Third-party Management Companies
A new governance model?

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The third-party management company is a familiar concept originating with UCITS. It has taken its next evolutionary step with AIFMD. The traditional model has to evolve from focusing on regulatory compliance to emphasising asset class and actual operations.

Investors have been focusing on the governance of investment funds ever since the unpleasant surprises experienced as a result of the global financial crisis of 2008/09. These included severe write downs in net asset values of funds and securities held by them, delayed payment of redemption proceeds, gating of funds, suspension of redemption rights, counterparty failure and, more extremely, insolvency of the funds themselves. Many investors, institutional or otherwise, felt that the service providers of funds which found themselves in trouble during the crisis, in particular investment managers and directors—who were tasked with managing and overseeing the funds—could have done more to support the funds in managing the crisis. Some investors and many prominent political and regulatory figures have even stated that there was a systemic failure of the fund governance model internationally. While such views may or may not be justified in specific cases, and they conveniently ignore how banks, investors, politicians and regulators contributed to the crisis and its handling, there is some degree of truth in the view that those charged with the governance of funds could have done better.

Various countries have responded in different ways to the aftermath of the crisis with a view to preventing a Global Financial Crisis, Part II. Most countries adopted new legislation aiming to regulate all aspects of financial markets, including the activities of investment managers, fund directors and other service providers. Others chose to follow the route of suggesting that codes of conduct be applied either on a mandatory or voluntary basis. A few decided to regulate further the activities of the funds themselves. Many ended up regulating the investment fund industry indirectly through banking, derivatives, tax and other specific regulatory initiatives. Investors have effectively overlaid the funds industry with indirect regulation in the form of due diligence teams that proliferated worldwide. One can argue about the merit and risk/reward calculus of these various regulatory and private initiatives, but ultimately it is clear that the industry has developed into a much more complex environment.

It is against this backdrop that the role of the third-party management company is evolving.

The concept of the third-party management company has its origins in the UCITS world—every UCITS fund (other than a self-managed one) requires a 'management company' to manage the fund (generally referred to in the industry as a 'ManCo'). The investment manager, as sponsor of the fund (i.e. an institutional asset manager, investor, bank or hedge fund manager) can either establish and operate its own ManCo or call on a third-party ManCo service provider. UCITS rules require that the ManCo legally manages the fund, but generally the ManCo delegates portfolio management and risk management to the sponsor's chosen investment manager, and administration and custody activities to an external administrator and custodian. The ManCo may also delegate distribution to a global distributor or sub-distribution network.

Given the extent of outsourcing in the UCITS model, the traditional UCITS ManCo focuses more on monitoring the delegated operations of the fund and ensuring compliance with UCITS regulations by the various service providers, rather than on running the fund itself on a day-to-day basis. It should be noted that even though the ManCo may delegate various fund-related functions to other parties, it retains legal responsibility for the proper discharge of those functions. So while generally the traditional UCITS ManCo remains legally liable for all fund activities, it rarely 'does' anything when it comes to actual operations—rather most UCITS ManCo service providers view their roles as being driven by regulation and compliance. While this model has been highly successful in the UCITS sphere, it will be trickier to implement in the more complex world of alternative investment funds.

The combination of recent regulatory developments should result in a shift in the traditional UCITS ManCo 'compliance' model:

- Luxembourg CSSF circular 12-546 (the 'substance circular') issued in autumn 2012 which generally requires UCITS ManCos to have more 'substances on the ground in Luxembourg
- The EU's Alternative Investment Fund Managers Directive came into effect between July 2013 and July 2014, after five years of legislative and regulatory wrangling, and AIFMD II is already in preparation
- National and international tax regulation, jurisprudence and discussions on proposed regulation (such as BEPS) have evolved to require greater substance on the ground for entities wishing to avail themselves of tax treaty benefits

The aggregate effect of these regulations is to require third-party ManCos to have more substance, meaning that they cannot be 'letter-box' companies or have a light operational base.

