

Coping with new corporate governance challenges

The Madoff scandal has proved a devastating blow for the fund industry both in Ireland and internationally. Directors of funds are faced with redemptions and other challenges including the valuation of illiquid assets. Kevin O'Doherty says how funds respond with these difficulties will attest to the quality of the Irish regulated financial product in the international marketplace. He says, the investment vehicles that are proven to function in times of adversity may prove more attractive than ever before.

While a rising tide may have once lifted all boats, a receding tide has exposed some ugly wreckage. Irish newspapers have had plenty to write about in the last year as previously-respected solicitors were exposed as multiple mortgaging properties and investment advisors seemingly promoted pyramid schemes as 'ground floor' investment opportunities for well-heeled marks who thought themselves friends and key contacts. The issue of director loans disclosures at Anglo Irish Bank arguably diminished the standing of the Irish banks in the capital markets generally as well as reducing Anglo's own chances of survival outside state ownership.

A sense of public bewilderment at such events has led to the issues of financial regulation and corporate governance being unexpectedly thrust to the fore of general debate in Ireland. However, such issues are not confined to the domestic business sector. Turbulent events elsewhere have affected business in the offshore sector in ways never previously contemplated. The recent claims in the Commercial Court by Thema International Fund plc and separately by AA (Alternative Advantage) plc against HSBC Security Services (Ireland) Ltd and sister company HSBC Institutional Trust Services (Ireland) Ltd have definitively brought the Madoff collapse on to Irish shores. These funds have been joined more recently by Fortis Prime Fund Solutions Custodial Services (Ireland) Ltd making a separate, unrelated claim against the first of these HSBC entities, again related to the Madoff collapse.

Hedge funds themselves have featured in the past as vehicles for fraudulent practices as Lancer Group, Manhattan Investment Fund and the Bayou group of funds have proven in their own moments of infamy. However, the scale of the collapse of Bernard L. Madoff Investment Securities LLC may prove the most extreme example of investor fraud yet and creates several



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interesting problems for the Irish funds, the service providers and their various board directors caught up in the issue.

The use of the legal doctrine of fraudulent conveyance in U.S. bankruptcy proceedings might mean that investors who withdrew their money before the fraud was revealed might be forced to return their profits or even part of their initial investment capital. Returning funds would be uncontroversial for clients who knew that Madoff's business was fraudulent, but would not be so clear for genuine investor clients who were unaware of Madoff's activities and may have successfully withdrawn their investment. If such investing clients were funds which received the redemption proceeds in good faith and perhaps distributed them to their own

exiting investors, the scope for unfortunate consequences and recrimination is obvious.

There is a significant corporate governance challenge posed by events such as these. While trading companies will always monitor counterparty risk and seek to limit exposures, investment entities such as funds operate to a fundamentally different model and may purposefully have significant direct or indirect counterparty risk. Trading entities will have significant internal resources that the board can call upon to assist them in their deliberations, while a fund vehicle's board will be reliant on third party service providers for many critical business processes.

In addition, the directors of a fund vehicle may be comprised of executives from the investment manager and the fund administrator, with independent non-executive directors forming a minority, if any are appointed at all. What appeared at first to be a sensible cost-saving measure is now throwing up significant governance issues, both for the fund involved and for the service providers. In a situation where the directors are drawn from interested parties, whose interests may not be perfectly aligned with the interests of the fund company itself, there is scope for difficulties to emerge.

For example, under Irish law whether the purpose of a company is to serve as an investment vehicle or not is irrelevant it is still bound by the concepts of the law applicable to all corporate entities. The directors are bound to exercise their powers in good faith and in the best interests of the company as a whole. The directors have a duty to exercise the utmost skill, diligence and care, to avoid conflicts of interest with the company and not to make an undisclosed profit from activities concerning the company.

