Key Considerations in Assessing a Third-Party Entity to be appointed as a Fund's Management Company

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Due to a variety of factors and in particular regulatory concerns at resource levels in self-managed funds, many Irish UCITS boards in particular, are currently actively considering a restructuring of their operations to appoint a separate management company. Part I of this article explored the drivers for such a restructuring, some of the different options and the restructuring process itself. Now in Part II, this article explores the range of key considerations to be assessed and factored in when selecting a third-party management company and highlights some significant considerations in negotiating the terms of the actual management agreement. (Terms not defined herein are as defined in Part I).

It must initially be acknowledged that for boards considering a proposal to approve a change from a self-managed structure to the appointment of a third-party management company cost will typically be one of the primary points of focus and scrutiny. While this will of course be a relevant issue in any commercial appointment, given that the self-managed model has typically been characterised by set, relatively low, annual fees, whereas management companies typically charge fees on a basis point basis with annual minimums, the differential could potentially be immense. Furthermore, as specific shareholder approval may be required (discussed further below) boards will need to be well satisfied as to their decision and that the range of benefits to the new structure can be demonstrated to investors. In addition, due to the fact that boards are also now specifically required by the Central Bank to confirm their confidence in the continuing viability of fund structures, any increase in fees will be an additional factor to consider in this regard. With fee schedules typically based on a sliding scale depending on AUM, but subject to minimum charges, it is advisable to base assessments on a series of different scenarios. Furthermore, in assessing costs it is appropriate to look beyond the standard fee schedule and be alert to hidden or potential additional costs, such as charges on a "time spent" basis for certain work or ancillary services if an issue actually arises, as well as any bundled services (discussed further below) provided in conjunction with the management services. Other items to be alert to include specific onboarding costs and a contingent departure charge. Accordingly, when modelling costs, it is important to ensure that these comprehensive totals are used based on all services anticipated to be used.

However, where additional benefits can demonstrably be shown this may make the transition from a self-managed structure to what will typically be a higher cost third party management company more palatable and indeed ideally will increase the attractiveness of the fund from an investment perspective. Management companies will usually be at pains to illustrate the differentiating factors their service can offer and the added value which they will bring.

Human Resources

Given that one of the primary drivers in the transition from self-managed funds to separate management companies is the requirement for substance, unsurprisingly an assessment of the scope of the staffing of any potential third-party management company will be an important consideration. Due diligence on a management company will inevitably show the levels of staff employed and indeed there are specific disclosure requirements for the fund prospectus pertaining to a management company which go beyond the requirements applicable to other service providers (such as the inclusion of director bios etc) which will further assist in

this regard. The fact that the entity will have been authorised by a relevant regulatory authority of a Member State such as the Central Bank of Ireland (the “Central Bank”) will give further comfort and ensure a certain level of substance and capacity. However, given the level of the forecasted significant shift from the number of self-managed entities to management companies over a relatively short period occasioned by the Central Bank’s Latest Guidance, it is important to ensure that relevant individual staff will have time to dedicate to a new fund appointment and are not going to be overburdened. Excess capacity is important, particularly in the event of a significant issue arising such as a liquidity crisis or other general market issue that may arise and impact multiple clients simultaneously. Accordingly obtaining confirmation regarding maximum client levels of a third-party management company and capacity over and above any minimum specifically required would be a useful comfort factor.

A follow-on point from this and the earlier cited cost considerations is to ensure that service pricing is set at a sustainable level that will endure for a reasonable period. The concern would be that having set pricing at a given level to assist in building market share, pricing could subsequently be ratcheted up either due to client levels not generating revenue expectations or due to a desire to maximise revenue when capacity is reached but higher paying clients are available for selection. This point is further considered under the section entitled Termination Provisions below.

Experience

Staff numbers and capacity are relevant considerations, but the Central Bank emphasised in the Latest Guidance that the requirement is for management companies to have staff of a level and quality appropriate to the nature, scale and complexity of the fund entity to be managed. Accordingly, it is appropriate to confirm that the specific staff available in the management company to be dedicated to the project at hand will meet this requirement. Rather than just general fund experience, ideally, they will have experience that is fund type and asset class specific where appropriate so that they are atuned to look out for and promptly identify the specific issues which may be more prone to arise in such individual contexts. This is particularly the case where funds may be operating strategies that are subject to additional regulatory requirements or entail higher levels of complexity, such as UCITS pursuing hedgefund type strategies with sophisticated use of financial derivative instruments. Ideally the management company will also have experience of working with the other key service providers to the fund, such as the depositary, administrator, and other key parties such as a prime broker, if appointed. Familiarity with the systems and staff of other components of the overall fund structure should greatly assist the changeover to the new governance structure and ensure smoother continuing oversight. Use of IT systems is addressed in greater detail below, but it is worth noting in this section that it is appropriate to clarify whether the systems of the management company will be compatible with the systems of other service providers to a fund and the extent to which and whether they are designed to operate independently and provide independent analysis, or indeed verification.

