Investment Fund Governance:
Developing a Risk-Based Oversight Framework
In response to the financial crisis there has been a focus on enhancing governance structures and processes right across the financial services sector. As a result there has been many developments across the sector that are designed to enhance governance and increase a Boards ability to implement Risk-Based governance methodologies. Indeed within the investment fund sector; boards, promoters and regulators have all worked to enhance the effectiveness of fund governance since the crisis. However there continues to be demands for further enhancements to the governance of investment funds.

The CIFD Institute and Deloitte are pleased to offer a Risk-Based Oversight Framework that can be implemented by investment fund boards and entities charged with governing investment funds. While the paper does not promote this model as the only appropriate governance model, nor does it designed to address specific regulatory requirements that may apply to a fund, it does provide a practical methodology that takes account of the unique characteristics of an investment fund and puts investor protection centre-place.

We believe that a Risk-Based Oversight approach to governance of investment funds significantly enhances investor protection.

We hope the view outlined by this paper provides a practical framework within which those charged with investment fund governance can operate and contributes to creating a global language of, and approach to investment fund governance.

Dr Margaret Cullen
CEO
CIFD Institute

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Executive summary

The purpose of this paper is to assist those charged with the governance of investment funds to implement a Risk-Based Oversight Framework. Reference will be made throughout this paper to investment fund directors or the investment fund board, however it is recognised that in some fund structures it may be others who are charged with governance. The governance framework presented is designed to take account of the unique characteristics of investment fund structures and the risk management roles performed by the fund service providers while also considering the responsibilities of the investment fund board.

While much of the scrutiny in the aftermath of the global financial crisis has focused on corporate board structures, practices and processes resulting in numerous corporate governance codes across the financial services industry, less has been written on investment fund governance. There is a tendency to entangle investment fund governance within the norms and rules of corporate governance (Radin and Stevenson, 2006¹, Roiter, 2015²). There are, however, fundamental differences between investment funds and ordinary corporations, and these differences have important implications for the governance of investment funds, differences that require a unique governance framework.

Investment fund governance in this context moves beyond mere regulatory compliance towards a Risk-Based Oversight Framework that which puts the protection of investors at its core. Operating within an overall investment fund governance framework that includes the service provider organisations, investment fund boards that (i) systematically identify the risks relevant to their funds and allocate accountability for the day-to-day management of these risks, (ii) agree common risk definitions/terminology with their service providers, (iii) agree the performance and risk metrics to be provided to the board and (iv) have clear policies and procedures in place reflecting each of those items, will be best placed to prioritise board activities to focus on the areas of greatest risk and to protect the interests of underlying investors.

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In the post financial-crisis world, the importance of robust governance frameworks is increasingly clear. In particular, regulators and investors have begun to pay greater attention to the inherent risk within particular types of businesses and the ways in which firms manage those risks. While the investment funds industry managed to weather much of this storm, there is a greater spotlight on risk oversight processes within the investment fund structure and the risk management processes of entities supporting that structure. Much of the focus to date however has been on investment risk. The relationships between an investment fund and the service providers to which it outsources functions (and the accompanying accountabilities and responsibilities) makes the identification, assignment and management of other risks particularly challenging. Nonetheless, risks other than investment risks can also pose a significant threat to an investment fund. Understanding the risks across all service providers on a consistent and aggregated basis allows the investment fund board to better focus on high-risk areas in executing its oversight role.

The objective of this paper is to provide those who are involved in the governance of investment funds, such as fund promoter organisations, investment fund boards, management company boards and service provider organisations, with an effective governance framework that will assist in protecting the interests of investment fund investors as well as enabling boards of directors to make risk intelligent decisions.

This paper does not interpret regulatory requirements across jurisdictions. Rather, the Risk-Based Oversight Framework captures the unique characteristics of investment funds and the respective roles, responsibilities and accountabilities of those involved in investment fund governance.

This document is divided into two parts. Part 1 provides the context underpinning the relevance of a Risk-Based Oversight Framework for investment fund governance. This section defines investment fund governance and investor protection, explores the unique characteristics of investment funds that have an impact on their governance and considers the roles of the various parties within the investment fund governance framework. Having considered the relevant contextual factors, Part 2 presents the Risk-Based Oversight Framework to investment fund governance. It provides a practical methodology and a range of enabling tools that can be implemented by those charged with governance. The approach and methodology is designed so it can be applied to a range of funds taking account of the specific fund characteristics such as regulatory requirements and operating complexity.

