MFSA

MALTA FINANCIAL SERVICES AUTHORITY

CORPORATE GOVERNANCE MANUAL

FOR

DIRECTORS OF INVESTMENT COMPANIES

AND

COLLECTIVE INVESTMENT SCHEMES

2013

CONTENTS **PAGE NO:**

1. CORPORATE GOVERNANCE IN THE INVESTMENT FUND INDUSTRY

1.1 The global financial crisis of 2007-09 caused severe dislocations in the funds industry. These manifested themselves mainly through unprecedented losses in asset value, but also through unexpected and prolonged limitations on shareholder liquidity, operational chaos, extremely compressed and extended time horizons, legal and regulatory paralysis, slow or poor communication from managers, and overall shareholder confusion and even panic. Many participants in the fund industry, politicians, regulators, investors and journalists believe that directors of investment funds generally failed to react properly in the context of such a crisis. Whether or not such a perception is merited, it is crucial that going forward directors of investment funds are cognizant of their role, duties and obligations. A number of jurisdictions have overhauled their corporate governance frameworks or are considering doing so. The Malta Financial Services Authority ("MFSA") considers the role of directors to be vital to the proper operation of an investment fund and accordingly issues this Corporate Governance Manual for Investment Funds (the "Manual").

1.2 Why is corporate governance important? Corporate governance is a tool that assures investors in a company that the company's objectives and operations will be carried out in a manner that benefits the best interests of the company. This is true whether the company is a public or private company; a fund; a special purpose vehicle; a corporate general partner of a limited partnership or a corporate investment manager; a holding company with limited activity; or a company with extensive operational activities.

1.3 Corporate governance is structural: "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined."[i]

1.4 But ultimately corporate governance is about engendering trust: "If management is about running the business, governance is about seeing that it is run properly."[ii]

1.5 Corporate governance in the funds industry is highly contextual and varies widely according to the laws and regulations applicable to the fund, its investment manager and even investors. However, corporate governance in the funds industry is sufficiently developed to enable a board of directors of a fund to identify and apply good corporate governance principles and practices that would enable it to understand and oversee a fund's operations and ensure that they are carried out in accordance with the expectations of all interested parties and particularly the fund's investors.

1.6 The purpose of this Manual is to provide general guidance to a director on how to implement good corporate governance practice for an investment fund, including some thoughts on typical issues that affect fund directors. The guidance set out in this Manual is not intended to be exhaustive and should not be followed as a simple check list or road map. Directors of a fund should use this Manual to develop their own "best" corporate governance practice to fit the particular context of the fund and its board.

2. ROLE OF DIRECTOR OF A FUND

2.1 Two particular aspects of fund structures have a material impact on the nature of the role of a fund director:

(a) The investment manager or sponsor sets the investment strategy and operational structure of a fund; and

(b) A fund does not have management staff or employees.

The role of a typical public company board is to determine the company's strategy and monitor its implementation by the company's management. The role of a fund board is usually limited to overseeing and monitoring the implementation of the fund's investment and operational strategy as set by the investment manager or sponsor and disclosed to investors in the fund's offering documents. This means that a fund board generally does not have much input in determining the investment and operational strategy of a fund, at least at the fund's inception. To the extent that regulatory, tax or operational planning requires the fund board's periodic input into strategy, such input usually occurs in the form of a review and approval of a recommendation made by the investment manager or sponsor.

2.2 Since a fund does not have management staff or employees and almost all of its operational functions are outsourced to delegates or agents, the traditional relationship that exists in a public company between the board and management does not exist in the fund context. A fund board has to understand that the traditional role of management in the fund context is played partly by the investment manager or sponsor and partly by the other service providers.

2.3 Both of these structural aspects give a "compliance feel" to a fund board and emphasize the monitoring role of a fund board. However, fund directors need to remember that they are not employees, and much less compliance officers, of a fund. They may have to rely to some extent on the various service providers to help them discharge their monitoring function. However, this means that fund directors need to be clear about what they have delegated to the service providers and how they are controlling those various activities.

3. APPOINTMENT AS A DIRECTOR

3.1 A fund director should expect and even demand that the investment manager or sponsor of a fund conducts due diligence on all directors to be appointed to a board.

