board does decide not to apply any provision of the code it should set out its reasons why in The Directors’ Report or alternatively publish the information through a publicly available medium (e.g. website) detailed in the annual report*”. As boards are required to explain deviations from the guidelines, the Code is not in fact voluntary. Rather, the Code appears to reflect a principles-based comply-or-explain approach to governance where boards have discretion to embrace the guidelines but, where they choose not to do so, must provide an explanation for their decision to deviate.

Recommendation 6: Principles-based, comply-or-explain status of the Code

If it is the intention of the IFIA for the Code to be a principles-based code, all references to the Code being voluntary should be deleted.

Recommendation 7: Compliance statement

The Code should clearly reflect boards’ discretion in applying the provisions of the Code but emphasise the importance of boards providing meaningful, customised explanations for deviations from the provisions. Boiler-plate explanations should be discouraged. It is recommended that provisions 2.2 and/or 13.1 (relating to compliance with the Code) be replaced with the following:

“Boards of Irish authorised investment funds must state in their Directors’ Reports whether they have applied the provisions of the Code during the financial period under review. In circumstances where boards have chosen not to apply one or more of the provisions of the Code, boards must provide bespoke explanations for their decision to deviate from the provision or provisions”.

The IFIA might consult the UK Corporate Governance Code and/or the Irish Stock Exchange’s Irish Corporate Governance Annex for standards appropriate to a principles-based governance regime.

Recommendation 8: Code should capture behavioural issues

It should be made clear in the introduction section that the Code should not be viewed as a compliance exercise by boards or indeed as another layer of regulation. Rather it should be viewed as an enabling document - one that clarifies the ambiguities inherent in governing this unique investment product. It should not merely be a codification of existing requirements. The Code should encourage appropriate board behaviour.

5. OVERRIDING GOVERNANCE OBJECTIVES

The Code refers to the IOSCO definition of investment fund governance which reflects, inter alia, the importance of investment funds being managed in the interests of investors. The Code, however, provides no clear articulation of what constitutes acting in investors' best interests. For example, the Code notes in the Introduction Section that "*it is important to ensure that investors are aware that the CIS or ManCo is operated at all times in their best interests through efficient disclosure standards being in place*". This is a narrow interpretation of the concept of investors' best interests. The phrase, "acting in the best interest of investors", is frequently used by directors to describe their role. Identifying those best interests can be a remarkably subtle and uncertain process in many situations. The core features of what constitutes acting in investors best interests is an important platform from which to build principles of good governance.

Recommendation 9: Defining investors' best interests

It is recommended that the Code clearly articulates what is meant by investors' best interests. For example, acting in the best interest of investors might include:

- (i) ensuring clear, transparent, relevant and accurate information is provided to existing and potential investors at all times via the Investment Fund prospectus and publicly disclosed information;
- (ii) safeguarding investor assets entrusted to investment funds and its management;
- (iii) ensuring all investors are treated equitably and fairly;
- (iv) optimizing the performance of investment funds within the constraints set by investment funds themselves and the regulatory framework within which they operate.

For all transactions involving an investment fund, boards should seek to ensure that (i) to (iv) above are sacrosanct.

6. GUIDANCE NOTE 4/07

In the Centre's submission to the Central Bank on Consultation Paper CP 50 (dated 15 March 2011), the Centre recommended that the Central Bank's Guidance Note 4/07 *Undertakings for Collective Investment in Transferable Securities (UCITS) Organisation of Management Companies* should form the basis or starting point for any fund governance framework in Ireland, one on which the Code can then build upon. The Centre re-iterates this recommendation. Care should be taken not to confuse fund promoters/asset managers by producing two unconnected documents. It would be a lost opportunity not to put together a single cohesive and unambiguous governance framework that could set the standard for fund governance in Europe.

Recommendation 10: Consistency with Guidance Note 4/07

The provisions of the Code should build on and be consistent with the provisions of Guidance Note 4/07. Using Guidance Note 4/07 as a springboard, it is recommended that the Code present a framework for governance best practice taking cognisance, inter alia, of the variance in fund promoter size, related internal governance frameworks (see Recommendation 4) and fund complexity.