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Part 1: Setting the scene for a risk-based oversight framework
1. Defining the principles of investment fund governance

Identifying globally accepted principles of fund governance can be difficult, particularly given the different stakeholders involved and the varying interests and views across the investor population. These challenges may explain why this is an area that has received less intensive treatment than other governance topics. One of the more respected sources in this regard are the regulatory expectations for investment fund boards and governance frameworks at a macro level posited by the International Organisation of Securities Commissions (IOSCO). Investment fund governance is defined by IOSCO as “a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated efficiently and exclusively in the interests of CIS Investors, and not in the interests of CIS insiders” (IOSCO, 2006, p. 3). The ultimate goal of the governance framework is investor protection.

Critically this goal of investor protection does not equate to protecting investors from market-related losses. Rather, according to IOSCO, the objectives are to:

- enable investors to understand the risks attached to investment fund products;
- prevent misleading or fraudulent practices;
- prevent investor loss due to the malfeasance or negligence of fund promoter organisations; and
- minimise conflicts of interest.

How can investment fund boards best protect the interests of investors? To answer this question, we must consider the unique environment within which fund boards operate.

2. Unique characteristics of investment funds versus companies

Traditional corporate governance models do not easily lend themselves to investment fund structures due to the unique characteristics of investment funds versus companies (Radin and Stevenson, 2006, Roiter, 2015). These unique features are, reflected in Figure 1.

Two key features that should be considered are the product nature of investment funds and the typical outsourcing model employed by investment funds.

i. Investment funds are fund promoter products

Unlike other corporates, the aim of an investment fund is limited to facilitating the collective investment by investors in capital markets. As reflected in Figure 1, the investment fund is an investment product conceived and developed within the fund promoter organisation. Investors invest in the fund promoter’s investment product, i.e. the fund, rather than the fund promoter organisation.

This product is the means by which investors gain access to professional investment management. Investors may invest for a variety of reasons including prior performance, strategic allocations of capital and identification with the fund promoter brand. This is an important characteristic of investment funds.

This means that fund investors, too, have a hybrid character: They are both customers of the fund's adviser and shareholders of a legal entity, the fund. This stands, of course, in marked contrast to ordinary corporations, whose shareholders and customers are two groups, distinct in law and in the marketplace. For an ordinary corporation, decision-making authority and oversight of all facets of its business rest squarely with the board of directors, and for this reason corporate directors are called upon to exercise wide-ranging business judgment over the corporation’s business and operations.

This is not the case for mutual funds. Most notably, federal law, the Investment Company Act of 1940, leaves decision making over a fund’s core business—not with the fund’s directors or officers but with a third party, the fund’s investment adviser, who in nearly all cases has taken the risks and borne the expenses of organizing and promoting the fund.

3. IOSCO is the world’s primary forum for international cooperation for securities regulatory agencies. In May 2004, IOSCO approved the mandate proposed by the Technical Committee Standing Committee on Investment Management (SCS sub-committee) regarding the “Examination of Governance for Collective Investment Schemes.” The mandate directed the SCS sub-committee to establish broad general principles for investment fund governance based on a review of both its past work and the results of a survey concerning investment fund governance in applicable jurisdictions (i.e. jurisdictions where investment funds are authorised and are members of IOSCO). IOSCO produced two documents aimed at establishing general principles for investment fund governance in June 2006 (IOSCO, 2006) and February 2007 (IOSCO, 2007).

Whereas CEOs sit at the apex of the corporation, fund promoters essentially fulfill this role for investment funds. Investment funds, along with their investment objectives and policies, are the brainchild of fund promoters. In response to sales opportunities presented by potential investors or in response to a perceived market opportunity in a particular jurisdiction, fund promoters decide to establish funds. A considerable amount of work goes on in the background within fund promoter organisations before investment funds are launched. During this time, the objectives, policies and strategies of funds are determined, and investment managers are identified to implement the funds’ strategies. Typically, it is only at this point that directors for investment funds are selected. When establishing funds, fund promoters have a vision consistent with their overall strategy across their range of fund products. They have targets or expectations for funds in terms of fund flow (i.e. subscription levels), expense ratios and asset growth, all of which are reflected in the fund design.