3.2 Fund directors should also conduct due diligence on an investment manager or fund sponsor who seeks to appoint them to the board of a fund. Such due diligence could include:

(a) Internet searches on the investment manager or sponsor and its principals and major shareholders;

(b) Confirmation of an investment manager's regulated status through its primary regulator (usually easy to obtain through the regulator's website);

(c) Review of marketing materials and website of the investment manager;

(d) Interview of the investment manager either in phone or in person – this interview could cover the following aspects of the investment manager's operations: investment and risk philosophy; market views; financial position and regulatory capital; operations; past regulatory issues if any; service providers to the fund; conflicts of interest; corporate governance philosophy; etc.;

(e) Visit to the investment manager's principal place of business or offices from which the investment management activity on behalf of the fund will take place;

(f) Request for and verification of references; and

(g) Know Your Client ("KYC") and Anti-Money Laundering ("AML") checks on the investment manager and its principals and shareholders if applicable.

3.3 Fund directors should also conduct due diligence on the fund and its service providers. Such due diligence could include:

(a) Request and review all material documentation of the fund, such as:

(i) Certificate of incorporation (or equivalent documents);

(ii) Memorandum and articles of association (or equivalent documents);

(iii) Offering documents including subscription agreement(s);

(iv) Any management agreement;

(v) Investment management agreement;

(vi) Any investment advisory agreement;

(vii) Administration agreement;

(viii) Custody agreement;

(ix) Any prime brokerage or counterparty agreements;

(x) Any side letters;

(xi) Auditor engagement letter;

(xii) Any registered office agreement;

(xiii) Register of Directors (if available); and

(xiv) Register of Members (if available).

(b) Confirmation of regulatory status of relevant service providers;

(c) Request and review of service provider annual reports (if available); and

(d) Interview by phone or in person with other directors to be appointed to the board by the investment manager or sponsor.

3.4 One highly effective due diligence tool for a fund director is to meet the investment manager or sponsor in person. While it is recognized that such a meeting is not always possible at the time of appointment of the director or the inception of the fund, it is considered good practice for fund directors to meet the investment manager or sponsor of the fund in person if possible within 12 months of the inception of a fund.

3.5 The acceptance and appointment of a director to a fund board should be reflected in writing (through an acceptance letter, terms of reference or director services agreement) to be entered into by the fund and the director.

4. BOARD SIZE

4.1 A fund board should have no less than three directors. It may be advisable to have more than three directors depending on the complexity and size of the fund and the aggregate skill set desired on the board.

4.2 A fund with more than seven directors would likely lose efficiency.[iii]

4.3 A board with an uneven number of directors ensures that action can be taken since a majority vote is possible.

While a Chairman could have a tie-breaking vote on a board with an even number of directors, it may not be advisable for the Chairman to have such voting power.

4.4 The quorum for any board meeting should be a majority of directors unless a committee constituting less than a majority of directors has been appointed to handle a specific matter.

5. BOARD COMPOSITION

5.1 Ideally the individual directors on a board should have a “collective skill set” that enables the board to understand and analyse a fund and its operations. This suggests that the directors should have individual skill sets that reflect functions carried out by the fund’s service providers: portfolio management, risk management, operations, legal and regulatory, accounting and audit, compliance, distribution etc. In addition to the soft skills required by any Board such as curiosity, strategic vision, effectiveness etc. However, it is unlikely that the board of a fund would have all or even a majority of such skill sets represented by its directors. As always there is a balance to be struck on such issues, including gender representation.

5.2 The directors of a fund board should have experience directly related to the fund industry.

5.3 It is incumbent on each director to ensure that the "collective skill set" of a board is balanced. For example, a board of directors should not consist only of former administrators.

5.4 It is also incumbent on each director to ensure that the other directors have a good reputation, experience in the fund industry and sufficient capacity to discharge their fiduciary duties to the fund. It is highly recommended that a director does not accept an appointment to a fund board without first learning the identity of the other directors on the board.

5.5 It is considered good corporate governance practice to have independent directors on a fund board – with independence defined relative to the investment manager or sponsor.[iv] Many institutional investors consider best corporate governance practice to be a fund board consisting of a majority of or even all independent directors.

5.6 Executives of the investment manager or sponsor of the fund may sit on a fund board. In their capacity as directors of a fund, executive directors when appointed by the manager or the sponsor of the fund owe their fiduciary duty to the fund, not to their employers. Executive directors appointed by the manager or the sponsor of the fund are not independent directors.

5.7 Executives of a service provider to the fund may sit on a fund board. In their capacity as directors of a fund board they owe their fiduciary duty to the fund, not to their employers. Nevertheless, such directors are not considered to be independent directors.

