CLERKIN LYNCH LLP

CP86 and appointment of Fund Management Companies

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Appointing a Fund Management Company

Although legal entities acting as funds can be self-managed or appoint a separate entity to manage them, the primary fund model for Irish domiciled fund vehicles to date, particularly those authorised as UCITS, has been the self-managed approach. However, for a variety of reasons discussed below this is now shifting towards the appointment of an external management company. This article explores some of the drivers to this, factors to consider in making the change as well as other potential options and then outlines the actual process for a change in the model in the context of Irish UCITS funds. Part II of the article will explore key factors to be taken into consideration in the actual selection of a specific third party management company if this is the option chosen**.**

Regulatory Impetus

The Central Bank of Ireland (the "Central Bank") has undertaken a lengthy and detailed review of the management of Irish domiciled funds over a period of years under the heading "CP86". Various pieces of guidance have issued pursuant to this, most recently a Dear Chair letter in October 2020 (the "Latest Guidance"). This was further to the Central Bank's thematic review assessing how fund management companies have implemented earlier relevant guidance issued. In summary, it noted that many existing entities had yet to update the level of their governance structures to meet the levels expected by the Central Bank as set out in the revised guidance. Particular areas of concern related to the level of resourcing available within fund management entities, with the Central Bank noting that it expected a minimum of three full time employees in any such entities. Furthermore such staff are required to have a level and quality appropriate to the nature, scale and complexity of the fund entity to be managed. These updated requirements mean that the self-managed model, which typically relied upon "designated persons" being appointed on an outsourced basis from third party consulting firms, will no longer be feasible in many cases. The Latest Guidance clarifies that boards should formally consider the issues set out in the guidance by the end of the first quarter of 2021 and approve an action plan with a view to addressing any shortcomings in existing governance resources and structures. It is likely that in many cases that this will lead to a determination to change from a self-managed to a separate management company model. However, while the above regulatory changes may be factors of immediate relevance, they are far from the only drivers in the change from the self-managed to the management company structure. Other factors include the increasing complexity of the management role, access to technology and expertise and of course commercial considerations. These points are discussed further below.

Other Drivers

While the Latest Guidance will constitute the trigger that will occasion many boards to move from the self-managed model, it is only one factor and in many ways is just a symptom of some of these underlying drivers. Primary among these is the gradual but unrelenting increase in regulatory obligations to which entities are now subject to due to new legislation. Examples even cited by the Central Bank in this regard include the European Market Infrastructure Regulation (EMIR) and the Securities Financing Transactions Regulation (SFTR). However, even apart from such specific pieces of new legislation, evolving and more onerous regulatory guidance which regulators have issued in response to market developments, for example with regard to ongoing liquidity stress testing etc. has been steadily further increasing the level of management oversight and reporting required by funds. The increased complexity of the regulatory environment funds are operating in

has driven an exponential increase in the resources required to address the issues identified. In addition to regulatory and legal considerations, there are also more commercially and strategic focussed factors acting as drivers for the move to the management company model. These include the ability to access a "bundle" of ancillary services from a single provider under the management company umbrella, such as AML, tax reporting, company secretarial etc., the ability to take advantage of access to additional services, which might include bespoke reporting software or distribution capabilities, profiting from the economies of scale inherent in being one of multiple clients of a large management company and other cost considerations. There are also practical considerations to be recognised – in an era of increased demand for specialised staff will it even be possible to access the requisite individuals with the necessary skills to facilitate the pursuit of the desired model (let alone at an acceptable cost level) - or will reliance on an established management company be the only practical solution ? Although both UCITS and AIFs can be self-managed or have a separate management company, this article focus's on UCITS since in practice self-managed AIFs have been relatively less common and accordingly UCITS are the type of structure most likely to be directly impacted at present.

Third Party Management Company or Own Entity ?

