SMICs Appointing an Affiliated Management Company – Key considerations for Boards

Mark Browne

Partner and Head of Asset Management and Funds at Clerkin Lynch LLP

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Many funds structured as self-managed investment companies ("SMICs") in Ireland are currently contemplating a change in structure to appoint a separate management company. Such an entity could be an entirely third party management company providing related services on a commercial basis. Alternatively the entity proposed could be a group company of the investment manager to the scheme (the "Investment Manager"), which may even be specifically established to meet these requirements for the relevant fund and other group products.

This article explores key points for consideration by boards of a SMIC where it is proposed that they resolve to appoint a group company of the Investment Manager as the management company to the fund complex (referred to here as an "Affiliated Management Company" or "AMC"). The primary focus of the context for this analysis is Irish domiciled funds authorised as UCITS since, for the reasons set out in the section below, they are the entities for whom this issue is of greatest relevance at present.

Background

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". This has led to increased emphasis on governance and substance. Various guidance has issued pursuant to this, most recently a Dear Chair letter in October 2020 (the "Latest Guidance"), which clarifies that fund boards should formally consider relevant issues 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. This is explored in greater detail in Part I of this series of articles, entitled "Appointing a Fund Management Company".

In some such cases SMIC boards will be presented with a recommendation to appoint one of the third party entities duly authorised and offering services commercially as their management company. Part II of this series of articles, entitled " Key considerations in assessing a Third Party Management Company", ("Part II") explores key points for consideration for boards when analysing such entities for appointment.

However, in other cases, particularly where larger asset managers are involved, rather than recommending the appointment of an unaffiliated third party entity (referred to here as an "Unaffiliated Management Company" or "UMC"), the promoter will wish for one of its group companies to be appointed as the management company to the fund. There are additional and specific points for consideration by boards when approving appointments in such scenarios, as explored further below.

Affiliated Management Companies

A review of the Central Bank's Register of regulated entities, publicly available through its website, reveals significant growth in the number of management companies established and authorised in Ireland in recent years. Many of the names of such entities reflect the fact that they are members of large international investment management groups. Examples include that of Dimensional, Legg Mason, Lord Abbott, Manulife or Marshall Wace. While the growing regulatory demand for increased

substance and governance, culminating in the Latest Guidance, has been a key driver in the general shift away from the SMIC model, another key factor in the establishment of AMCs during this period, in particular, has been the issue of Brexit. Traditionally many such investment houses would have only had fund structures based in Ireland or Luxembourg, which were then passported for pan-European and broader international distribution. However, with the spectre of Brexit endangering the provision of services, including sales and distribution, to European customers from what may have been their historic central office, or European headquarters, in London, the establishment of an Irish management company presented a convenient way of ensuring adequate substance and oversight to a fund range in Ireland while also acting as the building block for an EU based financial services business and a hedge against Brexit related risks.

Management companies can be authorised to also act for alternative investment funds (so called “super mancos”) and receive additional “top-up” authorisations to provide certain MiFID type services, allowing them to also engage in portfolio management and investment advisory work, for example. These additional authorisations mean that such an entity could potentially service group requirements across the EU as well as fulfilling a range of functions beyond the management of Irish or EU domiciled funds. Accordingly the strategic and business case for the establishment of such companies from the perspective of their parent asset management group is clear, but it is also necessary to consider the rationale and justification for their appointment from the perspective of the relevant fund board upon whom the onus to formally appoint them falls.

While political developments have evidently been a factor in the recent associated growth in the number of management companies established in Ireland, AMCs are of course not an entirely new phenomenon, as is clear from a review of the Central Bank's register. Traditionally groups may have established them as part of a unit trust or common contractual fund (tax transparent) structure, for example, or for other purposes. In such cases the AMC would have been appointed on establishment and authorisation of the relevant fund, which differentiates such scenarios from circumstances where an established SMIC is converting structure to the use of an AMC. Considerations in this regard are explored further below.