5.8 It is considered good corporate governance practice to limit non-independent directors to a minority of a board.

6. BOARD STRUCTURE

6.1 A fund board should appoint a chairman. The chairman can be an executive or independent director.

6.2 The chairman would be responsible for running board meetings and for communication between the investment manager and the board, or investors and the board.

6.3 Although it is relatively uncommon in the fund industry, a fund board could consider appointing a lead director, particularly if a chairman has not been appointed.

6.4 The lead director would be responsible for handling specific matters such as problems relating to the chairman, representing independent directors on the board, and special projects or topics.

6.5 Only funds with larger boards tend to use committees for specific functions. To the extent that such committees are used, risk, pricing/valuation and audit committees are the most common in the fund context. Remuneration and nomination committees have been rarely used to date. Remuneration committees may become more common for EU funds once the Alternative Investment Fund Manager Directive (AIFMD) is implemented by EU member states. Each board should evaluate whether the use of a function specific committee would be appropriate in the particular context of a fund. Committees should be formally established with written terms of reference and ratified by the Board. Minutes of committee meetings should be prepared and reported to the Board.

6.6 Committees are commonly appointed to review and execute documents related to transactions already approved by the full board in a prior meeting. The actions of any such committee, typically consisting of any one director, should be reported to the board at the board meeting taking place after such actions. Any material actions by such committee should be reported to the board immediately after the action rather than waiting to report it at the following board meeting.

7. BOARD MEETINGS

7.1 Board meetings should be held on a quarterly cycle to review the performance and operations of the fund for the relevant quarter. Board meetings may be held less frequently depending on the context of a specific fund but good practice is considered to be quarterly board meetings.

7.2 Ideally, quarterly cycle board meetings should be held before the end of the month following the calendar quarter end (i.e. before the end of April to review performance and operations from January to March).

7.3 Ad hoc board meetings may be scheduled as often as necessary to handle specific matters. For example, the board meeting which reviews and approves the audited financial statements often falls outside regularly scheduled quarterly board meetings.

7.4 Notice of meetings should be provided in accordance with the jurisdiction’s legal requirements and/or the memorandum and articles of association of the fund.

7.5 The board should have a regular agenda for its meetings. Additional agenda topics may be added on a permanent or ad hoc basis depending on the context. A typical standard agenda could include the following:

(a) Appointment of chairman (if no permanent chairman has been appointed) and secretary for the meeting, notice given or waived (if applicable) and quorum;

(b) Review of prior minutes and any action points from prior meetings;

(c) Conflicts of interest (either as a permanent or ad hoc agenda topic);

(d) Investment management report;

(e) Administrator (including Compliance Letter) report;

(f) Custodian report;

(g) Audit report (if applicable for the particular meeting);

(h) Marketing and investor relations report;

(i) Regulatory and legal update;

(j) Any exercise of discretionary powers – acceptance of subscriptions below minimum; acceptance of early redemptions, application of any gates; review and approval of side letters;

(k) Any other business; and

(l) Date of next meeting.

7.6 Board meetings should last as long as necessary to go through the agenda. There should be sufficient discussion on each item to ensure a proper debate and forward action decided. All board meetings must be recorded in the minutes and circulated to the Board for review and sign-off by the Chairman.

7.7 It is considered good practice to attend all regular and unscheduled board meetings. The Chairman or lead director should discuss repeated absences with the relevant fund director to ensure that director's attendance at future meetings. An attendance log should be maintained by the corporate secretary.

7.8 Board meetings should be held in person as often as possible but factoring in whether the cost associated with physical meetings is appropriate for the fund's financial resources. It is considered good practice to have at least one board meeting in person annually, but it may be advisable to have more frequent physical meetings depending on the context of the specific entity. If only one board meeting is held in person annually, it should be the meeting that reviews and approves the entity's audited financial statements.

7.9 Board meetings that are not held in person should be held by telephone or video conferencing facility. In order to increase exposure of board members to each other and to the investment manager or sponsor, telephonic board meetings could involve some members of the board meeting in person to call from one location.

8. INFORMATION PACK

8.1 The Chairman or lead director should ensure that the information pack for a board meeting includes all information necessary for the board to consider the meeting's agenda and any additional information requested by the fund board.

8.2 The Chairman or lead director should ensure that the information pack is delivered sufficiently in advance of the board meeting to permit the directors sufficient time to properly review its contents. Although circumstances may dictate otherwise, information packs should be sent at least 2 business days prior to the date of the board meeting.

8.3 The information pack should include at a minimum the following:

(a) Investment management report;

(b) Administrator report;

(c) Custodian report;

(d) Auditor report (if applicable); and

(e) Any other information that may be requested by the board.