Investors are the beneficial owners of investment fund assets. Investors in investment funds are both investors and consumers, investing in fund promoter products while at the same time being consumers of fund promoter brands (Ambler, 2005). As investors and consumers, investors’ objective is to purchase fund promoter products at the lowest price while optimising returns (i.e. selling them at the highest price possible). Empirical research suggests that investors invest in funds on the basis of the prior success and the associated reputation of fund promoters and their investment management arm (Sirri and Tufano, 1998).

Once fund promoters begin the process of establishing funds, they select the entities to provide services to the funds. As reflected in Figure 1, the core functions of investment funds are (1) investment management, (2) distribution or marketing, (3) fund administration (including transfer agency) and (4) safekeeping of assets (by a depository). Fund promoters make strategic decisions regarding the choice of service provider based, inter alia, on economies of scale, jurisdictional, technical and information technology issues. For all functions outsourced, while it is the investment fund boards that legally contract with service providers on behalf of investment funds, it is typically the fund promoters who in practice select the service providers.

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*Source: Cullen and Brennan, 2017, Differentiating Control, Monitoring and Oversight: Influence of Power Relations on Boards of Directors, Accounting, Auditing and Accountability Journal, forthcoming.*
Although fund promoters can choose an investment manager or sub-investment manager outside their fund promoter group, typically their own investment manager division provides this function. Thus funds’ primary income generating activity is generally provided by a division/subsidiary from within the organisation that has established the funds. Within this construct, investment fund boards must contract with and oversee investment managers who are part of the organisational entity that has actually selected them as directors.

ii. Outsourcing model
As reflected in Figure 1, investment funds typically outsource the core portfolio and related investment management activities to the investment manager and the operational and administrative functions (valuations, fund accounting and transfer agency) to entities other than the fund promoter (service providers). While retaining ultimate responsibility for the operation of the investment fund, the investment fund board ensures that the accountability for the delivery of the outsourced functions is reflected in legal contracts such as the investment management agreement, the administration agreement, the transfer agency agreement and the distribution agreement. The outsourced nature of investment funds’ activities to specialist, regulated service providers, represents a structure that requires a different governance model to a standard corporate governance model. The outsourcing model presents a number of challenges for investment fund boards. Much of this is due to the fact that the board is fully responsible and accountable from a legal perspective but may not in practice have the power or influence of a board of a traditional company. Some practical issues that create challenges include:

• The board may not be formed and functioning at the time of considering the selection of the various fund service providers. In practice a board’s formal role in the due diligence and appointment process of service providers may be relatively limited. This can limit the board’s ability to make demands of the service providers.

• Traditional corporate outsourcing involves the outsourcing of operations and management of risks that would otherwise be managed within the organisation. This is not the case with investment funds as the risks in question would typically not be able to be managed within the investment fund. Instead, the outsourcing model requires the board to effectively oversee the service providers in order to place reliance on the operations and management of risks being undertaken by the fund service providers. An understanding of this is critical to formulating an effective governance framework for investment funds.

• Management of risks that are not outsourced remain under the sole control of the board. This can create risks given the number of parties involved and increase the likelihood that certain risks may “slip between the gaps” or that legal agreements with the various service providers may fail to capture all risks that are outsourced.

• Increasing global standards and higher levels of expectation (of regulators and investors) in respect of the role of the fund director.
3. Understanding the governance framework of investment funds

The governance framework for investment funds is made up of:

- The oversight by the investment fund board (and/or management company)
- An executive layer consisting of:
  - fund promoters /investment manager
  - other service providers including the administrator, custodian and distributor and,
  - support services including legal and audit

It is important to appreciate the respective roles of fund promoter organisations, service providers and investment fund boards in considering the implementation of the Risk-Based Oversight Framework.

The traditional view in respect of corporates would be that the board has responsibility for identifying, managing and mitigating risk within the bounds of strategy and overall risk appetite. The corporate will have an infrastructure, assets, resources and management team which deliver the strategy. There is a direct correlation between the decisions made and the risks encountered. These risks are then managed within the corporates infrastructure and by its management team. Fund promoter organisations fit into this category (as do service provider organisations.)

As outlined above, investment funds are investment products whereby the fund strategy and risk profile are established by the fund promoter and set out in the fund prospectus and related documents. The board involvement is to oversee the operations to ensure that the fund operates within its mandate, as set out in the fund prospectus.