Fund Boards

The composition of boards of Irish authorised investment funds is subject to regulatory requirements including the obligation to have at least two Irish resident directors. The Corporate Governance Code for Collective Investment Schemes and Management Companies (the “Code”), which applies on an explain or comply basis, requires at least one independent director who will typically act as chair. In the self-managed model the independent chair will normally be responsible for the Organisational Effectiveness role.

There is no requirement for the fund board as a whole to be independent. In fact the Code even provides for at least one representative of the Investment Manager to be appointed to boards. However, given that there is no requirement for the board to be independent, in many cases several such representatives will be appointed so that a majority of board members will in fact be employees of the Investment Manager or its group companies, thereby ensuring effective control of the fund complex.

However, none of the foregoing exempts any of the directors from the standard fiduciary duties owed to the corporate vehicle to which they are appointed. These include: to act in good faith for the interests of the company and its members; to avoid conflicts of interest; and to exercise the appropriate degree of skill and diligence in carrying out relevant duties[1]. Furthermore, the Central Bank has made it clear that it expects to see “challenge, independence

and diversity"[2] from independent non-executive directors ("iNEDs"). Diversity is encouraged in the context of boards for reducing the likelihood of groupthink, enhancing risk management and reducing overconfidence thereby improving decision making[3]. This is seen as facilitating robust challenge and independent counsel to the benefit of the fund and its members. Fund board members owe obligations from such a role to the fund and its shareholders, not to the investment manager, who in strictly legal terms is merely a service provider to the fund complex[4].

Clearly therefore it is entirely inappropriate for a board to merely "rubber stamp" approval of the appointment of any management company and this also applies to the appointment of an entity which is a member of the Investment Manager's group. In fact arguably there is an even greater onus on boards, and iNEDs in particular, to demonstrate thorough analysis when resolving to approve the appointment of an AMC in order to show that they have indeed satisfied the obligation to challenge management and act in the interests of the shareholders of the fund. The appointment of an AMC would tend to give rise to a presumption of complying with the preference of the Investment Manager so independent board members would be advised to ensure that their queries, due diligence and any challenges raised to this proposal should be well minuted. This will serve as evidence of them carrying out their fiduciary duties and assist in satisfying the stated expectations of the regulatory authorities.

Conflicts of Interest and Corporate Responsibilities

Directors are required to disclose to the board any potential conflicts of interest they may have. By way of example, for entities structured as ICAVs disclosure is required pursuant to sections 81-83 of the Irish Collective Asset-management Vehicles Act 2015. In the case of representatives of the Investment Manager and its group, who as noted above are routinely appointed to fund boards and may even comprise the majority of members in some cases, their roles in such capacity should not only have been formally disclosed to the fund board as a whole, but will also be detailed in the prospectus to the fund (both in the director's bios and the conflicts disclosure sections respectively). It will be appropriate to review the terms of the constitutional document of the fund to determine if disclosure is sufficient or whether such directors would need to recluse themselves from the quorum when considering any resolution to appoint an AMC. It is unlikely that this further step would be necessary in most cases and typically disclosure of the potential conflict will suffice.

Fund Management Companies

The Central Bank has clarified that is will look to the board of the fund management company to ensure that such entities are being run properly and operating as they should, including that they both have all necessary and appropriate policies and procedures and that they are applying them in practice[5]. The corollary of this is that the onus will be on the fund board when assessing whether to appoint the management company in the first place, particularly where it is an AMC, to ensure they obtain representations and appropriate evidence to indicate that it will have the necessary substance, policies and procedures as well as sufficient resources to operate as intended and fulfil its obligations.

A further complicating factor is the fact that an AMC is likely to have board members in common with corporate funds to which it is appointed, if not in fact to mirror such board. Clearly this further raises concerns in relation to conflicts, "group think" and the presumption of the pervasive influence of the Investment Manager. This merely serves to underline the importance of ensuring comprehensive documentation of the analysis and challenge by iNEDs on behalf of the fund board in the interests of the fund and its shareholders prior

to making its determination in this regard and appointing an AMC. While the primary obligation to demonstrate challenge and independence is of course on the iNEDs, boards as a whole are responsible for their composition and the range of skills represented, so a failure to demonstrate such challenge would reflect on a board as a whole. The Central Bank highlighted the importance of considering and identifying any conflicts of interest that may arise in such scenarios, as well as ensuring that they are being appropriately managed, in its guidance on Fund Management Companies issued in December 2016 as part of the CP86 updates.