8.4 The Chairman or lead director should confirm that each director has reviewed the information pack and is prepared for each meeting. The Chairman should also encourage each director to contribute actively to the board's deliberations.

9. INVESTMENT MANAGEMENT REPORT

9.1 The investment management report is probably the most important report in the board pack as it covers the principal activities of the fund. Most investment managers prefer to provide a verbal report but it is considered good practice for the investment manager to provide a written report. In the event of a verbal report, all investor reports from the investment manager for the relevant period should be tabled at the meeting to the extent not already received by the directors. Some funds will have an investment manager and an investment advisor, in which case a separate report should also be provided by the investment advisor. In the event that a fund has multiple investment advisors (such as a fund of funds), reports from such advisors could be rotated through the board meeting cycle.

9.2 Reporting from investment managers will vary greatly depending on the type of investments made by the fund. Any investment management report must provide such information that will enable a board to understand and oversee the portfolio from a performance, risk, liquidity and compliance perspective.

9.3 An investment manager's report could include the following information, which is not meant to be exhaustive. Additional information may be included that is specific to the type of investment fund, the investment strategy pursued and applicable regulation.

(a) the period covered by the report – the end of this period should be as close as possible to the date of the board meeting during which the report will be reviewed;

(b) any investor reports produced by the investment manager since the last investment management report presented to the board – such reports should be sent to the directors of a fund at the same time as they are sent to investors but it is useful to have them included in a board pack;

(c) description of portfolio positions of the fund including five largest positions;

(d) description of liquidity profile of the fund including

(i) estimates of time required to liquidate all positions in the fund,

(ii) a liquidity analysis relative to the redemption provisions of the fund, and

(iii) highlighting any positions that have become illiquid since the last investment management report;

(e) description of risk profile of the fund including summary information on VaR, stress test and/or other forms of risk analysis used by the investment manager (or investment advisor where applicable) and any concentration of risk (ie market, liquidity, country);

(f) description of investment manager's (or investment advisor's where applicable) views of economic and market conditions and how the fund's portfolio is positioned to take advantage of such market conditions;[v]

(g) any compliance matters including any breaches of regulatory or prospectus-based restrictions (including investment and borrowing restrictions, and counterparty exposure limits where applicable) that have come to the investment manager's attention during the course of the review period or confirmation that no such breaches have come to its attention;

(h) remedial action taken or to be taken by the investment manager or any other parties involved to prevent a recurrence of any such breaches including description of any compensation due to the fund or investors;

(i) sales and marketing report;

(j) any investor complaints;

(k) report on the service providers to the fund, including the administrator, custodian, prime, execution or clearing brokers, distributors, auditors etc. as applicable;

(l) update on audit plan and timetable;

(m) any regulatory matters or updates applicable to the fund including compliance with all applicable regulatory filings;

(n) any tax matters including compliance with all applicable tax filings;

(o) management and performance fees paid and accrued;

(p) regulatory (including capital adequacy requirements if any), financial and operational report of the investment manager (and investment advisor where applicable)[vi].

10. ADMINISTRATOR REPORT

10.1 Reporting from administrators varies widely – some are very comprehensive in the information that they provide; others follow a minimalist approach. Administrators have a lot of information on the funds that they service – directors should ask for any information necessary to permit them to understand and oversee an administrator's service to a fund. Administrators can usually accommodate requests for additional information. An increasing number of administrators are providing middle office services which include detailed reports of middle and back office metrics which can be provided to fund boards.

10.2 An administrator's report could include the following information, which is not meant to be exhaustive. Additional information may be included that is specific to the type of investment fund, the investment strategy pursued and applicable regulation.

(a) the period covered by the report – the end of this period should be as close as possible to the date of the board meeting during which the report will be reviewed;

(b) a valuation and financial report including information on:

(i) net asset value of the fund and net asset value per share;

(ii) the level of accuracy and timeliness of the net asset value during the period;

(iii) information on securities valuation (including any derivative positions and unlisted securities);

(iv) any aged dividend and interest income;

(v) any pricing errors or misstatements;

(vi) any stale prices (i.e. where the current price of an asset does not reflect a recently established price);

(vii) any unlisted or hard-to-value securities;

(viii) asset and cash reconciliations;

(ix) income statement for the period covered by the report and year-to-date; and

(x) balance sheet.

