Investment Fund Governance

Developing a Risk-Based Oversight Framework

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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. 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 toward a Risk-Based Oversight Framework, which puts the protection of investors at its core. This framework seeks to provide those who are involved in the governance of investment funds, such as fund promoter organizations, investment fund boards, management company boards, and service provider organizations, with an effective governance framework that will assist in protecting the interests of investment fund investors as well as enable boards of directors to make risk intelligent decisions.

The Certified Investment Fund Director (CIFD) Institute was established to bring the unique characteristics and challenges of investment fund governance to the front of the governance agenda and to encourage a common, global approach to investment fund governance with investor protection at the core.

A Risk-Based Oversight Framework for Investment Funds (hereafter "Risk-Based Oversight Framework") is the cornerstone of the CIFD Institute's Certified Investment Fund Director Program and can be implemented by investment fund boards or those charged with the governance of funds.

Setting the scene for a Risk-Based Oversight Framework

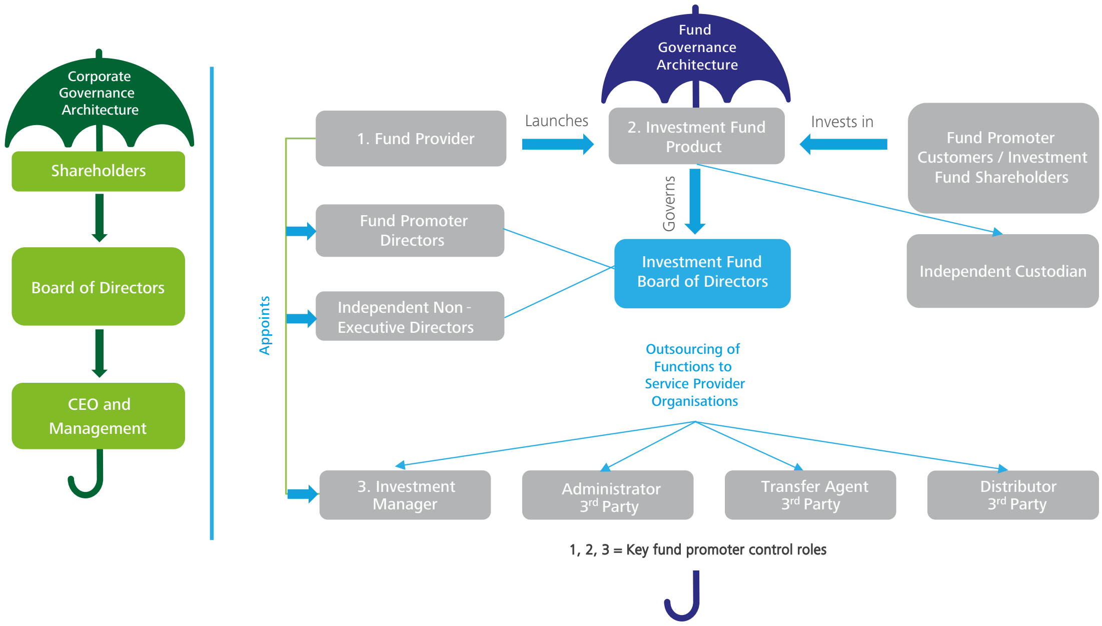
To better understand the framework we must first define investment fund governance and investor protection, explore the unique characteristics of investment funds that have an impact on their governance, and consider the roles of the various parties within the investment fund governance framework.

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. The ultimate goal of the governance framework is investor protection, which does not equate to protecting investors from market-related losses. Rather, according to IOSCO[1], 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 organizations
- minimize conflicts of interest

1 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 (SC5 sub-committee) regarding the "Examination of Governance for Collective Investment Schemes." The mandate directed the SC5 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).

Figure 1: Governance architecture



2. Unique characteristics of investment funds versus companies

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

The aim of an investment fund is limited to facilitating the collective investment by investors in capital markets. The investment fund is an investment product conceived and developed within the fund promoter organization. Investors invest in the fund promoter's investment product, i.e. the fund, rather than the fund promoter organization. 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, which is an important characteristic of investment funds.

Investment funds, along with their investment objectives and policies, are the brainchild of fund promoters. 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).

ii. Outsourcing model

As reflected in Figure 1, investment funds typically outsource the core portfolio and related investment management activities. 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.
- The outsource 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.
- 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.
- There are increasing global standards and higher levels of expectation (of regulators and investors) in respect to 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 managers
     - other service providers including the administrator, custodian, and distributor
     - support services including legal and audit

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.

In short, service providers (including those within the fund promoter organization) are experts upon which heavy reliance is placed regarding the management of 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.

Investment fund governance frameworks should go beyond regulatory compliance toward an architecture with investor protection at its core

Risk-based oversight framework for investment fund governance

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 vigor as the legal launch of funds. 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.