Analysis of the AMC

A range of key considerations to be borne in mind when considering the appointment of a management company and comparing the offerings of differing providers is contained in Part II of this series of articles, linked above, so I will not repeat these at length here other than to note that in summary these include: substance (including human resources, capital and IT systems), expertise (including existing clients), ancillary services and of course the commercial terms. Due diligence on the prospective AMC would be well served by conducting an analysis of it under the same headings to ensure that it satisfactorily meets board requirements and can provide a comparative service to that available in the market rather than merely meeting strict legal obligations.

The requirement for fund boards to engage in challenge would best be satisfied by not merely undertaking the above analysis of the AMC , which might be viewed as a minimum level of diligence, but by also ensuring there is active consideration of other alternatives. These other potential options would include building out substance in the existing fund entity, restructuring the fund as a hosted solutions on a separate platform or the appointment of a UMC rather than the AMC.

Commercial Considerations and Beyond

While commercial terms are of course highly relevant there are a variety of entirely valid reasons outside purely commercial considerations which can justify a determination not to pursue certain such models. These include control and quality assurance, as well as the various headings highlighted above. However, an analysis of the commercial arrangements will of course be a necessary part of any review. To show independence and fulfil their fiduciary duties such analysis should naturally be carried out by the fund board from the perspective of the fund rather than the Investment Management group. Where considerations other than purely a commercial rational from this perspective form the basis for a determination this should be well documented and, as this will frequently be the case where an AMC is to be appointed, this underlines the importance of this in such cases. Examples of additional factors that might be used to justify the appointment of an AMC where a purely commercial analysis might indicate an external entity might offer a better deal to shareholders might include the potential to hire dedicated sales staff for distribution within the AMC or a willingness to prepare bespoke reporting for the product. On the other hand factors which would likely be inadmissible from the perspective of the fund board might include a preference not to facilitate revenue "leakage" from the fund outside the group to UMCs or use of such management fees to effectively subsidise the creation of an EU based entity for the investment management group to facilitate the provision of other services and products. These may of course be valid reasons from the perspective of the investment management group driving the desire to set up the AMC and are entirely acceptable as such- for the group, rather than the fund board.

Fees

A change from a SMIC to a separately managed structure will typically see changes to the fund structure payable by a fund- an increase in most cases. As discussed in Part I this may require shareholder approval or just prior notification

depending on the terms of the documentation. As the Investment Manager is a delegate of the management company it is possible to group the fees of the Investment Manager and Manager in a single all-encompassing figure in the prospectus (which may include the fees of the Administrator also). This may be an attractive option for Investment Management groups prefering to provide for an element of opaqueness in their internal group fee arrangements. This may also facilitate them diverting revenue into a preferred group entity. However, a disproportionate or unjustifiable fee split between the Investment Manager and the AMC may generate transfer pricing and BEPS considerations, among other concerns. Where the fund pays the management company a single fee out of which all service provider fees are settled this may reduce responsibility for this break down at the fund board level, but it would still be appropriate for them to receive assurances that all was in order from such perspectives and it is an issue they would need to be alert to in initially approving the terms of appointment of the AMC.

As noted in Part I, the change in structure from a SMIC to the appointment of a third party may necessitate shareholder approval in order to facilitate additional fees, in addition to serving them with prior notice. However, while shareholder approval might be viewed as taking an element of responsibility from the board, in fact they will still bear this for recommending the relevant change in structure and approving related agreements reflecting the revised fee arrangements. Accordingly this should not be viewed as absolving them from the obligation to raise appropriate challenge and act in the interests of the relevant fund.