(c) a shareholder activity report including information on:

(i) subscriptions, redemptions and any conversions of shares;

(ii) number of shareholders and domiciles;

(iii) the largest 5 shareholdings in the fund;

(iv) whether any late subscriptions occurred and why – late receipt of subscription documents and/or late receipt of funds;

(v) whether any late redemptions occurred and why – late receipt of redemption documents;

(vi) whether shareholder statements/contract notes were issued on time (if applicable);

(vii) whether any subscription or redemption fees were levied; and

(viii) any investor complaints.

(d) a compliance comfort letter including information on:

(i) compliance with applicable anti-money laundering requirements and any issues arising;

(ii) any suspicious trading activity (to the extent that it may be reported) or PEP exposure;

(iii) transparency regarding the independence of pricing and verification of asset holdings;

(iv) any minimum capital adequacy requirement;

(v) any data protection issues;

(vi) any financial reporting issues;

(vii) any business updates from the administrator; and

(viii) regulatory update.

(e) any relevant internal audit and/or SSAE 16 (formerly SAS 70) report as may be required;

(f) any comments on service level during the period; and

(g) any significant matters that have arisen in the period since the last Board meeting which in the opinion of the Administrator should be brought to the attention of the Board.

11. CUSTODIAN REPORT

11.1 Reporting from custodians also varies widely and tends to be shorter than administrator reports.

Directors should ask for as much information as necessary to help them understand and oversee the custodian's services on behalf of a fund.

11.2 Custodians usually accommodate requests for additional information. More significant reporting from custodians should develop once AIMFD comes into effect.

11.3 A custodian's report could include the following information, which is not meant to be exhaustive. Additional information may be included that is specific to the type of investment fund, the investment strategy pursued and applicable regulation.

(a) the period covered by the report – the end of this period should be as close as possible to the date of the board meeting during which the report will be reviewed;

(b) description of any breaches of regulatory or prospectus-based restrictions (including investment and borrowing restrictions, and counterparty exposure limits where applicable) that have come to the custodian's attention during the course of the review period or confirmation that no such breaches have come to its attention;

(c) a portfolio report including trading volumes;

(d) any issues relating to the calculation of a fund's NAV not being in accordance with the fund documentation and regulations as applicable;

(e) any pricing errors reported to the Custodian;

(f) any settlement issues;

(g) any segregation issues;

(h) any issues relating to cash and asset reconciliations;

(i) any issues regarding the supervision and oversight of the Administrator's functions to include a review of the adequacy of the Administrator's controls and procedures (where relevant);

(j) any issues arising from the Custodian's oversight of Prime Brokers (where applicable) including compliance with re-hypothecation limits, if any;

(k) any relevant internal audit and/or SSAE 16 (formerly SAS 70) report; and

(l) any significant matters that have arisen in the period since the last Board meeting which in the opinion of the Custodian should be brought to the attention of the Board.

12. AUDIT REPORT

12.1 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. The board should engage the auditor actively, including having at least one *in camera* session (without the investment manager or sponsor being present), to understand the scope and timing of the audit, any issues expected or arising from the audit, the level of cooperation and efficiency from all service providers to the fund who contribute to the audit, and the contents and implications of the final audit report.

12.2 It is possible for audited financial statements to comply fully with the accounting standards applied by the fund but still provide an opaque or even misleading picture of the fund. Directors need to ensure that the audited financial statements of a fund accurately reflect the financial situation of the fund. Directors can ask for additional disclosure to be included in the footnotes to the financial statements, as necessary.

12.3 Reporting from auditors will vary according to the financial reporting and audit standards used by the fund and is beyond the scope of this Manual.

12.4 While the investment manager or sponsor of the fund generally manages the audit timetable and the interaction with the auditors, directors should always remember that the auditors work for, and their fees are paid by, the fund.

13. CONFLICTS OF INTEREST

13.1 The funds industry is laden with conflicts of interest. Fund disclosure documents contain conflicts of interest language that generally seeks to manage the identified conflicts of interest through disclosure to investors.

13.2 Various laws, regulations and codes of conduct require the identification, disclosure, monitoring and remediation of conflicts of interest. Fund directors should ensure that the fund's corporate governance procedures enable compliance with such laws, regulations and codes by all service providers as applicable.

14. CODE OF CONDUCT

14.1 Some regulators and listing exchanges require the adoption of specific codes of conduct. Various industry organisations have adopted voluntary codes of conduct to be followed by their members. A fund board should ensure that the fund has adopted any codes of conduct that are mandated by law, regulation or listing requirements (if applicable). To the extent that a code of conduct is not mandated for a fund, the fund board should consider the adoption of a voluntary code of conduct.