The portfolio management expertise sits with the investment manager and reliance is placed on these skills so that the investment manager will execute the fund strategy and decide how the various risks are managed. Similarly, service providers to whom the remaining functions (such as fund accounting, transfer agency, distribution) are outsourced are responsible for delivering functions and managing the day to day risk associated with this delivery.

In short, service providers (including those within the fund promoter organisation) are experts upon which heavy reliance is placed in respect of managing risk on a day to day basis. Upon appointment the investment fund board inherits an infrastructure with appointed outsource service providers, risk management methodologies and a prospectus detailing the parameters within which the fund can operate.

On a day to day basis the fund is managed by service providers accountable to the board. These service providers are generally regulated, governed by their own board of directors and manage the risks attached to their business. The investment fund board must effectively oversee the execution by service providers of their role. This is challenging and requires a robust governance process at the level of the investment fund board. The effectiveness of relationship between the investment fund board, the fund promoter and the service providers to whom functions have been outsourced is critical as is a clear articulation of responsibilities and accountabilities.
Failing to understand the important differences between traditional companies and funds may result in the adoption of inappropriate governance structures. The tensions created between legal and regulatory obligations and how funds have traditionally been formed, authorised and managed is clear. Given these competing demands, how can a board and an investment fund director best position itself to demonstrate it is complying with its obligations? The investment fund board adopts an oversight role (of the outsourced functions) while the fund service providers are responsible for the day-to-day management and control of the investment fund. The Risk-Based Oversight Framework suggested in Part II, reflects and integrates these respective roles into an effective governance framework that enables the investment fund board to leverage off the fund service providers to whom functions have been outsourced while allowing it to aggregate risks and identify where it needs to focus its attention in overseeing the outsource risk associated with that structure.

Conclusion
Part 2: Risk-based oversight framework for investment fund governance
Key risks

A Risk-Based Oversight Framework for investment fund governance understands and reconciles the various legal and regulatory obligations applicable to fund directors with the practical implications of how funds and their boards interact with service providers, including the investment manager. It acknowledges the increasingly onerous obligations imposed on fund directors and the resources and infrastructure that they may have available to them.

The Risk-Based Oversight Framework reconciles the objectives of investment fund governance, as articulated by IOSCO, with the oversight role of investment fund boards arising from the contextual factors outlined in Part 1. Table 1 identifies the component parts of investor protection (the “What” investment fund boards are trying to achieve). The Risk-Based Oversight Framework presented in this section, is one framework that investment fund boards can utilise in pursuit of investor protection (the “How” of investor protection).

A Risk-Based Oversight Framework provides various tools to allow fund directors to understand, identify and manage risks with an appropriate degree of certainty and in a way that is appropriate to the funds industry and the particular fund in question. This framework is reflected in Figure 2. Investment funds will always have a legal launch. It is critical that they also have an investment fund governance launch. As such, the framework is split into two phases to allow an effective governance launch (Steps 1 to 3) and the ongoing activity (Steps 4 and 5) to ensure appropriate governance into the future.

Table 1: Reconciling the Oversight role of Investment Fund Boards and the Objectives of Investment Fund Governance

<table>
<thead>
<tr>
<th>IOSCO 2006: Objectives of Investment Fund Governance</th>
<th>Risks to Investors</th>
<th>Components of Investor Protection (the WHAT)</th>
<th>HOW</th>
</tr>
</thead>
<tbody>
<tr>
<td>To enable investors to understand the risks attached to investment fund products</td>
<td>Investors invest in products inconsistent with their risk appetite</td>
<td>Identification and disclosure of the risks attached to the investment fund</td>
<td>Risk-Based Oversight Framework</td>
</tr>
<tr>
<td>To prevent misleading or fraudulent practices</td>
<td>Loss to investors arising from inappropriate controls and/or fraudulent activity within the entities involved in the day-to-day operation of the fund</td>
<td>Transparent investment performance within regulatory constraints and ‘consistent’ with ‘expectations’ of investors</td>
<td>Risk-Based Oversight Framework</td>
</tr>
<tr>
<td>To minimise conflicts of interest</td>
<td>Fund is managed in best interest of fund promoter/asset manager, related parties and/or service providers and not in the interests of investors</td>
<td>Conflicts of interest management through objective assessment</td>
<td>Risk-Based Oversight Framework</td>
</tr>
</tbody>
</table>