If it is determined to use the services of a separate management company the first question to be posed is whether the promoter should establish their own entity or recommend that the fund's board have the role outsourced to a third party provider. For larger investment managers the option to establish their own stand-alone management company may be attractive, particularly as it could potentially service multiple separate fund groups and play a number of roles, thereby minimising the leakage of fee income from the fund products outside the investment manager's group companies and indeed potentially providing an additional revenue stream. Management companies can be authorised as "supermancos" that have the regulatory authority to service both UCITS and AIFs ("Alternative Investment Funds"), as AIFMs ("Alternative Investment Fund Managers") and can also avail of the passport to provide their services into other EU member states. Accordingly a single licenced entity could service a range of EU funds operated by the investment manager or its group companies, regardless of member state domicile or regulatory authorisation. Certain fund structures, including unit trusts and common contractual funds, require a management company to exist so establishing such an entity opens up the opportunity to create alternative forms of fund legal structure with potentially preferable characteristics from, for example, a tax transparency and liability perspective compared to a selfmanaged corporate fund option. The benefits for a promoter in establishing its own management company entity include maintaining control, increased revenue, avoiding an additional source of external costs and the prestige of having their own licenced entity. On the other hand, some of the attractions of the external third party management company model include obtaining access to expertise, specific technology solutions and possible cost efficiencies through economies of scale. In recent years the larger management companies operating in the Irish market have expanded their headcount dramatically and also increased investment in technological solutions- allowing them to provide bespoke tech driven services including reporting and compliance monitoring specifically devised to satisfy not only their client and market needs but also preferences across a range of asset classes. As the management companies acting as third party service providers increase in prominence and recognition, so too does the strength of their brands and accordingly use of a "name" third party management company may be viewed as an easy way to ensure quality and that institutional investor's due diligence checks will be satisfied. As noted further below, there are extensive disclosure requirements pertaining to management companies of funds, which include an obligation to include biographical details of their directors in the prospectus of the

funds which they are responsible for managing, which should add further weight to the fund offering by showing the involvement of highly experienced professionals in such roles. In summary, therefore, in light of the pros and cons larger fund promoter groups are likely to have a preference to establish their own entities while using a third party management company option represents an attractive solution both generally but in particular to both smaller groups and also those with relatively low assets in EU vehicles or who are relatively unfamiliar with the regulatory environment.

Fund platform versus separate management company ?

If a decision is made that it is not commercially viable or otherwise deemed inappropriate to set up a new management company, but instead to use a third party solution, it is worth considering whether it is in fact even worthwhile to maintain the fund as a separate legal structure or if it would be more advantageous to reconfigure it as a sub-fund on a third party hosting platform ?. A restructuring of this nature could be achieved from a practical perspective through the use of the UCITS IV merger process. Such options can afford various advantages, including but not limited to, cost benefits. Please see my separate article entitled "Key Considerations when considering hosting a fund on a UCITS or AIF Fund Platform" for further insights into relevant considerations in such scenarios. (Available upon request). In summary, however, while a fund hosting solution can be an attractive route, particularly at the early stages of a fund's life when seeking to build assets or while the investment manager is becoming familiar with the relevant EU regulatory regime it is established under, such as UCITS, using a separate management company, even if it is a third party one, does pose specific benefits when compared to a hosting solution on an existing third party platform. These include the fact that in this structure ultimate control remains with the fund's board (which in the Irish context can have a majority of representatives of the Investment Manager) and it can determine to replace a management company - whereas in the platform hosting model the investment manager constitutes just a service provider to the fund platform, which will normally essentially control and have effective ownership of the fund and could even terminate the investment manager to a fund. Furthermore, at larger asset sizes and in scenarios where there are multiple fund products the management company route is likely to be more cost effective and having a standalone branded fund vehicle would generally be viewed as more prestigious. This may serve to act as a sign of greater confidence in the future of the fund product by the promoter compared to if it used a hosted fund option. However, that said, it certainly makes sense for boards to evaluate the potential to use a hosting solution when considering a restructuring of this nature so that they can demonstrate all options have been explored in order to act in the best interests of investors and fully satisfy their fiduciary obligations to investors.

The Appointment Process

While the appointment of a separate management company is relatively straightforward when undertaken as part of a fund's authorisation process, simply requiring board approval as part of the launch board meeting, the process can be more elaborate for existing funds. In cases where an existing management company is in place and this is to be changed, the Central Bank's "COSP" process must be adhered to, This is a two stage process involving the filing of relevant forms and documentation with the Central Bank, with the second stage occurring with a filing of final documentation the day before the actual appointment becoming effective. The benefits of a clear and straightforward streamlined process for such a transaction are clear. On the other hand there is not a specific process, as such, for the change from a self-managed to separately managed model for funds. While the new documentation will of course need to be approved by the Central Bank following a formal submission, the extent of the necessary process

to be undertaken is in part driven by the fund's existing documentation and in some cases specific investor consent will be necessary.