14.2 Adoption of a voluntary code of conduct or specific provisions of such code should only be considered in the context of the specific fund.

15. SHAREHOLDER COMMUNICATIONS

15.1 A board must ensure that shareholders receive all legally required communications and appropriate disclosures.

15.2 A board should obtain confirmation from the investment manager, the administrator and/or legal counsel to the fund that all such communications and disclosures have been provided.

16. ANTI-MONEY LAUNDERING AND COMBATING FINANCING OF TERRORISM

16.1 Investment funds marketing their units or shares are subject to anti-money laundering and combating financing of terrorism ("AML/CFT") legislation. All funds the units or shares of which are offered to or placed with investors, whether directly or indirectly, by the fund itself or by other third parties on behalf of the fund, have AML/CFT obligations. The board of the fund is ultimately responsible for compliance with all applicable AML/CFT legislation and requirements.

16.2 Investment funds that do not have a physical operational set-up in Malta and are therefore 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 ("AML/CFT obligations"), to the administrator. The MLRO duties of a fund may therefore be carried out by the MLRO of the administrator.

16.3 The delegation and outsourcing arrangements should be entered into with an administrator in Malta licensed or recognised under the Investment Services Act or with an administrator within another Member State of the European Community or in a reputable jurisdiction[vii]. Outsourcing arrangements should be made by means of a written agreement and may form part of the administration agreement. The agreement should set out the respective responsibilities and should expressly state that any document, data or information obtained by the administrator pursuant to such agreement shall be made available to the fund upon request.

16.4 Notwithstanding any delegation and outsourcing arrangement between a fund and the administrator, the fund, through its board of directors, remains responsible for compliance with its AML/CFT obligations.

16.5 The fund should receive from the administrator a periodic report, at least once a quarter, containing a complete list of unit holders of the fund, details of subscriptions and redemptions carried out by the unit holders within that period of time and a description of the customer due diligence (CDD) measures carried out by the administrator on the unit holders. The report should be signed by the MLRO of the administrator and transmitted to the board of directors of the fund. The administrator should confirm to the board of the fund that all other AML/CFT obligations are being conducted in compliance with the applicable legal requirements. The board of directors should ensure that the CDD measures and all other AML/CFT obligations being conducted by the administrator comply with the applicable Maltese AML/CFT legal requirements and, where the administrator is situated within another Member State of the European Community or in a reputable jurisdiction, with equivalent requirements.

16.6 Notwithstanding the fact that the reporting obligations have been outsourced to the administrator, should a suspicion of ML/FT be identified by the board of the fund, a report should be filed with the Financial Intelligence Analysis Unit.

17. INDEMNITY AND INSURANCE

17.1 Fund directors should be indemnified by the fund to the full extent permitted by law and subject to standard carve-outs for (gross) negligence, wilful misconduct and fraud.

17.2 Fund directors should also be covered by directors and officers ("D&O") insurance. The terms and amount of a policy are beyond the scope of this Manual.

17.3 As a practical matter, funds with relatively small assets under management are less able to afford D&O insurance. In this context, the fund board should set a level of assets under management above which the fund will be required to obtain D&O insurance.

18. ADVISORS TO THE BOARD

18.1 Normally in the fund industry outside advisors (i.e. legal counsel, auditors, valuation agents, compliance and other consultants) act on behalf of the investment manager or the fund but are often paid for by the fund.

During normal times the board may rely directly or indirectly on such advisors for information, analysis, judgment and advice even though they may be appointed by the investment manager or sponsor. However, there are times when the fund board must retain its own advisors. A fund board should ensure that it has the ability under the constituent documents of the fund to retain outside advisors at the fund's expense.

19. CRISIS MANAGEMENT

19.1 A fund board should anticipate potential crises that could affect the fund. Examples of such crises include, but are not limited to:

(a) Serious disruption in markets in which the fund invests;

(b) Failure of a service provider or counterparty;

(c) Fraud;

(d) Loss of regulatory status of a service provider;

(e) Breaches of investment, borrowing or other fund guidelines or restrictions;

(f) Breaches of applicable laws and regulations;

(g) Ineligibility of investors previously allowed into the fund;

(h) Pricing errors or irregularities;

(i) Fall in liquidity of specific assets or instruments;

(j) Accounting errors or irregularities;

(k) Force majeure events (natural disasters, currency crisis, civil unrest, war etc.);

(l) Investment manager is paralyzed or ineffective; and

(m) Investigation of or litigation against the fund or the investment manager or sponsor.