Key risks

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 above. Table 1 identifies the component parts of investor protection (the "What" that investment fund boards are trying to achieve). The Risk-Based Oversight Framework presented in this section, is one framework that investment fund boards can utilize in pursuit of investor protection (the "How" of investor protection).

IOSCO 2006: Objectives of Investment Fund Governance	Risks to Investors	Components of Investor Protection (the WHAT)	HOW
• To enable investors to understand the risks attached to investment fund products	• Investors invest in products inconsistent with their risk appetite	• Identification and disclosure of the risks attached to the investment fund • Investment strategy employed consistent with expectations of investors. Distribution of investment fund in line with regulations, fund promoter brand and product offering	
• To prevent misleading or fraudulent practices • To prevent investor loss due to the malfeasance or negligence of fund promoter organisations	• Loss to investors arising from inappropriate controls and/or fraudulent activity within the entities involved in the day-to-day operation of the fund	• Transparent investment performance within regulatory constraints and 'consistent' with 'expectations' of investors • Oversight of integrity of the Net Asset Value of the fund: 1. Safety of assets 2. Valuation methodology 3. Transparency	Risk-Based Oversight Framework
• To minimise conflicts of interest	• Fund is managed in best interest of fund promoter/ asset manager, related parties and/or service providers and not in the interests of investors	• Conflicts of interest management through objective assessment	

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 for the funds industry and the particular fund in question. This framework is reflected in Figure 2. Investment funds will always have a legal launch, and 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.

Step 1: Understanding the fund DNA

The governance framework originally adopted by the board should be appropriate for how the fund is legally structured but also how the fund will operate in practice. The framework should be tailor-made to the unique characteristics of the fund in question, since once a fund is up and running, changes to the governance framework become more difficult to implement. 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 analyzed to understand the risks within the investment fund.

Successful completion of the first step will provide the board with sufficient understanding of the funds' modus operandi to develop the risk profile of the fund.

Step 2: Risk profiling the fund

A documented understanding of a fund's DNA provides the foundation on which to build an appropriate Risk-Based Oversight Framework of governance. Risk profiling the fund involves identifying the universe of risks attached to the fund (macro and micro level, strategic, market, credit, legal, fiduciary, reputational, operational, organizational, industry, tax, political, and competitive risks to mention a few) but particularly the risks specific to the fund.

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. 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, or obtaining risk-focused management information and service organization control reports (e.g. SSAE 3402 or SOC 1 Report).

The input for step 2 is:
1. Risk identification
2. Risk reconciliation
3. Risk allocation
4. Determining residual risk
5. Risk assessment/measurement

The output from Step 2 is a risk heat map reflecting the following key fund information:

1. Inherent risks (including materiality)
2. Risk ownership and accountability (agreed between the board and each service provider)
3. Controls mapped to the risks
4. Residual risk
5. Residual risk measurements

Step 3: Establishing a governance framework

Step 3 involves comparing the top down analysis from the board with the bottom up analysis of each service provider to ensure that:

1. There is complete alignment across all parties as to the nature of risks as well as ownership of and accountability for these risks and related controls, and that this is reflected in contractual agreements.
2. The operating policies of each of the service providers reflect the DNA of the fund, its respective risk profile, the ownership/accountability for each risk, and are agreed by the investment fund board.
3. 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.
4. 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 controls which can be allocated to an appropriate service provider through contract or SLA.

Step 4: Implement and report

Once the governance framework is structured, it must be implemented by the investment fund board and the service providers. Step 4 is essentially the ongoing oversight by the investment fund board based on the framework developed over Steps 1 to 3.

Service providers must provide management information to the investment fund board in the nature, format, and frequency agreed under Step 3. In executing its oversight role, the investment fund board seeks to confirm that the parties to whom the risk has been outsourced are effectively managing these risks.

Through ongoing consideration of management information and through the escalation of risk events or breakdowns in 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 specific to the fund and I am satisfied with what is being said and by whom).

The result is a governance framework encompassing:

1	Operating policies specific to the fund
2	Escalation and reporting procedures (including MI) specific to the fund
3	Accurate contractual arrangements and SLAs
4	Compliance with regulations
5	Compliance with legal documentation

Step 5: Reflect, review, and revise

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*
  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 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 has an impact on the fund's DNA and its related risk profile. This assessment may result in updates to operating policies, escalation and reporting procedures, and SLAs.

Conclusion

Investment fund governance frameworks should go beyond regulatory compliance toward an architecture with investor protection at its core. The objective of this article is to provide those who are involved in the governance of investment funds, such as fund promoter organizations, investment fund boards, management company boards, and service provider organizations, with an effective governance framework which will assist in protecting the interests of investment fund investors as well as enable 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. Understanding the distinction between corporate and investment fund governance is critical, as 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.

To the point:

- Define the objectives of investment fund governance
- Unique characteristics of investment funds
- Understanding the governance framework for investment funds
- Understanding the fund DNA
- Risk profiling the fund
- Establishing the governance framework
- Implement and report
- Review, reflect, and revise