Capital

While a certain minimum level of capital is required to satisfy regulatory requirements and notwithstanding the higher requirements required above certain threshold asset levels, in assessing a management company it is important for a board to be satisfied that it has what they consider an adequate level of capital. Considerations in this regard may include that it is sufficient to satisfy any indemnity obligations (particularly in the case of smaller funds or those where such a provision is more likely to be invoked), to allow for further growth in the scale of the business (whether occasioned by business growth and related requirements or by additional regulatory obligations) and to invest

in the provision of relevant IT systems and other infrastructure. Clearly such requirements may lead a board to determine that a capital buffer significantly above any minimum figure set by regulatory obligation is more appropriate. Access to additional sources of funds if required, for example due to membership of a large group, stock market listing or debt raising facilities may also provide comfort in this regard. It can be noted that certain of the most prominent management companies operating in the Irish market have announced significant capital investments from private equity investors in recent months.

Systems

IT systems can of course dramatically assist in compliance monitoring, reporting and other management tasks and reduce the need to rely on purely human resources. A number of Irish management companies have been investing heavily to create bespoke systems to assist in carrying out their functions and offer increased optionality. It is appropriate to explore the range and types of report a management company can prepare as well as the oversight they provide and in particular whether they have bespoke solutions adapted to the requirements of specific asset classes or types of funds – such as money market funds or, again, funds using complex financial derivative instruments that reflect hedge-type strategies. These can be key differentiating factors when selecting a service provider, both in terms of indicating the potential to add value but also providing a minimum level of expected infrastructure that may rule out service providers lacking such capabilities, particularly in the context of certain asset classes and levels of AUM. Analysis of related systems will not be confined to the range of services but also of course encompass quality assurances such as ISO certification and confirmation of compliance with regulatory requirements, especially where they are based on outsourcing solutions. It is also appropriate to clarify if any elements of the potential service available (such as specific reports or compliance monitoring) constitute a variable or added cost.

Client List

The current client list of the management company will assist in demonstrating its expertise and may also bestow an element of comfort as well as illustrating likely service levels based on the track record of the entity with its existing clients. However, some related considerations when reviewing such a list would include reflection on potential conflicts of interest and whether it is desirable to use the same management company as direct competitors. Concerns in this regard may include a lack of differentiation when marketing (as well as potentially unflattering comparisons) and confidentiality issues. The later emphasises the importance of confidentiality and privacy related provisions in the contractual arrangements. Fortunately, the requirements relating to clarity of purpose and use of personal data under relevant European data protection legislation, the General Data Protection Regulation, means that it is relatively straightforward to include restrictions on use of personal data and breach of these regulations would subject the management company to stiff regulatory penalties as well as potential civil action. However, anonymised data would not normally be subject to restrictions under GDPR but could still have significant commercial value, so it is unlikely to be sufficient to rely purely on regulatory provisions to protect a fund's best interests in this regard.

In addition, where a fund has a non-financial objective or policy (such as an ESG focus or otherwise), it will be appropriate to consider whether any of the other clients of the management company are incompatible with this since such a scenario could lead to embarrassment or be viewed as problematic by potential fund investors, in particular. For funds pursing an ethical or other belief-based objective, it may be appropriate to consider seeking to include restrictions on a management company acting for funds that pursue goals which could be considered incompatible with such ethical or belief-based objectives (although in practice advance notice of other clients may be all that can be guaranteed).

Bundled services

One touted attraction of some management companies is their ability to offer a packaged range of ancillary services with the convenience of a principal primary contact. Such services may include AML, company secretarial, Irish resident director, local tax reporting, registered office or data protection officer, by way of examples. If these ancillary services are offered a prospective client should consider if use of such services is on a purely discretionary basis or whether it is a requirement to use them as part of the management company offering. In the latter case it would of course be essential to ascertain if the provision of such services also represents a good offering from price and quality perspectives and include this in the overall assessment.

Added value

Moving away from the concept of appointing a management company purely to fulfil regulatory obligations, the appointment of a separate management company can potentially boost a fund through additional services that will be viewed as value adding. While the additional services cited in the paragraph above are only likely to be of benefit from the perspectives of convenience and cost efficiencies (with the exception of the potential addition of an experienced director from the management company to the board of the fund), bespoke reporting and related software are examples of such potential distinguishing service characteristics (discussed above) but other examples might include a fund distribution capability or capital introductory service. In the context of third country managers, including those in the UK in this post-Brexit era, assistance with distribution related activities "chaperoning" services may be particularly useful. ESMA has already issued a warning regarding the provision of MiFID regulated services into the EU post Brexit (addressed in one of my recent posts on Linkedin), and the provision of international financial services is likely to be a focus of increased regulatory scrutiny and, ultimately, potential enforcement actions in the years ahead.