19.2 While not all crisis events can be predicted or even anticipated, it is incumbent upon a fund board to be as prepared as they can be to handle such eventualities should they occur. For example, whenever a currency is under stress, it is entirely appropriate to ask an investment manager to confirm the fund's investment and contractual exposure to that currency and to describe its plans to handle a severe disruption therein.

19.3 Fund boards should ask the fund's service providers to provide periodic updates on their respective business continuity and disaster recovery plans ("BCP"). Such updates should specifically cover the scope, trigger, implementation and testing of the BCP.

19.4 A crucial element of crisis management is for the fund board to be informed of and involved in the management of a specific crisis as soon as possible. Methods of escalation to the fund board should be agreed in advance with the investment manager and other service providers.

19.5 Another crucial element of crisis management is organization. Contact lists should be maintained to enable all service providers to the fund to access quickly any other service providers including the fund directors.

20. RESIGNATION BY A DIRECTOR

20.1 There may be times when a director needs to consider resigning from a fund board. Examples include, but are not limited to:

(a) Serious disagreement with the investment manager or sponsor of the fund;

(b) Serious disagreement with one or more other directors;

(c) Knowledge or suspicion of illegal or improper activities by any service provider to the fund;

(d) Material and unsolvable conflict of interest affecting the director;

(e) Inability to discharge the director's fiduciary duties to the fund due to lack of time, change in personal circumstances or any other reason; and

(f) Any of the investment manager, sponsor or fund board requests that the director resign.

20.2 The decision whether to resign from a fund board is highly subjective and depends entirely on the specific context of the fund. However, it is at times the only tool available to a director to make a statement about the particular circumstance leading to the director's resignation. Due consideration should be given to the legal context of a resignation, particularly who would remain in control of a fund once the director resigns. It may be appropriate for the resigning director to participate in the identification and appointment of a replacement director.

21. TERMINATION OF A FUND

21.1 The termination of a fund also depends entirely on the specific context of a fund. However, a number of common elements are generally present in fund terminations:

(a) Assessment of the fund's solvency and ability to operate as a going concern (if applicable);

(b) Assessment of the portfolio's liquidity;

(c) Realization of the portfolio into cash;

(d) Final accrual of all recurring expenses;

(e) Reserves created for any one-off expenses related to termination;

(f) Sign off by auditors or liquidation audit (if applicable);

(g) Identification and discharge of any remaining liabilities including final payment to any creditors and statutory agencies or regulator if applicable;

(h) Distribution of cash to investors including any claw-backs;

(i) Distribution of any illiquid assets to investors or creation of specific structures to house such investments;

(j) Termination of all service provider agreements;

(k) Formalities for liquidation of the corporate entity under local law including appointment of liquidator or strike off (as applicable); and

(l) Discharge of directors (if applicable).

21.2 A fund board needs to be actively involved in the on-going monitoring of the fund's solvency and the planning and implementation of a liquidation once it has been decided to terminate the fund (at least until a liquidator is appointed if applicable).

The fund board also needs to understand the implications of its actions vis-à-vis creditors, shareholders and regulators in a termination context.

22. ISSUES COMMON TO ALL DIRECTORS

22.1 The MFSA evaluates, the directors in terms of their fitness, integrity and probity as part of the approval process. The quantum of directorships is therefore not the primary evaluation but is used as an input in forming an overall view of the person's capacity to take on an additional role. A person's standing, knowledge of the industry and ability to escalate potential issues are important to the MFSA.

22.2 Time, information and resource gap – Directors have a challenge finding the time, information or resources to enable them to cover everything that a director should or could do. Therefore:

(a) Fund directors need to ensure that sufficient time is provided to them by the other service providers to enable them to review and analyse all information received.

For example, it is ultimately up to the directors to refuse to accept repeated instances of late deliveries of information packs or board meetings called on short notice to review a large amount of documents.

(b) Fund directors need to ensure that sufficient information is provided to enable them to review and analyse the specific matter being considered. For example, it is ultimately up to the directors whether they accept the description of a trade error by the investment manager without an explanation of the context in which the trade error occurred and a description of the actions taken or to be taken by the investment manager to prevent a recurrence of the same type of error. Fund directors should never hesitate to ask for more information or greater transparency from any service provider.