Table 1: Reconciling the Oversight role of Investment Fund Boards and the Objectives of Investment Fund Governance
Figure 2: Risk-Based Oversight Framework for investment fund governance

Step 1
Understanding the fund DNA

Step 2
Risk profiling the Fund

Step 3
Establishing the governance framework

Step 4
Implement and reflect

Step 5
Review, reflect, revise

Ongoing governance

Governance launch
Step 1: Understanding the fund DNA

The first step in the framework is to develop an understanding of how the fund will actually operate, or in other words, the fund's DNA. To do this it is useful to distinguish between the legal establishment of the fund and the governance launch. These lines are often blurred. The governance framework originally adopted by the board should be appropriate to how the fund is legally structured but also how the fund will operate in practice. The framework should be bespoke to the unique characteristics of the fund in question as once a fund is up and running, changes to the governance framework become more difficult to implement. While funds will have many risks in common, generic, one-size fits all frameworks are not conducive to effective governance and should be avoided.

An effective governance framework cannot be designed and implemented without a full appreciation of the risks attached to the fund, which, in turn, are only determinable by understanding how the fund operates. The DNA mapping process will provide a broad overview of the key areas within the investment manager, other service providers and the investment fund requiring consideration and the key documentation that should be analysed to understand the risks within the investment fund. Successful completion of the first step will provide the board with sufficient understanding of the fund's modus operandi to develop the risk profile of the fund. Table 2 summarises the objectives of Step 1, the areas to be considered by the board and the output of Step 1.

<table>
<thead>
<tr>
<th>Table 2: Step 1 Understanding the fund DNA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objectives</strong></td>
</tr>
<tr>
<td>01. The investment objectives and policies of the fund, how it will be marketed and distributed (Product)</td>
</tr>
<tr>
<td>02. Who the key players are (including individuals), their level of independence, experience, expertise and technological sophistication (Players)</td>
</tr>
<tr>
<td>03. The interactions between key players and critical dependencies</td>
</tr>
<tr>
<td>04. The process and procedures by which service providers will service the fund (Processes)</td>
</tr>
<tr>
<td>05. The skills and expertise that board members are bringing to the boardroom</td>
</tr>
<tr>
<td><strong>Areas to Review: Fund Service Providers and Board</strong></td>
</tr>
<tr>
<td>01. Track record (including regulatory record)</td>
</tr>
<tr>
<td>02. Management style</td>
</tr>
<tr>
<td>03. Time commitment</td>
</tr>
<tr>
<td>04. Resources / team</td>
</tr>
<tr>
<td>05. Market</td>
</tr>
<tr>
<td>06. Instruments (including derivatives)</td>
</tr>
<tr>
<td>07. Use of leverage</td>
</tr>
<tr>
<td><strong>Investment Management Process:</strong></td>
</tr>
<tr>
<td>08. Performance and risk metrics</td>
</tr>
<tr>
<td>09. Risk management structure (including models)</td>
</tr>
<tr>
<td>10. Internal Controls / 3 lines of defence</td>
</tr>
<tr>
<td>11. Control reviews (eg SSAE 16)</td>
</tr>
<tr>
<td>12. Proposed MIS</td>
</tr>
<tr>
<td>13. DDQ</td>
</tr>
</tbody>
</table>
### Areas to Review: Fund service providers and Board

**Other service providers:**
To include: Administrator, Custodian, Prime Broker, Transfer Agent, Lawyer, Auditor, Distributor

01. Experience (generally and vis-à-vis fund type)
02. Expertise
03. Reputation / References
04. Commitment
05. IT Platforms / level of automation
06. Scale
07. Contingency
08. Risk Management structure (risk dashboard)
09. Internal Controls / 3 lines of defence Control Reviews (SSAE 16, SOC1)
10. Resources devoted to fund – number, seniority, experience levels and back-up
11. Policies and procedures (e.g. NAV sign off, errors, fraud prevention, escalation, whether bespoke to fund)
12. Culture of organisation

### Board:
01. Directors qualifications and experience and collective board strength
02. Conflicts of Interest / Independence
03. Chairman – chair experience
04. Agenda setting process
05. Director Insurance
06. Sub-committee composition and terms of reference
### Table 2: Step 1 Understanding the fund DNA (contd.)