7. OVERSIGHT OF COMPLIANCE WITH THE CODE

Implicit in the requirement that boards report deviations from the Code in the Directors' Report is the assumption that such disclosure will be reviewed for adequacy. It is further assumed that a mechanism will exist to oversee and determine whether those boards that choose not to apply the Code's provisions do in fact make adequate customised disclosures. In short, a level of oversight is required. The Code provides no guidance on the nature or scope of this oversight.

Recommendation 11: Oversight of implementation of the Code

Once the Code is finalised, it is recommended that the Central Bank take responsibility for overseeing compliance with the Code. Given the dispersed nature of shareholdings in investment funds, particularly retail funds, it is unrealistic to consider that underlying investors can play a significant stewardship role in relation to the Code. Central Bank ownership of the Code will demonstrate clear lines of accountability on governance matters to other EU regulatory bodies, fund promoter organisations and investors alike.

8. TERMINOLOGY

A number of terms are used to describe the Code's underlying tenets such as "principles", "provisions", "guidance" and "requirements". This is confusing to the reader.

Recommendation 12: Code 'provisions'

The Code should use a single term within the Code to describe its main tenets. It is recommended that the term "provisions" be used.

9. DEFINITIONS (CODE SECTION 1)

(i) Definition of executive director

There is currently no definition of executive director in the Code. The Code should define the category of fund promoter representatives on fund boards who are involved in the day-to-day management of funds.

Recommendation 13: Definition of executive directors

It is recommended that the following definition be included in the definitions section of the Code (but see Recommendation 22 below):

"Executive Director: A director of an investment fund who is also involved in the day-to-day management of the investment fund".

(ii) Definition of non-executive director

The definition of non-executive director in the Code is too narrow. A non-executive director should be a director who is not involved in the day-to-day management³ of investment funds. Further, it is important to distinguish clearly between three possible types of non-executive director: (i) directors employed by fund promoter organisations but not involved in the day-to-day management of funds, (ii) directors not employed by fund promoter organisations but affiliated in some way to fund promoter organisations, and (iii) those who meet specified independence criteria.

Recommendation 14: Definition of non-executive directors

Non-executive directors should be defined as directors who are not involved in the day to-day management of investment funds.

Recommendation 15: Fund promoter non-executive director

It is recommended that the following definition be inserted in the Code:

“Fund Promoter Non-executive Director”: A director who is employed by a fund promoter organisation but not involved in the day-to-day management of investment funds”.

Recommendation 16: Independent non-executive director

It is recommended that the definition “Independent Director” be deleted and replaced as follows:

“Independent Non-executive Director: A non-executive director who meets the Independence Criteria specified in the Code (see Recommendation 18)”.

Recommendation 17: Affiliated non-executive director

It is recommended that a new term, affiliated non-executive director, be added to the list of definitions as follows:

“Affiliated Non-executive Director: A non-executive director who does not meet the Independence Criteria specified in the Code (see Recommendation 18)”.

(iii) Independence

The definition “independence” is confusing as it implies that only independent directors should “*exercise sound judgement and decision-making independent of the views of the promoter, political interests or inappropriate outside interests*”. All directors have equivalent responsibilities for governing investment funds. All directors should demonstrate independence and objectivity. Fund promoter directors are not on fund boards to represent their own organisation, rather they have a duty to govern investment funds overall. The Code should emphasise the importance of collective board strength. Fund promoter directors on fund boards

³ Day-to-day management includes discretionary investment management, fund administration (fund accounting, financial reporting and transfer agency), marketing and distribution.

must be sufficiently senior within fund promoter organisations to understand the importance of wearing their investment fund director hat (see Recommendation 22 below).

Recommendation 18: Independence criteria

It is recommended that the existing definition “Independence” in Section 1 of the document be deleted from the document and that a new term “Independence Criteria” be inserted reflecting the four criteria currently included under the definition “Independent Directors” in addition to the following:

“whether the organisation by which the individual is employed (and/or has shares in) is in receipt of remuneration and/or fees from the investment fund or the fund promoter organisation”

Recommendation 19: All directors have equivalent fiduciary obligations

The Code should be clear that directors appointed from within fund promoter organisations and directors appointed from outside fund promoter organisations have equivalent fiduciary obligations to the investment funds on whose board they sit. The importance of boards working together as a whole cannot be understated and this philosophy should be enshrined in the Code.