(c) Fund directors need to ensure that they have sufficient resources to enable them to discharge their duties to the fund. While some directors work within directorship service firms, the level of resources differs from one firm to another. Directors who work as solo practitioners arguably have the least amount of resources to help them in their directorship duties and should keep this in mind when taking on additional appointments. Fund directors should not hesitate to ask the investment manager or sponsor of the fund for additional resources, although in practice such requests may not always be met for perfectly valid practical reasons (i.e. the cost of providing the requested resource).

22.3 Director capacity – The topic of director capacity is probably at the core of any analysis of the director's ability to discharge his duties, whether such analysis takes place before or after the fact. While it is impossible to derive a hard limit of fund directorships that a director may have and still be deemed to have sufficient capacity to serve all his fund boards efficiently and effectively, it is generally agreed that there is a limit above which a director would be acting irresponsibly by taking on additional directorships. Such limit would by necessity be very specific to each director's specific context (based on educational and professional experience, administrative and system support available to the director, fund industry knowledge, size and complexity of the funds, etc.) However, each fund director must be able to defend, usually in hindsight, the number of directorships held at any given time.

22.4 Proportionality – Any sound corporate governance program needs to take into account the concept of proportionality. While all investment funds and management companies should adopt sound corporate governance practices, the principle of proportionality recognizes that funds and management companies with greater resources will be able to do more with respect to corporate governance than those with less resources. However, proportionality cannot provide bright line tests and should not be viewed as an excuse to ignore sound corporate governance practices.

22.5 Compensation – It is generally believed that fund directors are underpaid relatively to the work expected from them and the potential liabilities to which they are exposed. While it is impossible to state a minimum level of compensation for a director, there is a direct correlation between the perceived "value added" provided by the director to the fund and its board and the compensation received by the director – the more value that the directors adds, the better the director is compensated. The moral of the compensation story is that fund directors should demand higher director fees but they need to be prepared to deliver demonstrably more value for those higher fees.

22.6 Training and continuing education – The role of director is not generally accepted as a professional activity. Yet directors need to be knowledgeable in the following areas - asset classes and sectors, portfolio management, risk management, economic analysis, accounting, audit, brokerage and prime brokerage, fund administration, transfer agency, custody, listed and non-listed securities and instruments, credit analysis, regulatory regimes, listing requirements, sales and marketing, distribution, compliance, legal regimes and documentation, transaction management, insurance, employment matters, local and international taxation and analysis, psychology, group dynamics, IT and other systems, data protection, corporate governance and many others. Clearly such a body of knowledge should qualify directors as professionals in their field.

Having said this, it would be impossible to keep up with developments in all of these areas without on-going training. 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.

22.7 Evaluation – Fund boards should encourage individual directors to undergo a periodic self-assessment of their respective performance as fund directors. In addition, a fund board may choose to implement a formal board evaluation program. This could be done by agreeing to standards for self-assessment and then discussing the self-assessments of individual board members with the rest of the board or the Chairman (if privacy is preferred), or the retention of a consultant specializing in board evaluations.

22.8 Networking – The role of director is often described as a lonely one. However, there are many national and international director associations that can provide access to seminars and discussions on specific topics as well as to other directors. Fund directors should reach out to other directors to discuss common issues and topics.

22.9 Helpful advice to fund directors – Ten things for directors **not** to allow to happen to a board[viii]

(a) The board is a mouthpiece for shareholder anxieties;

(b) The board does not know shareholders;

(c) The board doesn't take ownership of the company strategy;

(d) The board does not have a team leader;

(e) The board is not a sparring partner;

(f) The board misjudges the nature and ranking of risks;

(g) The board "disenfranchises" the Chairman/CEO;

(h) The board is a poorly trained team;

(i) The board is dysfunctional;

(j) The board does not play a co-leadership role.

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[i] OECD (2004)
[ii] Bob Trickier (2009:7)
[iii] Current thinking on group dynamics suggests that the ideal board size is 3 to 7 directors.
[iv] This is a growing trend in most fund jurisdictions.
[v] Items (a) through (f) should be the minimum provided in the investment management report.

[vi] Items (g) through (o) could be included as part of the investment management report but many of these items are often provided an individual reports, such as compliance, operations and regulatory reports which are tabled or delivered by service providers other than the investment manager.

[vii] Reputable Jurisdiction is defined in Reg. 2 of the *Prevention of Money Laundering and Funding of Terrorism Regulations* L.N.180/2008 and is the subject of further explanation and guidance in Section 8.1 of the Implementing Procedures Part 1, issued by the Financial Intelligence Analysis Unit.

[viii] Frank Dangeard (2011)

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