Board Assistance

The analysis presented to the board in order to assist them with their determination and justify it will generally be prepared by the Investment Manager. Boards should consider if the assistance of external consultants is warranted where the appointment of an AMC is proposed in order to ensure they have sufficient independent information to make an informed decision. Such advice might include analysis of available alternatives, both in terms of the model to be pursued as well as market terms, including fee levels , for such models. Boards may be content to determine to rule out certain generic options on principal without recourse to such detailed commercial analysis, for example ruling out a move to a hosted solution due to concerns around loss of control, or may be satisfied that a move to an AMC model is appropriate due to other positive factors noted above, such as the ability to build a dedicated distribution network. However they may nevertheless feel additional detail and independent analysis is warranted to provide evidence to justify the preferred option or to provide specific detail in relation to aspects of factors in the decision. In many cases the iNEDS will of course already be familiar with market terms available due to their general experience and other roles (and indeed may be called upon to advise the board as a whole in this regard) but even if in circumstances where they feel that additional independent input is not required, it would be advisable for the minutes to note their analysis based on such pre-existing market knowledge.

While considering the notion of independent advice to boards in such scenarios, consideration should also be given to the need for independent legal advice. In the context of Irish domiciled funds, at least, a single law firm is inevitably engaged on fund establishment, who acts for the fund promoter for the purposes of the establishment and authorisation and then enters into a new engagement with the fund complex. However, on establishment and authorisation there are no investors and all parties are on notice that the promoter, which will typically be either the Investment Manager itself or a group company, is initially meeting the costs of all establishment expenses. In the context of an operational fund with numerous investors where a determination is made to change from a SMIC

model to appoint an AMC, a lack of independent advice may be viewed as potentially detrimental for such investors. In such a case a conflict will exist in having a single law firm representing both the fund and management company and indeed if a tripartite agreement is used for the investment management agreement. Boards should therefore consider if it is appropriate for a single law firm to be advising the fund, Investment Manager and management company on the same agreement or agreements. At the very least if a single law firm is to be used, it would be advisable for clarification to be given as to who the law firm is representing and a formal conflicts waiver process to be conducted and documented where necessary.

Summary

The appointment of an AMC can represent an attractive option from the perspectives of both the board of a fund and the Investment Manager when considering restructuring options, whether on a general basis or at present in the context of the CP86 reforms. However, far from this being something that a board should simply approve at the instigation of the Investment Manager, such an appointment should give rise to analysis from the perspective of the fund prior to the approval of such an appointment to ensure that the board can demonstrate the challenge and independence required by regulatory authorities and satisfy general fiduciary duties.

[1] **See section 79 of the Irish Collective Asset-management Vehicles Act 2015 in relation to ICAVs or section 228 in relation to corporate funds structured as plcs.**

[2] **See for example the speech of Michael Hodgson, Director of Asset Management and investment Banking of the Central Bank of Ireland at:** INEDs – The spirit of challenge and responsibility - Michael Hodson, Director of Asset Management and Investment Banking (centralbank.ie)

[3]**See for example the speech of Ed Sibley, Deputy Governor of the Central Bank of Ireland at:** Culture, diversity and the way forward - Deputy Governor Ed Sibley (centralbank.ie)

[4] **This is without prejudice to potential conflicts where directors are also board members of sister companies to the AMC, possibly including the Investment Manager, addressed in the section below.**

[5] **See the speech of Michael Hodgson, Director of Asset Management and investment Banking of the Central Bank of Ireland at:** INEDs – The spirit of challenge and responsibility - Michael Hodson, Director of Asset Management and Investment Banking (centralbank.ie)

Author: Mark Browne

Partner and Head of Asset Management and Funds at Clerkin Lynch LLP
Email: markbrowne@clerkinlynch.com
Phone: +353 1 611 4400

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.

- **Contact Details:**

Mark Browne
Partner and Head of Asset Management and Funds at Clerkin Lynch LLP
Email: markbrowne@clerkinlynch.com
Phone: +353 1 611 4400