10. GENERAL REQUIREMENTS (CODE SECTION 3)

Provision 3.1 states that the requirements contained in the Code “*are the minimum recommended requirements that a CIS or ManCo should meet in the interest of promoting strong and effective governance*”. This contradicts a statement in the Introduction Section which notes that “*the code provides a set of principles and guidance but is not intended to be prescriptive, rather a codifying of existing practice combined with what is seen as best international practice*”.

Recommendation 20: Clear enunciating of principles-based approach

It is recommended that the Code reflects international best practice in investment fund governance by clearly enunciating a principles-based approach to its application. While fund boards should be encouraged to go beyond Code principles in enhancing their governance frameworks, it is recommended that phrases such as the “*minimum recommended requirements*” be avoided. The Code represents an opportunity for the Irish funds industry to demonstrate to other EU member states (as well as investors and fund promoters) that the governance framework for Irish investment fund is not only robust and well supervised but at a standard to which other member states should aspire. This is an opportunity to brand Ireland as good place to do business not only because the best practice and regulatory framework expects the highest standards of governance but also because the principles-based approach to fund governance reflects the fact that one size does not fit all.

Provision 3.4 provides that “*no one individual may have unfettered powers of decision*” but provides no context to this provision. What category of director is the provision referring to? This terminology is used in the UK Corporate Governance Code in relation to the separation of the roles of CEO and chairman on corporate boards. Fund promoters occupy a unique position of power within the investment fund governance framework and particularly vis-a-vis investment fund boards.

Recommendation 21: Unfettered powers of decision

Taking cognisance of fund promoters' position of power, it is recommended that Section 3.4 be amended to reflect the importance of having appropriate balance of power on fund boards (i.e. fund promoter directors versus independent non-executive directors).

11. COMPOSITION OF THE BOARD (CODE SECTION 4)

Investment fund boards should be structured to maximise board empowerment in discharging their roles and responsibilities. To maximise the empowerment of investment fund boards, it is preferable that those involved in the day-to-day management of investment funds do not sit on investment fund boards (i.e. that there are no executive directors, as defined under Recommendation 13, on fund boards). Fund promoter representation on fund boards is, however, critical to board effectiveness but these representatives should not be involved in the day-to-day management of investment funds.

Provision 4.1 provides that at least one investment fund director be independent. The Code provides no explanation for this provision. Given the role of trustees/custodians within the Irish regulatory framework, it is important that the Code clearly outlines the philosophy behind the requirement to appoint independent non-executive directors to fund boards. Further, to ensure independent directors are sufficiently empowered, there should be at least two independent non-executive directors on fund boards.

Recommendation 22: Executive versus non-executive director representation on fund boards

It is recommended that investment fund boards comprise non-executive directors only⁴.

Recommendation 23: Fund promoter non-executive director representation on fund boards

It is recommended that investment fund boards comprise at least one fund promoter non-executive director.

Recommendation 24: Seniority of fund promoter directors

Fund promoter directors should be sufficiently senior within their own fund promoter organisations to ensure that they have the standing to create effective accountability inside fund boardrooms.

Recommendation 25: Rationale for independent non-executive directors

It is recommended that the Code clearly articulates the rationale for the provision pertaining to the appointment of independent non-executive directors. This should be done in the context of the role and responsibilities of custodians.

⁴ It is acknowledged that there is a valid argument for management companies that carry out certain fund activities themselves (rather than outsource these activities to third party service providers) to have executive directors on their boards.

Recommendation 26: At least two independent non-executive directors

It is recommended that fund boards should comprise at least two independent non-executive directors to ensure that independent directors have sufficient support in the event of disputes at board level.

12. CHAIRMAN (CODE SECTION 5)

It is noted that Section 5 of the Code does not provide for the appointment of an independent chairman. Where a fund promoter non-executive director is appointed as board chairman, it is critical that the individual has sufficient seniority within the fund promoter organisation to command the respect of those involved in the day-to-day management of investment funds as well as the other directors. Where the board chairman is not a fund promoter director, it is not appropriate that the board chairman be an affiliated non-executive director.

