

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

**CORPORATE GOVERNANCE MANUAL
FOR
DIRECTORS OF INVESTMENT COMPANIES
AND
COLLECTIVE INVESTMENT SCHEMES**

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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 The board of directors is the fund’s primary decision-making body with collective responsibility for its affairs. 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 the fund's 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 its supervisory or monitoring role. Fund directors need to remember that they are not (normally) executives, much less compliance officers, of the fund and will normally have to delegate or rely on the performance of operational and monitoring functions by the various service providers to the fund. The fund directors need to be satisfied that the delegation is to appropriate service providers, clear about what they have delegated to those service providers and how they are supervising and controlling their 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 investors;
 - (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; attitude towards compliance 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/AIFM agreement;
 - (vi) Any investment advisory agreement;
 - (vii) Administration agreement;
 - (viii) Custody/depositary 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 recommended 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/their appointment.
- 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 may reduce 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 always 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. Other factors which may help to avoid group thinking and encourage independent opinion include a range of age, gender, geographic provenance, and educational and professional background.

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 duties to the fund. A director should 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 generally defined relative to the investment manager or sponsor and other service providers.^{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 (or other service providers to) the fund may sit on a fund board. In their capacity as directors of a fund, directors when nominated by the manager or the sponsor of the fund owe their duties to the fund, not to their employers.

6. BOARD STRUCTURE

6.1 A fund board should appoint a chairman. An independent chairman is often a good idea.

- 6.2 The chairman is responsible for ensuring that the board operates effectively and as a team, for planning and managing the board's business, 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 (although there is no requirement or expectation on this). To the extent that such committees are used, risk, pricing/valuation and audit committees are the most common in the fund context. 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 also 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 or two directors, should be reported 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 PROCEEDINGS

- 7.1 Generally, the board members should actively apply their minds to their supervisory role over management and the fund's operations, ensure that they receive appropriate information for this purpose and gives that information proper consideration. Normally this will involve the board receiving reports on aspects of the fund's affairs and considering them at formal board meetings. The board should meet sufficiently regularly to discharge its duties in this way.
- 7.2 Regular board meetings should be held on at least 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 board meetings at least every quarter.
- 7.3 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).
- 7.4 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.
- 7.5 Notice of meetings should be provided in accordance with the jurisdiction's legal requirements and/or the constitution of the fund.
- 7.6 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 (historic and forward looking);
- (e) Administrator (including anti-money Laundering etc.) report;
- (f) Custodian report;
- (g) Audit report (if applicable for the particular meeting);
- (h) Marketing and investor relations report (including a review of subscriptions and redemptions);
- (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.

7.7 Ad hoc topics would include:

- (a) approval of the fund's offering documents and any changes to the offering documents or other constitutional documents;
- (b) reviewing and signing off the fund's annual report and accounts;
- (c) the exercise of discretionary powers granted to the board under the fund's constitutional documents, such as the acceptance of late subscriptions or the convening of an investors meeting;
- (d) any other exceptional events of significance from a governance point of view.

7.8 It is considered good practice for directors to try to attend all board meetings, whether regular or unscheduled. 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.

7.9 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.

7.10 Board meetings that are not held in person should be held by telephone or video conferencing facility to the extent permitted by the fund's constitution and applicable tax laws etc. In order to increase exposure of board members to each other and to the investment manager or sponsor, telephonic board meetings could, subject to local requirements, involve some members of the board meeting in person to call from one location.

- 7.11 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.
- 7.12 Both an individual director and the board as a whole must make their decisions objectively and in the interests of the fund. While they will frequently act on recommendations or advice from the fund's service providers, they should insist on clear and cogent explanations of those recommendations and each director must exercise his own judgment and form his own views on the relevant matters. A director should not simply rubber-stamp decisions made by others or blindly sign whatever documents are put in front of him without reading them or, if he does read them, without applying his mind to the content.
- 7.13 All board meetings should be minuted so that the reasons behind the board's decisions, as well as the decisions themselves, are documented. It is particularly important to do this in the case of difficult or delicate subjects. If a dissenting view is expressed it too should be minuted. The fact that alternative views are aired, and perhaps rejected by the majority, may provide important evidence to rebut the presumption that the board or a particular director acted unreasonably in pursuing a particular course of action.
- 7.14 The minutes should always be reviewed, including by any directors who were not present. It is good practice for the minutes to be formally adopted at the next board meeting to acknowledge that the whole of the board are happy with the substance of the minutes. Copies of any relevant material either distributed in advance or produced at the meeting and on which opinions and decisions were based, should be referred to in the minutes and kept with them.

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 properly to review its contents. Although circumstances may dictate otherwise, information packs should arrive at least two business days prior to the date of the board meeting.
- 8.3 The information pack should generally 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.
- 8.5 Where, as will normally be the case for a non-UCITS fund, the fund is an Alternative Investment Fund ("AIF") under the Alternative Investment Fund Managers Directive ("AIFMD"), the information pack should also reflect relevant information from the AIFMD regime. An indication of some of the relevant areas is given in the following sections. A more general discussion of AIFMD is included in section 16 below.