<table>
<thead>
<tr>
<th>Areas to review: Fund service providers and Board</th>
<th>Documentation to review:</th>
</tr>
</thead>
<tbody>
<tr>
<td>01. Contracts with service providers</td>
<td>01. Contracts with service providers</td>
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<tr>
<td>02. SLAs</td>
<td>02. SLAs</td>
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<tr>
<td>03. SLDs</td>
<td>03. SLDs</td>
</tr>
<tr>
<td>04. Policies and procedures for fund</td>
<td>04. Policies and procedures for fund</td>
</tr>
<tr>
<td>05. SSAE 16 or SOC 1 documents</td>
<td>05. SSAE 16 or SOC 1 documents</td>
</tr>
<tr>
<td>06. Investor DDQ / Pitch Book</td>
<td>06. Investor DDQ / Pitch Book</td>
</tr>
<tr>
<td>07. Workflow diagrams</td>
<td>07. Workflow diagrams</td>
</tr>
<tr>
<td>08. Prospectus</td>
<td>08. Prospectus</td>
</tr>
<tr>
<td>09. Business plan (per regulatory approval)</td>
<td>09. Business plan (per regulatory approval)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Areas to review: Fund</th>
<th>Documentation to review:</th>
</tr>
</thead>
<tbody>
<tr>
<td>01. Domicile</td>
<td>01. Prospectus</td>
</tr>
<tr>
<td>02. Legal Structure</td>
<td>02. Constitutional documents</td>
</tr>
<tr>
<td>03. Investment Strategy</td>
<td>03. Financials</td>
</tr>
<tr>
<td>04. Distribution Strategy</td>
<td>04. Investor DDQ</td>
</tr>
<tr>
<td>05. Tax Status</td>
<td></td>
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<tr>
<td>06. Fee Structures</td>
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</table>

<table>
<thead>
<tr>
<th>Output</th>
<th>Mapping of the operation of the fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sufficient understanding to develop the risk profile of the fund, including the risk and related controls attached to the servicing of the fund (Step 2)</td>
</tr>
</tbody>
</table>
Step 2: Risk profiling the fund

A documented understanding of a funds' DNA provides the foundation on which to build an appropriate Risk-Based Oversight Framework of governance. Once the board has an understanding of the workings of the fund and the interactions across the various parties and service providers to the fund, it can work with these parties in risk profiling the fund (Step 2), the objective of which is to drive the nature and frequency of management information to and from the board on an on-going basis. Risk profiling the fund involves identifying the universe of risks attached to the fund (macro and micro level risks, strategic risks, market risk, credit risk, legal risk, fiduciary risk, reputational risk, operational risk, organisational risk, industry risk, tax risk, political risk and competitive risk to mention a few) but particularly those risks bespoke to the fund. The investment fund board must ensure that the initial assessment of risk is broad and holistic, goes beyond investment risk and extends across all outsourcing arrangements.

This step also involves allocating ownership and accountability for each risk and the related controls across the various service providers (including the investment manager) and, where applicable, the investment fund board. A number of factors will have a bearing on the bespoke risk profile of a fund including, inter alia, fund size, the assets and number of funds in the umbrella, the structure of management and service provider arrangements, the distribution strategy, fees, and the nature of fund investment objectives and strategies. The investment fund board should be comfortable with the day to day management of risk by fund service providers to whom functions have been outsourced. This comfort may be obtained from conducting due diligence prior to appointment, conducting ongoing assurance testing and/or obtaining risk focused management information and service organisation control reports (e.g. SSAE 3402 or SOC 1 Report).

Investment manager and service provider involvement in profiling the risk is critical to Step 2, reflecting their fundamental role in the overall governance framework, as articulated in Part 1. The steps outlined in Table 3 provide an approach for understanding and measuring the risks associated with each of the service providers and the operation of the fund, providing clarity on areas where board oversight should be focused.

Each risk will usually be measured on the basis of the likelihood and impact of an event occurring pre and post the application of a control. A control can include processes and procedures, training and system controls amongst other things. A board is unlikely to have the resources to consider the controls in place for each and every risk but boards may consider assessing the control framework in place within the service providers. By considering the expertise, resourcing, experience and reporting lines of the control functions within the service provider such as legal, compliance, financial control, internal audit, credit, risk, in short the corporate and internal governance framework of each service provider, the board will be able to gain an appreciation for the strength of the overall risk/control framework.

