

# Regulatory Update

## 1. New Irish Corporate Governance Code for Funds: What Will it Mean?

The Irish Funds Industry Association has circulated a draft Voluntary Corporate Governance Code for the Funds Industry in Ireland.

### 1. Background

On 13 June 2011, the Irish Funds Industry Association circulated a draft Voluntary Corporate Governance Code for the Funds Industry in Ireland (the "Code"). This arose from an invitation from the Central Bank of Ireland (the "Central Bank") to the funds industry last year, as part of a process of introducing Corporate Governance Codes for specific sectors of the financial services industry in Ireland, to develop such a code. A steering group within the industry was established to lead the project, which involved significant consultation with the Central Bank.

### 2. Application

The Code will apply to Irish authorised investment funds and Irish authorised management companies. The Code has been confirmed by the Central Bank as an appropriate and robust code of standards for the governance and management of such Irish authorised investment funds and management companies. The draft has been circulated for industry consideration and any observations or feedback was requested to be submitted on or before 24 June 2011. The IFIA received a significant amount of feedback from the industry and this is currently being considered by the Central Bank Policy Committee.

Although the Code is voluntary in nature, its adoption is strongly recommended by the Central Bank. However, rather than introducing a completely new corporate governance regime, the Code largely outlines a set of principles and guidance which codify existing practice and it combines this with what is seen as best international practice. The requirements outlined in the Code are the minimum recommended requirements that a fund should meet in the interests of promoting strong and effective governance.

### 3. Timing

It is expected that a response to industry feedback will be received from the Central Bank shortly, with a finalised Code to be circulated afterwards. The final Code will not be effective until January 2012 and it is currently envisaged that a transitional

period of 12 months will apply. The Code will ultimately come into effect on a "comply or explain" basis. This means that where a Board decides not to apply any provision of the Code, it should set out its reasons why in the Directors' Report in the annual financial statements or alternatively publish its reasons through a publicly available medium (eg a website).

### 4. Main Implications of Adopting the Code

We are satisfied that the vast majority of the requirements set out in the Code are already being complied with by Irish authorised funds. As stated above, the Code represents a re-statement of obligations which already apply, rather than the introduction of a significant new corporate governance regime.

However, over the coming months, Boards of Directors of funds and management companies will need to review the Code and consider whether to adopt it. Obviously, the practical implications of adopting the Code will need to be understood by each director. Accordingly, the following is a summary of the principal practical implications of adopting the Code in full (as it currently stands), in terms of processes to be implemented and documented, which may or may not be in place at the moment:

- i. the Board will need to specify on a periodic basis, as appropriate, the time commitment it expects of each director;
- ii. directors will be required to disclose to the Board any concurrent directorships held on other authorised funds, management companies and/or related entities which supply services to such schemes;
- iii. directors will also be required to disclose to the Board their other time commitments, including those devoted to any directorships of non-Irish funds;
- iv. the Board will need to satisfy itself that directors have sufficient time to fully discharge their duties;
- v. in considering director appointments, the Board will be required to assess, and document its consideration of, possible conflicts of interest;
- vi. the Board will also be required to document its procedures for dealing with such conflicts and must review compliance with those procedures annually;
- vii. the Board will be required to formally review Board membership at least once every three years;
- viii. the Chairman of the Board will be required to be reviewed at least once every 3 years;

- ix. the overall performance of the Board will be required to be reviewed annually, together with the performance of individual directors, with a formal documented review taking place once every three years;
- x. a schedule of directors' attendance at Board meetings will be required to form part of the annual informal Board performance review process;
- xi. the Board will be required to establish a documented "conflict of interest" policy for its members and where conflicts arise, the Board must ensure they are noted in the minutes;
- xii. the Board will be required to establish a formal schedule of matters specifically reserved to it for decision, which schedule must be documented and updated in a timely manner;
- xiii. the Board may establish committees, which will be required to have documented terms of reference evidencing all authorities delegated to them and detailing their functions, membership, reporting lines, meeting frequency, voting rights and quorums;
- xiv. the Fund will be required to detail in its annual report its compliance with the Code and explain any deviation, or alternatively publish the information through a publicly available medium (eg a website) detailed in the annual report;
- xv. the Board must ensure that internal control procedures of delegates are being monitored to ensure that they are effective;
- xvi. the Board will be required to ensure that there are appropriate processes and systems in place to monitor and manage risks identified by it or its delegates at all times.

The above is a summary only of what we see as being the most likely practical implications of adopting the Code. We would recommend that the directors review the Code in detail and formally consider the Board's current practices to identify any deficiencies.

