Investing in Good Corporate Governance: MFSA publishes Manual for Investment Funds

Background and Scope

There is no denying that many participants in the funds industry believe that directors of investment funds generally failed to react properly in the midst of a global financial crisis. As a result, a number of jurisdictions have overhauled their corporate governance framework.

The Malta Financial Services Authority (the "MFSA") published a Corporate Governance Manual for Directors of Investment Companies and Collective Investment Schemes on 15th February, 2013. The manual has been developed against the backdrop of the MFSA's increased emphasis on corporate governance which in the funds industry varies widely according to the laws and regulations applicable to the fund, its investment manager and even investors.

Fund Directors

The traditional management role in the fund context is played partly by the investment manager or sponsor and partly by the other service providers meaning that the fund does not have management staff or employees and the monitoring role rests with the fund board.

The manual recommends that a fund board should have no less than 3 directors and that a fund with more than 7 directors would likely lose efficiency. A board with an uneven number of directors ensures action being taken since a majority vote is possible. The quorum for any board meeting should be a majority of directors.

Boards tend to function most effectively when their individual members bring a diverse set of skills to the boardroom, thereby creating a board with a mosaic of skills and perspectives. Their individual skill sets need to reflect functions carried out by the fund's service providers: portfolio management, risk management, operations, legal and regulatory, accounting and audit, compliance. Such extensive skill set coverage may produce helpful information for investors who seek to know more about their fund.

The presence of independent representatives on a fund board, capable of challenging the decisions of the management, is widely considered a means of protecting the interests of investors. Executive directors appointed by the manager or the sponsor of the fund are not independent directors. Executives of a service provider to the fund may sit on a fund board – however such directors are not considered to be independent.

The fund Chairman is responsible for running board meetings and for communication between the investment manager and the board, or investors and the board. The manual suggests that board meetings be held on a quarterly basis to review the performance and operations of the fund. Physical meetings should factor in the cost and whether that cost is appropriate with the financial resources of the fund. If only one meeting is held in person annually, it should be the meeting that reviews and approves the audited financial statements.

What is an Information Pack?

The Chairman should ensure that the information pack for a board meeting includes all information necessary for the board to consider the meeting's agenda and which should be sent at least 2 business days prior to the date of the board meeting. The investment management report is probably the most important report in the board pack and reporting will vary according to the type of investments. Such report must provide information that will enable a board to understand and oversee the portfolio from a performance, risk, liquidity and compliance perspective. An administrator's report could include: a valuation and financial report, a shareholder activity report, a compliance comfort letter, any relevant internal audit and/or SSAE 16 report (as may be required), any comments on service level during the period and any significant matters that have arisen. The auditor should present the fund's audit plan and timetable to the board for its review and approval once it is agreed with the investment manager or sponsor of the fund.

"... Ultimately corporate governance is about engendering trust: "If management is about running the business, governance is about seeing that it is run properly ... "

Shareholder Communications

The board should ensure that shareholders receive legally required communications and appropriate disclosures.

Anti-Money Laundering and Combating Financing of Terrorism

Investment funds that do not have a physical operational set-up in Malta and are not involved in the acceptance and processing of subscriptions and the collection of funds from investors may delegate the implementation of their AML/CFT obligations, including customer due diligence, record-keeping, risk-assessment procedures and reporting obligations to the administrator.

Indemnity and Insurance

The manual asserts that fund directors should be indemnified by the fund to the full extent permitted by law. This is subject to carve-outs relating to negligence, fraud and willful misconduct. Appropriate insurance cover should also be in place for fund directors in the form of a directors and officers (D&O) insurance policy.

Crisis Management

A fund board should anticipate potential crises that could affect the fund, for example pricing errors or irregularities. The Fund board should ask the fund's service providers to provide periodic updates on their respective business continuity and disaster recovery plans ("BCP").

Resignation by a Director

The manual identifies circumstances such as material and unsolvable conflicts of interest affecting the director which may lead to resignation from a fund board. In line with standard MFSA requirements, a resignation by a fund Director must be notified to the MFSA within 14 days. The appointment of a new director should be reflected in writing between the fund and the Director.

Conclusion

The MFSA evaluates, the directors in terms of their fitness, integrity and probity as part of the approval process. Fund directors need to be allocated sufficient time to review and analyse matters being presented to them. They also need to ensure that they have sufficient resources to enable them to discharge their duties to the fund.

The manual does not establish a "quantum" of directorships, but indicates that there is a limit above which a director would be acting irresponsibly by taking on additional directorships. Each fund Director must be able to defend, usually in hindsight, the number of directorships held at any given time. Any sound corporate governance program needs to take into account the concept of proportionality which recognizes that funds and management companies with greater resources will be able to do more with respect to corporate governance.

Finally the manual emphasizes the importance of training of fund board directors. Moreover fund directors should avail themselves of the growing number of director and specialist training courses given by fund industry associations, national and international directors associations, universities and service providers such as law firms and audit firms.

In summary the objective of the new manual is to make sure that the fund board is adopting corporate governance measures to ensure better governance and increase transparency.

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Printed in Malta.

April 2013