Fund governance round-up

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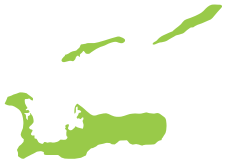
Fund governance continues to be a much debated topic among the wider investment community. In the wake of the financial crisis, governance models are under scrutiny and investor and regulator attention has been focused on key governance aspects such as ultimate responsibility, independence, conflicts of interest and demands for greater accountability, which is being reflected in some notable developments on fund governance from around the globe over the last few months.



Cayman Islands

The Cayman Islands Monetary Authority (CIMA) commissioned the Hedge Fund Corporate Governance Survey earlier this year. The survey was conducted as part of a wider effort by CIMA to gain feedback from hedge fund managers, investors, directors and various hedge fund service providers on proposed corporate governance policy and standards from the local industry and its stakeholders.

The survey (which can be found on CIMA's website at www.cimoney.com.ky) demonstrated that director knowledge, experience and independence were the most highly valued elements of a corporate governance structure. In particular, investors—as evidenced by the survey—place a greater emphasis on director independence than on knowledge and experience. A director's duty is to the fund and, as such, the director's role in the corporate governance structure is to serve as a source of fiduciary oversight. Independence is therefore considered a crucial aspect of a director's ability to perform his/her duties objectively and protect investors' interests. The judgment in the Weavering case in August 2011 served to highlight the need for impartiality on the part of the directors. In this instance, a family relationship between the fund's manager and the directors allowed the fraud to be perpetrated through the directors' wilful failure to discharge their duties to the fund. It was alleged that if the directors had properly discharged their responsibilities, then the fraud would have been discovered and the fund's losses could have been mitigated.

Respondents to the survey were divided on whether there should be a limit on directorships held by each director, and whether this would benefit the industry. Most respondents who believed that this would be beneficial to the industry felt that this should be based on the number of manager relationships and not the number of single directorships held. This was particularly felt by hedge fund managers. Investors expressed concern that directors with a large number of directorships may spread themselves too thinly, and see a limitation on the number of directorships as a means of increasing directors' ability to focus on the efficiency of the due diligence process. The importance of having sufficient time for this purpose was further echoed by directors. Non-executive directors generally sit on numerous boards for which a meeting is convened periodically. The irregularity of these meetings was seen as a weakness of the industry. The large number of directorships held by a director is therefore seen as a constraint on a director's ability to effectively provide adequate fiduciary oversight. Another key theme which came out of the survey was a need for greater transparency. Investors, in particular, want more information on directors. Investors were particularly interested in the number of directorships held by each director, as well as any previous, current or pending litigation involving the directors.

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This information is of great importance to the corporate governance due diligence process, as it is one of the determinants that may be used by an investor to assess whether a director is 'fit and proper' to serve as the fund's director in accordance with the statutory requirements of the Cayman Islands. To achieve this transparency, the majority of investors were in agreement with information on the number of directorships held by directors being provided through a database managed by CIMA. However, directors who agreed with the disclosure of the number of directorships were least in favour of this method of communicating such information. Overall, the survey demonstrates that the Cayman hedge fund industry sees the importance of establishing strong corporate governance standards and practices and a robust regulatory framework pertaining to the Cayman Islands funds sector. Director knowledge, experience and independence continue to be ranked among the key strengths of the local industry, and as such will continue to drive local regulatory policy.

Ireland

The Central Bank of Ireland ('CBI') continues to focus on the conduct of boards and director responsibilities across the financial services sector. The new Governor of the CBI, Cyril Roux, has stressed the importance of individual responsibility on persons operating in financial services providers, and on directors in particular. The CBI has taken a three pronged approach in this regard.

Firstly, all directors are considered to be pre-approved controlled functions under the fitness and probity regime, meaning they must undergo competency, capacity and probity tests by their firm prior to being assessed by the CBI on similar criteria. The time commitment by individual board members, as well as the level of board activity and range of competence and skillsets on the board are areas likely to come under scrutiny in CBI themed inspections during 2014. The CBI has a number of significant powers in this regard, including the ability to fine or disqualify directors that fail to adhere to the requirements.

Secondly, the CBI has begun to flex its powers under PRISM , its new risk based approach to supervision. In particular the CBI has increased the number of inspections conducted in the last year. PRISM inspections may involve interviews of board members, which can be challenging in nature and focussed on technical, risk and strategic matters.

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Finally, the CBI has adopted a strong stance on adherence to the Corporate Governance Code for Collective Investment Schemes and Management Companies issued by the Irish Funds Industry Association (the 'IFIA Code'). While the IFIA Code is voluntary in nature, the CBI considers it 'essential' that all Irish fund boards adopt the code, with 2013 marking the first full year of compliance following a transitional period. The CBI is now monitoring industry take-up of the IFIA Code and requiring management companies to confirm in their online filings that the IFIA Code has been adopted. Where the IFIA Code is adopted, the annual report should confirm compliance or explain the reasons for not adopting any provision.

The IFIA Code draws on the existing corporate governance practices as outlined in the Central Bank Notices and in the Irish Companies Acts but also includes some significant changes and additional focus relating to:

- Independent directorships
- Time commitment of the board
- Conflicts of interest
- Board performance review
- Attendance at meetings
- Terms of reference for committees
- Director training

The implementation of the Alternative Investment Fund Manager's Directive ('AIFMD') has resulted in the addition of further requirements for the boards of Irish management companies which become authorised AIFMs. The CBI has clarified additional managerial functions for which the board retains responsibility, with individuals required to accept responsibility for monitoring and controlling these activities on a day-to-day basis.