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 also 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 multi-manager fund), primary 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; [see also 10.2(c)(viii)]
- (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}

9.4 For funds within AIFMD, the One-off matters AIFM should also report on its handling of relevant AIFMD requirements such as:

- (a) conflict management issues;
- (b) delegation arrangements operated by the AIFM;
- (c) operation of the AIFM's risk management policy in respect of the AIF;
- (d) any leverage issues;
- (e) monitoring of liquidity risk in accordance with the AIFM's liquidity policy for the AIF;
- (f) the operation of the valuation policy and procedures for the AIF.

This would also be a good practice for other funds (in particular, UCITS).

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. (In practice some of this information may be more appropriately provided by another service provider.) 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 or unit;
 - (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) an investor activity report including information on:
 - (i) subscriptions, redemptions and any conversions of shares or units;
 - (ii) number of investors and domiciles;
 - (iii) the largest 5 investors in the fund;
 - (iv) whether any late redemptions occurred and why – late receipt of redemption documents;
 - (v) whether investor statements/contract notes were issued on time (if applicable);
 - (vi) whether any subscription or redemption fees were levied; and
 - (vii) any investor complaints received or handle by the administrator.
- (d) an anti-money money laundering report (see further paragraph 18.5 below).
- (e) 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 Politically Exposed Persons 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;
- (f) any relevant internal audit and/or SSAE 16 (formerly SAS 70) report as may be required;
 - (g) any comments on service level during the period; and
 - (h) 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.

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 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.
- 11.3 Where the custodian is also a depository under the AIFMD or UCITS Directive, more detail may be expected on its discharge of its mandatory functions. These include:
- (a) monitoring the AIF's/UCITS's cash flows, including subscription and redemption payments;
 - (b) verification of the ownership of non-custodied assets such as derivatives and foreign exchange positions;
 - (c) oversight of the sale, issue, re-purchase, redemption, cancellation and valuation of units or shares of the AIF/UCITS, and the remitting of consideration and application of income.
- 11.4 If the depository has itself appointed a key sub-custodian such as a prime broker the board should consider whether they should also receive a separate report from that sub-custodian and if so what matters this should cover.

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 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.

- 12.5 Lastly directors should not blindly sign the ‘management letter’ required (often at the last minute) by the auditors. As process is required to ensure that each representation to be given to the auditors can be given in good faith and with reasonable certainty as to accuracy.

13. CONFLICTS OF INTEREST AND CONFIDENTIALITY

- 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.
- 13.3 At the board level, directors need to consider and whether they have any potential conflict situations, such as a directorship, shareholding or other interest in a business which is a customer or competitor of or service provider to the fund. Any such conflict should be disclosed to the board and dealt with in accordance with the fund’s constitution and applicable law.
- 13.4 A director also owes a duty of confidentiality to the fund of which he is a director, and generally should not utilise confidential information obtained in his capacity as director of company for other purposes, such for as his private benefit or the benefit of an unconnected business. Where the director is also employed by the fund’s investment manager or another fund service provider, in which case a degree of flexibility in this principle is likely to be agreed or understood.

14. REGULATION AND CODES OF CONDUCT

- 14.1 The board should be aware of the regulatory regime within which the fund operates and understand how this impinges on its operations. Some regulation, such as local fund licensing requirements or European Market Infrastructure Regulation (“EMIR”) will apply to the fund directly. In other cases regulation may apply indirectly through requirements imposed on the fund’s service providers. This is particularly so in AIFMD and is discussed further in this context in section 16 below.
- 14.2 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.
- 14.3 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. INVESTOR COMMUNICATIONS

- 15.1 A board must ensure that all investors receive all legally required communications and appropriate disclosures.
- 15.2 A board should obtain confirmation from the investment manager and/or the administrator that all such communications and disclosures have been provided.

16. THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (“AIFMD”)

- 16.1 Under the AIFMD each EU-based AIF which is not a UCITS must have an EU-authorized AIFM, which must ensure that a series of obligations are met in relation to the way the AIF is operated.
- 16.2 If the AIF is self-managed it will be its own AIFM and the AIFMD requirements will apply directly to it. As such it will be the direct responsibility of the fund board to establish, in conjunction with its manager or sponsor, how these requirements will be met, for example by adding additional staff and resources.
- 16.3 Where the AIF has an external AIFM (typically the manager or investment manager) that AIFM will need to liaise with the directors to establish how it will meet the requirements and what cooperative and other arrangements with the board will be needed to achieve this.
- 16.4 In cases where both the board and the AIFM have legal responsibility for a particular matter, such as valuation, it will be particularly important to establish how this will be managed so as not to put the board in breach of its duties under the fund’s constitution and local law or the AIFM in breach of its duties under the AIFMD.
- 16.5 In other cases, the board may need to establish the extent to which it will delegate responsibility to the AIFM, or involve itself in the process. This may include reviewing and approving the proposed arrangements, appointing external service providers directly rather than via the agency of the AIFM, and agreeing a level of ongoing reporting in relation to the relevant arrangements. An example of a matter which merits the direct involvement of the board is the appointment of the AIF’s depositary. A matter where the board could be expected to want ongoing reporting is the operation of the AIFM’s risk management policies and procedures in relation to the AIF.
- 16.6 Similar considerations arise as a matter of good practice in respect of the relationship between the board of a UCITS fund and its external management company.