The output from Step 2 is a Risk Heat-map reflecting the following key fund information (See Appendix 1):

- Inherent risks (including materiality)
- Risk ownership and accountability (agreed between the board and each service provider)
- Controls (including testing)
- Residual risk
- Residual risk measurements

The understanding derived from Step 2 will enable the board to manage the risks that sit with it but will also enable the board to evaluate and if necessary challenge how fund service provider’s risk management systems and infrastructure are designed to operate and meet fund objectives.
<table>
<thead>
<tr>
<th>Sub-Steps</th>
<th>Explanation</th>
<th>Objectives</th>
<th>Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Risk identification</td>
<td>Based on the review carried out at Step 1, agree the risks attached to the fund itself and to the servicing or operation of the fund</td>
<td>To identify the risks specific to the fund</td>
<td>Risk Heat-map Identifying: Risks • Risk ownership and accountability • Controls (including testing) • Residual Risk • Measurements • Reporting to the board Sample included at Appendix I</td>
</tr>
<tr>
<td>2. Risk reconciliation</td>
<td>Agree the risks identified, along with the allocation of same, with the appropriate parties</td>
<td>To ensure the boards interpretation of the risks specific to the fund is consistent with that of the service providers</td>
<td></td>
</tr>
<tr>
<td>3. Risk allocation</td>
<td>Allocation of the risks and related accountability to the appropriate parties</td>
<td>To ensure appropriate ownership and accountability of risk is established and understood by all parties</td>
<td></td>
</tr>
<tr>
<td>4. Determining residual risk</td>
<td>Assessment by service providers of the level of materiality of each risk identified along with an articulation of the compensating controls in place</td>
<td>To ensure that the board has a clear understanding of the residual risks attached to the fund as a driver of board on-going oversight and related management information.</td>
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<tr>
<td>5. Risk assessment / Measurement</td>
<td>Based on 1 to 4 above, agree how risk will be measured and reported</td>
<td>To ensure policies and procedures accurately reflect risk, risk measurements and reporting. To ensure board is getting the most appropriate information in the format and timeliness required.</td>
<td></td>
</tr>
</tbody>
</table>
Step 3: Establishing a governance framework

As part of Step 2, each service provider will have documented the risks it believes it is managing on behalf of the investment fund. The output from the risk profiling is the raw material around which the investment fund board’s governance framework is established. It isn’t sufficient that the investment fund board conducts its oversight of the operation of the fund on the basis of the heat-map alone. Step 3 involves comparing the top down analysis from the board with the bottom up analysis of the each service provider to ensure:

01. There is complete alignment across all parties to the fund as to the nature of risks, ownership of and accountability for these risks and related controls and that this is reflected in contractual agreements.

02. That the operating policies of each of the service providers reflects the DNA of the fund, its respective risk profile, the ownership /accountability for each risk and are agreed by the investment fund board.

03. That the escalation and reporting procedures of the service providers for the particular fund ties into the aligned risk profile of the fund and related risk measurements agreed with the board. It is this management information that will drive the board oversight process for each fund.

04. That all service level agreements are accurate and up to date, reflecting the above. It will be possible to quickly identify gaps in risk management/ internal control, the board oversees the operation of the investment fund. In reviewing reports provided and asking appropriate questions the investment fund board will be able to positively transition from a reassurance model (i.e. it is ok because I am told it is), to gaining reasonable assurance (i.e. it is ok because I have reviewed various reliable sources of information bespoke to the fund and I am satisfied with what is being said and by whom).

Step 5: Reflect, review and revise

Investment fund governance is an iterative process. Investment fund boards cannot become complacent. MIS, operating and escalation procedures are not fit for purpose indefinitely and need to adapt to changes affecting the fund caused by internal or external events. Investment fund boards must be cognisant of contextual factors impacting on the funds DNA and its related risk profile on an on-going basis. Changes to the fund risk profile may also drive changes to the governance framework information received by the board. Two contextual factors are identified below but many more are likely to exist in individual funds.

New products

Introduction of new investment products and strategies into a fund’s portfolio often present valuation, systems, legal and other risk issues which, if not properly addressed, could give rise to losses. Prior to a fund engaging in a new type of portfolio investment, the board should be satisfied that the adviser has considered the risks of the new investment and determined that the instruments are appropriate in light of the fund’s risk tolerance, investment strategies and related objectives.