Regulatory Authorisation

Following-on from the above, while a third-party management company will necessarily be authorised as such by the relevant regulatory authority, it may be useful for it to have additional authorisations to enable the provision of services to sister products of the fund or to provide further regulated services. For example, if the entity is also licensed as an AIFM (a so called "supermanco") it may also be able to act for any AIF products in the promoter's group, which may facilitate negotiating costs savings across the suite of products. Furthermore, if it also has MiFID add-on authorisations these could potentially be used as the basis for providing further services. Accordingly, when conducting modelling for comparative and assessment purposes it is worth giving sufficient consideration to all such variables.

Jurisdiction

The search for a suitable management company need not be confined to the domicile of the relevant fund. Both UCITS management companies and AIFMs can passport their services across the EU and there are multiple practical examples of firms successfully taking advantage of this opportunity. The process is relatively quick and inexpensive so if there is a management company with a distinctive offering or which a promoter is particularly keen to use perhaps due to existing familiarity and the potential for economies of scale, then it may even be possible to persuade the management company to undertake this exercise even if they do not currently passport their services into the relevant domicile of the fund. This may also facilitate the provision of services by the management company to multiple funds from a given investment management group, potentially enabling obtaining costs savings that can be passed on to investors.

At the same time some investors may have concerns over the use of a management company based in a separate domicile. Grounds for this may include concerns regarding their specific expertise and the differing substance requirements between regulators. Accordingly, in pursing such a strategy the board should be satisfied that this is not sufficient of an issue to warrant concern and that the benefits of using the relevant management company outweigh any such possible negative impacts.

Liability

The liability standard in the management agreement is relevant both in its own right but also as the management company is unlikely to accept a lower standard to this in any agreements with the other service providers it contracts with on behalf of a fund since that could potentially lead to it facing liability for the actions or inaction of another party. Where there is any inconsistency in a proposed standard, it is necessary to consider the potential implications and whether it might lead to the termination of their role by any other service providers. One potential way in which this could arise inadvertently is through a choice of law clause.

Choice of Law

Although specifying Irish law might seem standard for a management company agreement pertaining to an Irish domiciled fund, there is in fact no legal or regulatory requirement to do this and accordingly for management companies passporting in from other jurisdictions, in particular, it may be tempting to seek to include reference to the law of their home Member State due to their familiarity with this. However, it is a requirement that both the administration and depositary agreements to Irish domiciled funds be subject to Irish law so care should be taken that a variance in applicable law will not generate issues such as a mismatch in liability terms due to different interpretations. In addition, apart from general differences between common law versus European codified systems, the law and related rules of procedure of some European member states, such as for example the Netherlands, may have features which are quite alien to those used to the adversarial common law system so care should be taken to fully understand the implications if agreeing to a foreign or unfamiliar choice of law clause. Similarly, while Ireland is Ireland may be considered a natural location of dispute resolution in a post-Brexit scenario, there is no requirement to specify Ireland as the jurisdiction for conduct of any disputes arising from the management company agreement. However, apart from cost and convenience considerations, given that in the unfortunate circumstances of a dispute arising it is likely to involve various service providers to the fund rather than just the management company, so having a distinct jurisdiction clause for the management agreement is likely to significantly add to the complexity of any related litigation.

Termination Provisions

One of the key attractions to the third-party management company model when compared to the hosted fund solution is the element of control this retains over the fund. This includes ultimately the ability to terminate the arrangement and move to a different management company if necessary. It is important to ensure that the commercial terms of the contract do not overly limit this flexibility- for example by requiring a significant minimum contractual period, limiting the circumstances under which a termination can be served or imposing contingent charges on a termination that will make a change of management company uneconomic from a practical perspective. At the same time termination provisions are very much a two-edged sword. Changing management company, or any major service provider, entails significant costs and will inevitably generate considerable disruption to operations, as well as potentially causing investor disquiet and acting as a “red flag” for future investors, so naturally the frequency of any such changes should be minimised. In

addition to these commercial points there are relevant regulatory considerations applicable – for example it is not permitted for the contract to an Irish UCITS to provide for a notice period in excess of 6 months, an initial term in excess of three years or successive periods (without termination on notice) following an initial term in excess of one year. Noting again the concerns around mispricing mentioned above- which are possibly particularly pronounced at present given the level of change, the new entrants to the market and the growth of the sector generally (including in terms of infrastructure and personnel), and bearing in mind the potential for a management company to seek to revise this pricing to the detriment of the fund in the relatively near term following appointment- preferable terms from a fund's perspective would probably entail an initial three year term without upward review of fee levels but which may be terminated at the discretion of the fund for breach including if service levels prove inadequate.

Summary

In summary, key considerations in selecting a third-party management company include, its resources, expertise, client list, capacity, regulatory authorisation, list of ancillary services as well as the overall costs and the general terms of the appointment. Ideally, the appointment of a management company will add real value to a fund rather than merely fulfilling the regulatory requirements so due diligence on potential offerings and the differentiating factors between potential service providers can constitute an important investment of time as part of the selection process.

Please feel free to contact me to discuss related issues!

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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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