Recommendation 27: Seniority of fund promoter chairmen

Further to Recommendation 24, it is recommended that the following provision be inserted in Section 5:

“Where a fund promoter representative is appointed to the position of board chairman, the individual in question (who must be a non-executive director) should have sufficient seniority within the fund promoter organisation to command the respect of those involved in the day-to-day management of investment funds. It is not appropriate for affiliated non-executive directors to be appointed to the position of chairman of investment fund boards.”

13. INDEPENDENT NON-EXECUTIVE DIRECTORS (CODE SECTION 6)

Investment management is the primary income generating activity of investment funds and arguably the most complex. It is important that investment fund boards have an appropriate spread of skills and technical fund knowledge. To enable independent non-executive directors to adequately oversee investment management activities, it is preferable that at least one independent non-executive director have a strong understanding of investment management.

Recommendation 28: Technical knowledge/experience of investment fund directors

It is recommended that the following provision be inserted to Section 5:

“At least one independent non-executive director should have strong investment management knowledge.”

14. ROLE OF THE BOARD (CODE SECTION 7)

Further to Recommendation 9, the role of investment fund boards should reflect the objectives established for fund boards.

Recommendation 29: Linking role of, to underlying objectives of, investment fund boards

The role of investment fund boards per the Code should be linked to the underlying objectives of fund boards as set out by the Code.

15. APPOINTMENTS (CODE SECTION 8)

The section of the Code on director appointments could be more substantive. The process of selecting and appointing directors to investment fund boards should be clear and transparent. It is critical that no service providers to fund promoter organisations and/or investment funds have undue influence over the selection and appointment of directors to investment fund boards.

Recommendation 30: Appointment of investment fund board directors:

It is recommended that the following provision be added to Section 8:

“The process around the selection and appointment of investment fund directors should be clear and transparent. Fund boards should retain, for inspection by the Central Bank, written evidence of the due diligence conducted in identifying and selecting investment fund directors. No service providers to the fund should have undue influence over the selection and appointment of directors of investment funds”.

16. DELEGATES (CODE SECTION 14)

It is considered 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.

Recommendation 31: Outsourcing rather than delegation

It is recommended that the terms “delegated” and “delegation” be replaced with the term “outsourced” throughout the document.

Provision 14.5 provides that investment fund boards are responsible for “*monitoring the performance of its delegate service providers including, inter alia, the monitoring of investment performance*”. Further guidance is needed on what this provision actually implies for fund boards, particularly as investment management is the sole activity generating fund performance. For example, are boards required to monitor absolute or relative fund performance, fund performance within agreed constraints, over-performance as well as under performance?

Recommendation 32: Boards’ role in monitoring investment performance

Provision 14.5 should reflect regulatory expectations of fund boards in relation to fund performance. Guidance in this area should reflect the practical realities of how funds operate and, in particular, the role of fund promoter organisations in ensuring their investment products deliver optimal performance. (See also Recommendations 9 and 29 regarding boards’ governance objectives and related roles).

17. FORMAL REVIEW OF BOARD PERFORMANCE AND MEMBERSHIP

Provision 4.11 provides that “*CIS and ManCo shall formally review Board membership at least once every three years*”. Provision 8.2 provides that “*the Board shall review the overall Board’s performance and that of individual directors annually with a formal documented review taking place at least once every three years*”. The scope of these provisions is unclear. Is the IFIA recommending an independent evaluation of board membership and board performance every three years?

Recommendation 33: Evaluation of board performance

Provisions 4.11 and 8.2 should be re-worded to better reflect the objectives of the provisions. It is recommended that the Code advocate an independent evaluation of board performance, including whether the board remains fit for purpose, at least every three years.

We hope the above discussion, suggestions and recommendations assist in developing the Code further. We would welcome the opportunity to discuss the contents of this submission with you further, and specifically the basis for the recommendations made.

Yours sincerely,

Professor Niamh Brennan
Academic Director
Centre for Corporate Governance at UCD

Margaret Cullen
Ad Astra Research Scholar
Centre for Corporate Governance at UCD

cc Ms Carin Bryans, Outgoing Chairperson, IFIA
Mr Gary Palmer, CEO, IFIA