17. EUROPEAN MARKET INFRASTRUCTURE REGULATION (“EMIR”)

- 17.1 If the fund deals in derivatives it will come within the scope of EMIR which applies requirements on risk mitigation, reporting and clearing to transactions in derivatives. EMIR’s requirements apply directly to the fund itself, as the principal party to such transactions, rather than to the fund’s investment manager acting on behalf of the fund.
- 17.2 The board will need to establish to what extent EMIR applies to the fund and what arrangements are to be put in place to meet EMIR’s requirements. As part of this it will need to establish the fund’s status under EMIR. In practice, a fund established in Malta is likely to be classified as a financial counterparty, meaning that it will be subject to all the requirements of the regime.
- 17.3 The board will need to appoint a service provider to ensure the fund’s day to day compliance with the EMIR requirements. This is likely to be the investment manager who enters into the actual transactions on the fund’s behalf, but other arrangements are possible. The fund should agree the terms on which this service will be provided to it and the level of ongoing reporting it will receive from the service provider.

18. ANTI-MONEY LAUNDERING AND COMBATING FINANCING OF TERRORISM

- 18.1 Investment funds marketing their units or shares are subject to anti-money laundering and combating financing of terrorism (“AML/CFT”) legislation. All funds 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 applicable AML/CFT legislation and requirements.
- 18.2 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.
- 18.3 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.
- 18.4 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.
- 18.5 The fund should receive from the administrator a periodic report (see paragraph 10.2(d) above), at least once a quarter, containing a description of the customer due diligence (CDD) measures carried out by the administrator on the fund’s investors, particularly in relation to any new investors. The report should be signed by the MLRO or other appropriate officer 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 satisfy itself 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.
- 18.6 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 MFSA.

19. INDEMNITY AND INSURANCE

- 19.1 Fund directors will generally be indemnified by a fund to the full extent permitted by law and subject to standard carve-outs for (gross) negligence, wilful misconduct and fraud and, on occasion, for gross negligence.
- 19.2 Fund directors may also be covered by directors and officers (“D&O”) insurance. The terms and amount of a policy are beyond the scope of this Manual.

- 19.3 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 may set a level of assets under management above which the fund will be required to obtain D&O insurance.

20. ADVISORS TO THE BOARD

- 20.1 Normally in the fund industry outside advisors (i.e. legal counsel, auditors, valuation agents, compliance and other consultants) are appointed or directed by 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 or directed 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 and should not hesitate to exercise this right if they believe it to be prudent to do so.

21. CRISIS MANAGEMENT

- 21.1 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, ineffective or out of control; and
- (m) Investigation of or litigation against the fund or the investment manager or sponsor.

- 21.2 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.

- 21.3 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.
- 21.4 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.
- 21.5 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.

22. RESIGNATION BY A DIRECTOR

- 22.1 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 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.
- 22.2 The decision whether to resign from a fund board is highly personal and depends on the particular circumstances of the fund. A problem should be confronted and, if possible, resolved before a director considers resignation. 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 or to make his or her views known to relevant persons including the MFSA.

23. TERMINATION OF A FUND

- 23.1 Appropriateness of termination of a fund depends entirely on the specific context of a fund.

However, a number of common elements are generally present in fund terminations:

- (a) Consideration of critical means and viability;
- (b) Lack of viability of the fund’s chosen investment objective and/or process;
- (c) Assessment of the fund’s solvency and ability to operate as a going concern (if applicable);

- (d) Assessment of the portfolio's liquidity;
- (e) Realization of the portfolio into cash;
- (f) Final accrual of all recurring expenses;
- (g) Reserves created for any one-off expenses related to termination;
- (h) Sign off by auditors or liquidation audit (if applicable);
- (i) Identification and discharge of any remaining liabilities including final payment to any creditors and statutory agencies or regulator if applicable;
- (j) Distribution of cash to investors including any claw-backs;
- (k) Distribution of any illiquid assets to investors or creation of specific structures to house such investments;
- (l) Termination of all service provider agreements;
- (m) Formalities for liquidation of the corporate entity under local law including appointment of liquidator or strike off (as applicable); and
- (n) Discharge of directors (if applicable).

23.2 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.

24. ISSUES COMMON TO ALL DIRECTORS

24.1 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.

24.2 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).
- 24.3 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.
- 24.4 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.
- 24.5 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.
- 24.6 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.

- 24.7 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.
- 24.8 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.

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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 in 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.