## 5. Other Key Provisions

The other key provisions contained in the Code can be summarised as follows:

### *i. Composition of the Board*

- three directors is recommended as the minimum size for the Board;
- the majority of the Board must consist of non-executive directors and there must be at least one independent director;
- an independent director will not be an employee of any service provider firm receiving professional fees from the fund;
- it is strongly recommended that at least one director be an employee of the promoter or the investment manager;
- a minimum of two directors on the Board must have Irish residency;
- if any director has in excess of eight non-fund directorships it raises a rebuttable presumption that that director's time available is impacted – this must be explained in the "comply or explain" statement referred to above;

- before being appointed, a new director needs to demonstrate to the satisfaction of the Board that he or she meets the Central Bank's fit and proper standards.
- appointments to the Board require the prior approval of the Central Bank and any departure from the office of director, along with the reason(s) for departure, should be made known to the Central Bank.

### *ii. Chairman*

- a non-executive Chairman, who will lead the Board, encourage critical discussions, challenge mindsets and promote effective communication, must be appointed to the Board.

### *iii. Independent Directors*

- independent directors must be identified clearly in the annual report;
- they must have a knowledge and understanding of the investment objectives, policies and outsourcing arrangements to enable them to contribute effectively.

### *iv. The Role of the Board*

- the Board is responsible for the effective, prudent and ethical oversight of the fund;
- it is ultimately responsible for ensuring that risk and compliance is properly managed on behalf of the fund and the Code sets out how this responsibility might be discharged;
- it may delegate to committees or third parties, must have mechanisms in place for monitoring the exercise of delegated functions but cannot abrogate responsibility for those functions.

### *v. Appointments*

- the Board is responsible for appointing all directors and for ensuring they are adequately trained to discharge their duties.

### *vi. Meetings*

- the Board must meet as often as is appropriate to discharge its duties but should normally meet quarterly;
- detailed agendas must be circulated in advance and detailed minutes must be prepared afterwards;
- all directors should attend all meetings;
- ongoing conflicts of interest may necessitate a change in Board membership.

### *vii. Committees*

- the Code outlines some details governing the manner in which Committees of the Board conduct their business.

### *viii. Delegates*

- the Board may delegate all or part of the management of the fund to third parties and the Code make specific reference to investment management, administration and distribution as examples of management functions that may be delegated;

- the Code outlines under what conditions the Board can delegate;
- the Board shall be responsible for monitoring the performance of such delegates and must have mechanisms in place to do so;
- specific reference is made to the fact that the delegates should provide reports to the Board on at least a quarterly basis.

#### ix. Risk Management, Audit, Control & Compliance

- The Code also outlines in detail the specific responsibilities of the Board in the areas of:
  - o External Audit
  - o Compliance
  - o Identification, Monitoring and Management of Risks
  - o Internal Control

## 2. Central Bank Guidance on the appointment of Prime Brokers

The Central Bank has issued a new Guidance Note 2/11 in relation to the appointment of a prime broker to Irish regulated funds and related matters.

The guidance note entitled “Professional collective investment schemes: Appointment of prime brokers and related issues” details the circumstances under which a professional collective investment scheme (“CIS”) may enter into arrangements with a prime broker or counterparty. It gives examples of the types of arrangements that may be entered into such as clearing and custody facilities.

A professional investor fund (“PIF”) and qualifying investor fund (“QIF”) may deliver assets of the CIS (by way of title transfer or security interest) to a prime broker under certain circumstances.

In the case of a PIF, cash delivered to the prime broker which is not protected by client money rules or other similar arrangements may not exceed 140% of the level of the PIF’s indebtedness to the prime broker.

In the case of a QIF there is no limitation on the extent of the assets available to the prime broker but these must be disclosed in the QIF’s prospectus.

Collateral arrangements with OTC counterparties may be entered into but the counterparty must have a minimum credit rating of A-2 or equivalent.

The fund must also ensure that the trustee monitors compliance with GN 2/11 on an ongoing basis.

Arrangements with prime brokers or other counterparties must be disclosed in the prospectus and the agreement with the prime broker must be submitted to the Central Bank.

## Amendments to existing Position

It can be noted that Guidance Note 2/11 replaces and implements the draft Guidance Note regarding the appointment of prime brokers to Irish authorised funds initially released by the Central Bank in 2004 and which was reflective of the approval of the Central Bank since then until now.

While the guidance note as implemented largely reflects the earlier draft, a number of amendments have been included.