Luxembourg

ALFI (Association of the Luxembourg Fund Industry) issued a revised Code of Conduct in an update to its initial version, which was published in September 2009. There have been many developments in fund regulations and governance over the last four years, partly as a response to the onset of the financial crisis, which led to the need to review and update the Code of Conduct.

The 2013 revision of the Code did not, however, change its overall approach, which remains based on principles rather than detailed rules. As in its initial version, each of the Code's principles is supported and explained by a number of recommendations, which in most cases will represent the practice to be followed by industry participants in order to implement these principles. The revised Code was published on the occasion of the Annual General Meeting of ALFI held on 19 June 2013.

ALFI's Board of Directors strongly recommends that all funds and management companies, whether UCITS or non-UCITS, adopt the revised Code, and that they confirm adherence to the principles of the Code in their annual financial statements. Despite the voluntary nature of the Code, it is interesting to note the wide extent to which the Code in its initial version has already been adopted. According to the most recent and very extensive survey of Luxembourg fund governance published in January 2013, 85% of the UCITS covered by the survey reported that they had adopted the Code and, furthermore, all respondents in the survey declared that the principles-based approach of the Code was appropriate.

In an era marked by the ever-increasing number and complexity of rules and regulations, there is nonetheless a widespread acceptance by industry participants of the need to adopt sound principles of governance underpinned by recommendations for best practice.

As for the revisions to the Code, two additional principles have been added to the eight principles included in the initial version of the Code.

These two new principles (on external governance and remuneration of board members of funds respectively) incorporate the significant regulatory and governance developments in these areas that have taken place since 2009.

The recommendations underpinning the ten principles of the Code have been reviewed and updated to take account, in particular, of the increased focus on the management of conflicts of interest, risk management and internal controls, which have been major features of new regulations and developments in practice since the publication of the initial version of the Code. Additionally, greater focus on the role and the composition of fund boards is reflected in new and revised recommendations covering the role of the chairperson, diversity in board membership, the role of independent directors and the recommendation for fund boards to perform periodic reviews of their performance.

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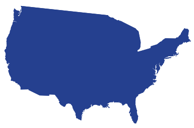

United States

In June 2013, the U.S. Securities and Exchange Commission (SEC) issued its findings against the former directors (Morgan Keegan directors) of the Morgan Keegan funds, in connection with the fair valuation of the funds' securities (http://www. sec.gov/litigation/admin/2013/ic-30557.pdf)[1].

The funds heavily invested in below investment grade debt, with the majority of the funds' assets invested in structured products including those backed by subprime mortgages. Often a difficult asset class to value, these holdings became more challenging to price during the relevant period of January through August 2007, due to extreme market conditions, including reduced liquidity and price volatility.

In the Morgan Keegan case, the SEC found that the funds' valuation procedures relied on boilerplate-type factors taken directly from Accounting Series Release 118 (ASR 118). These factors included fundamental analytical data relating to the investment, the market for the securities and the issuer's financial statements. The SEC found that, beyond these factors, the procedures provided no meaningful methodology or other specific directions on how to make fair value determinations for specific portfolio assets or classes of assets.

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The SEC also found other issues with the funds' procedures, including the fact that the procedures did not include any mechanism for identifying and reviewing fair valued securities whose prices remained unchanged (so-called stale prices) for weeks, months and entire quarters. Finally, the SEC found that the procedures did not require the Morgan Keegan directors to ratify fair value determinations, and that the Morgan Keegan directors did not ratify such valuations in practice. As is common in enforcement actions, the SEC found that management did not follow the funds' written procedural requirements, including the requirement for the Morgan Keegan directors to receive written explanatory information in support of the fair valuations assigned. The SEC also found that while the funds' procedures required fair value decisions to be made by a management valuation committee, fair values were assigned in practice by the fund accounting group, with significant influence from the portfolio manager.

In the case, the SEC found that fair valuation decisions were made with significant input from portfolio management. In this regard, the SEC found that the Morgan Keegan directors did not receive information on management 'overrides' of prices provided by a pricing service or broker-dealers. More broadly, the SEC found that the information and reports provided to the board did not provide sufficient information for the Morgan Keegan directors to understand what methodologies were used to calculate the fair value of the funds' securities.

The SEC also used the case as a platform to reiterate its long-standing position that fund directors are ultimately responsible for fair valuations and that directors must actively ensure that fair valuations are appropriate and related processes are working as intended[2].

1 The SEC found that the Morgan Keegan directors caused the funds to violate Rule 38a-1 of the Investment Company Act, which requires registered investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including policies and procedures that provide for the oversight of compliance by the investment adviser. The case against the Morgan Keegan directors follows an SEC settlement with management concerning the funds' valuation practices. See http://www.sec.gov/litigation/admin/2013/ic-30557.pdf.

2 See section 2(a)(41)(B) of the Investment Company Act, which requires the board to determine a security's fair value in good faith when market values are not readily available, and Accounting Series Release No. 118, Investment Company Act Release No. 6295 (December 23, 1970) regarding the SEC's interpretation of this requirement.