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"AIFMD requires the demonstration, initially and on an on-going basis, of significant substance in companies and their senior management that seek to be approved as AIFMs, both for portfolio and risk management. In the traditional cross-border fund centres such as Luxembourg, senior people with the necessary experience, especially in private equity and real estate, but also in hedge and traditional investment strategies, are increasingly difficult to find" – Keith Burman, Partner, ManagementPlus Group.

It is somewhat unclear at this stage what this means in practice. To be fair to regulators, it is important to recognise that most of the regulations requiring substance have been politically mandated and typically poorly drafted. Regulators are operating just as blindly as the affected sectors of the funds industry, although everyone's experience with AIFMD at the European level, the substance circular in Luxembourg and other such regulations increases every day. However, it is clear that the traditional UCITS ManCo model will not work for UCITS anymore. AIFMD charges the ManCo with control and management of the fund at a much more operational level than the early UCITS legislation ever foresaw. In this sense we can see a convergence between the UCITS and AIFMD ManCo models. While this may be considered a detriment and an unnecessary increase in costs by many investment fund managers and even some investors, it does raise an interesting possibility—that of a ManCo that can provide operational value-added services to a fund.

The traditional 'compliance' third-party ManCos are generally populated by former compliance officers, auditors, administrators, etc.—in other words, by individuals who do not have actual experience working with an investment manager. While this may have worked in the past, it is no longer a viable option given the new regulatory framework. If the third-party ManCo is to insert itself into the fund structure as an effective gatekeeper (for investors but also for all other stakeholders of the fund), its management and personnel must have:

- Relevant background and experience—to discuss and, if necessary, to handle portfolio and risk management issues, it is essential that the third-party ManCo has staff with specific asset class knowledge (i.e. equities, fixed income, commodities, FX, hedge, private equity, real estate, infrastructure), if nothing else to be able to communicate with the investment manager and the other service providers using the same technical and industry language
- Practical operational experience—to be an added-value proposition to the investment manager, in addition to the regulatory and compliance functions, a third-party ManCo should also be able to provide actual operational support to the investment manager, which can have many cost and tax advantages depending on the structure
- A policy of engagement with the investment manager/sponsor and all other stakeholders of the fund—communication between the ManCo and the service providers should not be limited to quarterly board meetings or monthly service provider meetings, but should be continuous and take place as often as necessary
- A problem-solving mindset—the ManCo's staff should have the ability to foresee problems before they happen, handle them efficiently and effectively when they happen, and exercise leadership to focus the fund service provider team on developing and implementing appropriate solutions
- An understanding of the fund eco-system and team orientation—ultimately the ManCo has to lead the team of service providers of the fund to reduce the odds of failure; while the risk of failure cannot be eliminated, its occurrence and impact can be minimised by the ManCo if it has the qualities listed above

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Of course all of these value-added qualities have to be delivered over and above the traditional regulatory and compliance requirements for a third-party ManCo, whether under UCITS or AIFMD:

"Third-party management companies could be the next iteration of the front, middle and back office outsourcing concept. The function of operational third-party management companies is not to replace the investment manager as sponsor or the administrator as middle or back office service provider, but to work with them to strengthen the fund's operating model as an independent value-added proposition." states Antonio Thomas, Partner, ManagementPlus Group

To the **point**:

- While the third-party ManCo model is generally a European concept, it does not have to be limited to the geographical borders of Europe
- One can envisage interesting applications of this model to funds established in the Cayman Islands and other offshore jurisdictions
- The third-party ManCo should be viewed as another tool for fund governance, but a better one, if it provides operational added value to the investment manager/ sponsor and ultimately greater comfort to investors and regulators. While the 'new' operational third-party ManCos may not prevent the next crisis, they should go a long way to ensure that a fund operates in accordance with applicable regulations and the disclosures provided to its investors