New legislation or regulation

The introduction of new legislation or regulation is also likely to create additional risks for a fund. Risks can include compliance risk or project risks. Responsibility for implementation normally sits with the service providers but the investment fund board should seek assurance that the new legislation or regulation has been implemented correctly. Boards may seek to fully understand the technical implementation of the legislation but many potential issues can also be identified by the implementation approach taken by the service providers and the resources used.

Investment fund boards should undertake, in conjunction with the service providers, a periodic risk and change control assessment. The objective of this assessment is to determine what has changed in the operational, regulatory or economic landscape that impacts on the fund’s DNA and its related risk profile. This assessment may result in updates to operating policies, escalation and reporting procedures and /or SLAs.
Conclusion

Investment fund governance frameworks should go beyond regulatory compliance towards an architecture with investor protection at its core. The objective of this Paper is to provide those who are involved in the governance of investment funds, such as fund promoter organisations, investment fund boards, management company boards and service provider organisations, with an effective governance framework which will assist in protecting the interests of investment fund investors as well as enabling boards of directors to make risk intelligent decisions. The Risk-Based Oversight Framework captures the unique characteristics of investment funds and the respective roles, responsibilities and accountabilities of those involved in investment fund governance. Fund promoters and investment fund boards should ensure that the governance launch of investment funds occurs in parallel and with the same vigour as the legal launch of funds. In doing so, fund promoters and investment funds boards can provide a very clear signal to their investors and regulators that they take investor protection seriously. Understanding the distinction between corporate and investment fund governance is critical. Also critical is the understanding that governance is an iterative process and investment fund boards should make certain that their governance framework keeps apace with regulatory, operational and product development.
Appendices:
Risk analytics tools
**Risk analytics tools**

In order to implement a Risk-based Oversight Framework, the Board should have robust tools that can support practical processes to capture, measure and allocate risks being faced by the funds. There are a number of tools that can be of assistance. In this appendix we provide examples of our Risk Analytics Tools and how they can be applied in implementing the Risk-Based Oversight Framework.

The risk planner (right) summarises how a board can track, measure, calculate and view risks across both risk type and third party provider. High level visualisation of these risks can help boards in their assessment of ongoing monitoring of the fund.
Risk dash, allocation and measurement and controls need to be capitalised across each risk area. The risk tool outlines how risk can be identified, numbered and classified at both the fund DNA level and risk allocation level.
Tools to support the Oversight Framework should provide clear reporting that allows Boards to demonstrate their application of the Framework and keep the monitoring of the process under continuous review.
About the Certified Investment Fund Director Institute

The Certified Investment Fund Director (CIFD) Institute is a global non-for-profit community of investment fund directors. Through its specialist focus and membership, the CIFD Institute has the following key objectives:

A. to raise professional standards in investment fund governance internationally and in doing so safeguard the interests of investors; and
B. to develop and support investment fund directors in the execution of their roles as such; and
C. to be thought leaders in the area of investment fund governance.

Members of the CIFD Institute comprise professionals who have successfully completed the institute’s flagship programme, the Certified Investment Fund Director Programme, and, thus, have been awarded the professional designation of Certified Investment Fund Director by the CIFD Institute.

The CIFD Institute seeks to achieve its objectives:

A. by managing and co-ordinating the delivery of the Certified Investment Fund Director (CIFD) Programme in a number of key locations, by awarding the professional designation Certified Investment Fund Director and by the operation of the continuing professional development required to retain that designation; and
B. by providing a community and a forum in which CIFDs can network and leverage off each other’s experience, thereby developing in the execution of their roles.

The CIFD Institute offers the Certified Investment Fund Director professional designation. It provides continuing professional development seminars, webinars and publications to allow members and holder of the professional designation of Certified Investment Fund Director to stay current on developments in the area of investment fund governance.

The CIFD Institute is a specialist body within the Institute of Banking, a recognised college of University College Dublin.

...the CIFD provides continuing professional development seminars, webinars and publications to allow members and holder of the professional designation of Certified Investment Fund Director to stay current on developments in the area of investment fund governance.
If you are interested in hearing more about the work of the Certified Investment Fund Director Institute or the Certified Investment Fund Director Programme, please contact Dr Margaret Cullen or Mr Frank Ennis, CEO and Chairman, Advisory Committee, of the Certified Investment Fund Director Institute, respectively.

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