For example under Section 3 of the 2004 draft, one of the conditions whereby a PIF or QIF may enter into arrangements with other counterparties is if the counterparty has a minimum credit rating of A2/P2. The finalised Guidance Note provides that counterparties will also qualify if they are “*deemed by the CIS to have an implied rating of A-2 or equivalent.*”

Section 4 of the finalised Guidance Note notes that compliance should be monitored by the trustee on an on-going basis.

Where a prime broker is appointed by a PIF or QIF or in the case of a QIF with an OTC counterparty risk exposure in excess of 40% of net assets, a number of new obligations are placed on the trustee. These include receiving daily reports from the prime broker or counterparty on assets held by the prime broker outside the custody network and valuations for those positions. Further, these must be reconciled with its own records.

The trustee is also required to confirm that on each valuation point it will reconcile assets on a valuation basis. Where the period between valuation points exceeds two weeks, the valuations received from the prime broker or counterparty must be independently verified.

The trustee is further required to request confirmation from the prime broker or counterparty that it does not hold assets other than in accordance with the requirements of the Guidance Note and the provisions of the sub-custody agreement.

The Central Bank issued a Guide to these changes in July entitled “Amendments to the UCITS Notices, Non-UCITS Notices and related Guidance Note to reflect UCITS IV and other Changes.”

## 3. New Central Bank Guidance on marketing International UCITS

The Central Bank has issued a new Guide to “UCITS authorised in another Member State intending to Market UCITS in Ireland.”

Directive 2009/65/EC (the “UCITS Directive”) was transposed into Irish law by the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (the “Regulations”) on 1 July 2011.

Article 91 of the Directive puts the responsibility on UCITS host Member States to ensure that UCITS are able to market their units within their territories upon notification in accordance with the requirements of Article 93.

Additional requirements must not be imposed and the Member States must ensure complete information on laws, regulations and administrative provisions which do not fall within the field governed by the Directive and which are specifically relevant to the arrangements made for the marketing of units of UCITS, established in another Member State within their territories, is easily accessible by electronic means. Information must be clear and unambiguous and kept up to date.

UCITS Notice 15 as published by the Central Bank states that such UCITS must comply with the advertising standards as set out in paragraph 10 of UCITS Notice 6 which provides that advertisements should:

- be easily understood;
- be presented so it is obvious it is an advertisement;
- be aimed at ensuring potential investors fully grasp the nature of any commitment which may be entered into; and
- not be misleading.

The Central Bank must be informed in writing when the UCITS or its sub-funds ceases its marketing activities in Ireland.

The Central Bank issued a Guide to these changes in July entitled "Amendments to the UCITS Notices, Non-UCITS Notices and related Guidance Note to reflect UCITS IV and other Changes."

#### 4. Central Bank Updates Procedures for Changes of Service Providers

In June 2011, The Central Bank updated its Application Forms for Change of Service Providers Part I ("COSP 1") and Part 2 ("COSP 2") to facilitate the process of approving such changes.

The changes to COSP I include:

- The addition of Requirement 6 and 7 which provide that;
  - i. if the revised prospectus/supplement does not refer to the change of service provider and the effective time and date of this change, then the prospectus/supplement must be dated the first business day after the effective date.
  - ii. the agreements must be dated and noted by the Central Bank prior to the effective time.

Section 2 on audited accounts has been removed.

The Central Bank has updated its procedures in relation to the replacement of Custodian for an investment company and replacement of Trustee or Manager for a unit trust in Section 7. The procedures to be followed in the replacement must now be approved by the investment company or management company.

The changes to COSP 2 include;

- a change to Requirement 1 that the Form should be received by the Central Bank before 12 noon on the business day before the effective date of the proposed change of service provider together with the relevant document. This was previously before 12 noon on the date of the proposed change.

#### 5. Alternative Investment Fund Managers Directive Update

On 13 July 2011 the European Securities and Markets Authority ("ESMA") published a consultation paper setting out its proposals for the detailed rules underlying the Alternative Investment Fund Managers Directive.

The ESMA consultation sets out ESMA's proposals for advice to the European Commission for Level 2 regulations under AIFMD and also contains its commentary on the proposals. The Consultation also contains an Annex which lists 72 questions posed by ESMA to market participants and other "external stakeholders." It follows on from the Discussion Paper that ESMA issued on April 15.

Interested parties have until 13 September 2011 to give their feedback to ESMA. ESMA will then finalize its advice to the European Commission in time for submission by November 16 2011. The Commission will convert ESMA's technical advice into binding legislation which it is expected to adopt by mid-2012.

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