Change of constitutional documentation

The constitutional documentation of the fund will need to be reviewed to see if any changes are warranted by the proposed change in structure. In most cases the standard articles will contemplate or at least be accommodating to the potential appointment of a management entity even if the selfmanaged model has been used to date. However, the terms of any replacement or removal of a manager must reflect those of the constitutional document. Furthermore, where a maximum management fee is provided for such maximum may not be increased without the approval on the basis of a majority of shareholder votes cast at a general meeting. The annual fee for such purposes includes any performance related fee charged by the management company or by the investment manager. However, the maximum fee provided for in the prospectus may be increased without investor approval if the prospectus discloses the potential for a higher fee. However, in such cases reasonable prior notice must be given to facilitate any redemption requests from investors. Where a management company is appointed, various disclosures relating to this are required to be included in the prospectus, including not only its name, office address, legal form and authorisation but also details of the group it is a member of and a bio of each of its directors. This level of information is not required for any other service providers. Naturally an update to the prospectus detailing this additional information and all other changes contemplated as part of the restructuring project will need to be submitted to the Central Bank for consideration and prior approval through the standard Central Bank approval process**.**

Implications on existing contracts

Contracts relating to existing appointments made directly by the fund, including of the administrator and investment manager, will need to be amended or replaced to reflect appointment by the management company. The new arrangements may be tripartite agreements with both the fund and the management company acting as parties but this is not a legal or regulatory requirement. Where a management company has been appointed it must also make any distributor or local agent appointments so existing such contracts directly with the fund alone should also be amended. While other service providers are likely to use the change to ensure their up to date terms are reflected, particularly in legacy cases where agreements have been in place for many years, care should be taken to avoid them seeking to take advantage of the restructuring to revise contractual provisions to the detriment of the fund. This can be done by inquiring at an early stage of the proposed restructuring regarding any changes to be required so if it appears likely that significant changes will be requested options with other service providers can be explored.

Investor Notification

While a change in the constitutional documentation or an increase in the management fee will necessitate communication with investors, it is highly likely that boards will wish to correspond with investors in all cases where a change of structure from the self-managed model to a separately managed entity is contemplated. Such correspondence will emphasise the benefits of the new arrangements and the potential added value to be provided by the management company in order to seek to ensure shareholder approval and continuing support for the fund project. This will be addressed in greater detail in Part II of this article.

Fund Board Changes

The addition of a management company may also involve a reconsideration of the composition of the fund's board. Some third-party management companies will actively propose one of their representatives be appointed to the fund board but even where

this is not the case, the nature and focus of the fund oversight role of the board is likely to shift n emphasis following the appointment of a management company and accordingly this may prompt a consideration of the mix of skills and experience which is appropriate in the structure of the new environment. In considering the addition of a representative from the management company to the fund board it is worth considering the impact this may have on its independence and whether this might warrant the creation of subcommittees, as well as cost implications (including possible savings) but also the potential value add that the new director may potentially bring.

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Summary

There are a number of factors driving the shift from what to date was the standard “self managed” model for Irish UCITS funds, in particular, to structures involving a standalone management company. Recent correspondence from the Central Bank means that the boards of many existing funds are currently actively considering this issue. There are various options available but appointing a third-party management company does pose many advantages and is likely to be the preferred option for smaller funds and asset management groups in particular. The second article in this two part series will explore the key factors to take into account when selecting a third party management company and negotiating the management agreement.

About the Author

Mark is from Clontarf in Dublin and was educated at Belvedere College S.J., University College Dublin and the Law Society of Ireland.

He trained and qualified as a solicitor in a leading Dublin law firm, where he specialised in the investment funds area and has over fifteen years related experience.

Prior to joining Clerkin Lynch as Head of Asset Management and Funds, Mark was a financial services partner in an international law firm.

His expertise primarily involves advising on the structuring, establishment and operation of investment funds in Ireland, including UCITS and Alternative Investment Funds for international distribution. He also advises on issues affecting clients throughout the financial sector, including with regard to AML, MiFID, crypto-currencies, emoney and payment systems, data protection (including GDPR), distance selling and internet-based products and investments. His international funds experience covers a number of key global fund centres and he has previously worked in the funds practice of a leading Cayman Islands firm as well as for a global custodian based in Luxembourg. Mark was elected to the Global Board of the Alternative Investment Management Association (AIMA) in 2020.

A frequently published author and speaker with regard to issues relating to the financial services industry he is recommended as a leading investment funds lawyer by The Legal 500 and Chambers & Partners (Europe and Global). Previous editions of Chambers Global noted that "he garners significant praise for launching UCITS funds and ICAVs, as well as handling the relevant regulatory issues with clients describing him as "terrific: he is responsive, almost always available and knowledgeable." And reported that clients stated "the amount of attention he gave us was outstanding," praising his "knowledge of how to get the deal done, and his great end product." He is recognised as a "notable practitioner" by IFLR1000, the guide to the world's leading financial law firms. He was previously named as 'Investment Fund Formation Lawyer of the Year in Ireland' in the CIM Global Awards and Investment Management lawyer of the year in Ireland by the Lawyer International 's Legal 100 awards.

In addition to his Irish legal qualifications, Mark has also been admitted to the roll of solicitors in England and Wales and qualified as an attorney at law in the Cayman Islands. He currently only practices Irish law.

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