In the instance where it is in the interest of the fund company to dismiss an investment manager which may have sponsored the fund vehicle or to litigate against a service provider, either of

whom may have provided serving executives to act as directors, the directors in question may have difficulty in demonstrating they are properly fulfilling their required duties of care. As they struggle to serve two masters, they may owe a legal duty of care to both fund and service provider, but be of little practical assistance to either because of the need to excuse themselves from deliberations regarding the other entity.

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This is a minor issue however beside the question of the directors being able to demonstrate in an objective verifiable manner that they are carrying out their legal obligations and are not being negligent in their actions. The losses that some investors have incurred are more than adequate to overcome any initial reluctance to indulge in the cost and uncertainty of litigation.

Where directors are serving at the request of their employer and do not gain any personal remuneration for the position, there may be additional questions to be asked regarding directors and officers liability insurance. It has only become commonplace in recent years for investment vehicles to be explicitly requested to arrange insurance cover for independent directors and directors nominated by service providers. Where the investment vehicle has not put such insurance in place itself, are directors covered by their employer's insurance or do they fall foul of a standard exclusion for serving as a director or officer of another entity? Where the employer's insurance coverage does include nominated directorships, has the director kept the schedule of directorships of which the insurer is informed of up to date?

It might be expected that recent litigation in this area may see a re-appraisal of the advisability of

employees serving as client fund directors at the request of fund service providers. Investment disputes are not the only area which cause concerns for the boards of regulated investment vehicles. Current market turmoil has caused difficulty for the valuation of thinly-traded or illiquid investments. This in turn creates issues for accurately determining the net asset value of funds. The importance of achieving an accurate valuation for portfolio investments is magnified where the fund is to process subscriptions or redemptions at the calculated net asset value. Any material under or over valuation would result in an unwarranted transfer of value between groups of investors.

More importantly, where investments have become hard to realise, the temptation is to realise the more liquid investments from the portfolio to raise the cash needed to pay redemptions. This leaves the remaining invested shareholders holding a more volatile, less balanced portfolio of investments that may or may not achieve their ascribed value when eventually liquidated. One way around this is to effectively split the fund into two (or more) segments pro rata for all investors, placing the less liquid investments in a side pocket which will pay out the actual values achieved when realised. While this runs counter to the concept of open-ended redemptions, that concept has always been reliant on the portfolio consisting of readily realisable liquid securities. As such side pockets are an equitable if inelegant solution to the problem of preserving equity between divergent groups of investors. The disadvantage however is that departing investors are unable to promptly divest themselves of their holdings that they may have legitimately expected could be redeemed upon demand and paid out to them in cash.

The decision to create a side pocket is not one that should be taken lightly by a board of directors, as it may represent a material variation of the terms on which an investor subscribed to the fund. The preservation of a degree of liquidity for those wishing to redeem while maintaining equity between them and remaining shareholders is a difficult balance to strike, the quality of which the directors may ultimately find themselves held accountable for in a court of law.

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pockets and wouldn't impose a maximum percentage of assets that can be allocated to a side pocket or otherwise restricted in terms of redemption capability in the case of Professional and Qualifying Investor Funds. The Financial Regulator has stated that it remains the responsibility of the board of directors, in conjunction with the fund's trustee, to ensure that the proposed arrangements take into account the interests of all investors and is in accordance with the fund rules. It could be argued that any imposition of side pockets or gate limits on redemptions which is in accordance with existing published fund documentation is not a material change in arrangements, but frustrated investors may have a different perspective, particularly if they are in possession of side letters promising them alternative treatments.

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Again, this places particular focus on the responsibilities of directors to discharge their legal responsibilities to the company in its best interests, in an objective demonstrable fashion, rather than favouring an individual connected party or investor.

It is issues of this sort that pose a significant challenge for the Irish financial services industry, in particular for those who serve on boards of directors, in a time of adversity. However, if affected boards can adequately demonstrate ability to deal with issues of this nature, it will attest to the quality of the Irish regulated financial product in the international marketplace as a seasoned offering that offers tested protective qualities for investors. As we seek to invent new products to market internationally, investment vehicles that are proven to function in times of adversity may prove more attractive than ever before.

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