

FUND GOVERNANCE PRACTICE

Recent years have seen increased focus on the composition and activities of investment fund boards. The Irish Funds Industry Association has issued a draft corporate governance code for the investment funds industry. While the code is intended to be voluntary it is unlikely that many funds will wish to fail to comply with such a code. Similar codes are being developed in Guernsey and at an EU level.

KB Associates, which provides both directors and consulting services to funds across a range of jurisdictions, recently completed an exercise to look at fund governance practice. The focus was on the requirements and views of asset managers/fund promoters which assume responsibility for appointing the initial directors to fund boards. The key findings are outlined below.

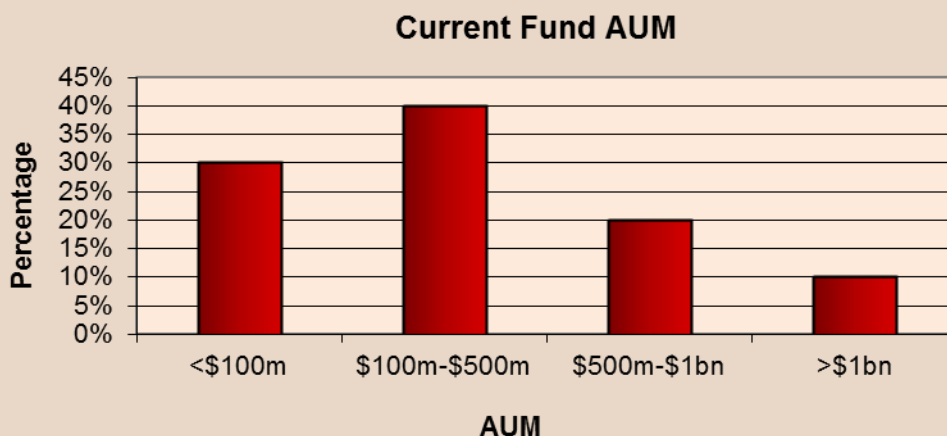
Scope

KBA conducted interviews with forty asset managers. Managers were based principally in the UK (40%) and Europe* (40%). Other managers participating were based in USA, Hong Kong and Australia. The managers had established funds primarily in Ireland (77%) and Cayman Islands (13%) though funds had also been established in Bermuda, Luxembourg and Mauritius. Each manager responded in respect of the largest offshore fund (AUM) for which it was responsible.

A number of the funds had been established as far back as 1993 though a majority had been created in the past five years. Both UCITS (55%) and non-UCITS (45%) were captured by the survey.

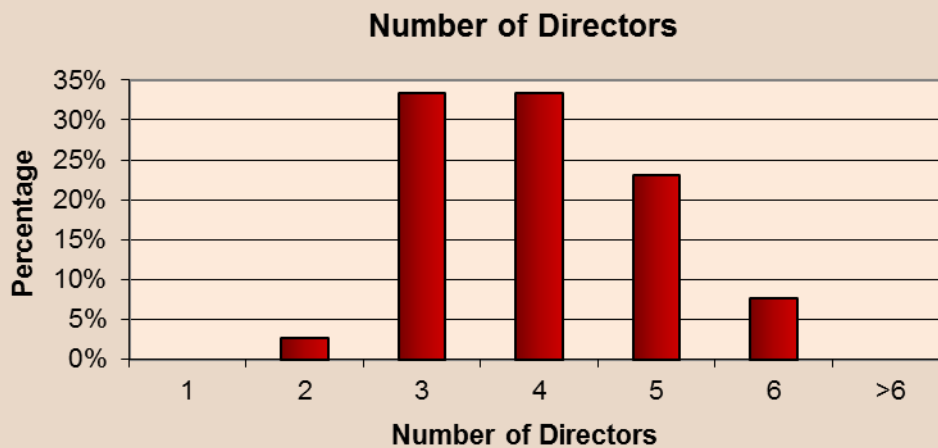
Fund AUM ranged from less than \$100m to in excess of \$1bn with 40% of funds considered falling in the range of \$100m to \$500m.

The Funds were designed primarily for distribution to European* (50%) and UK (27%) investors.

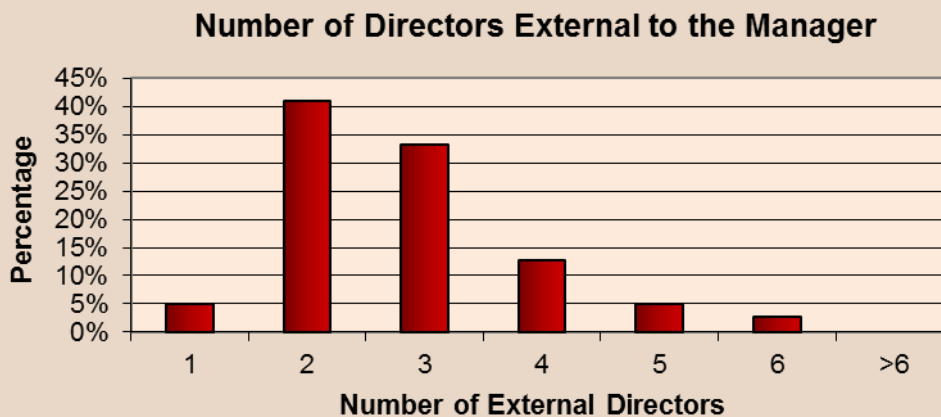


Board Composition

As the new fund governance code proposed for Ireland recommends at least three directors it is interesting to note that virtually all funds (90%) operated with between three and five directors. Only one fund, which was Cayman based, operated with just two directors.



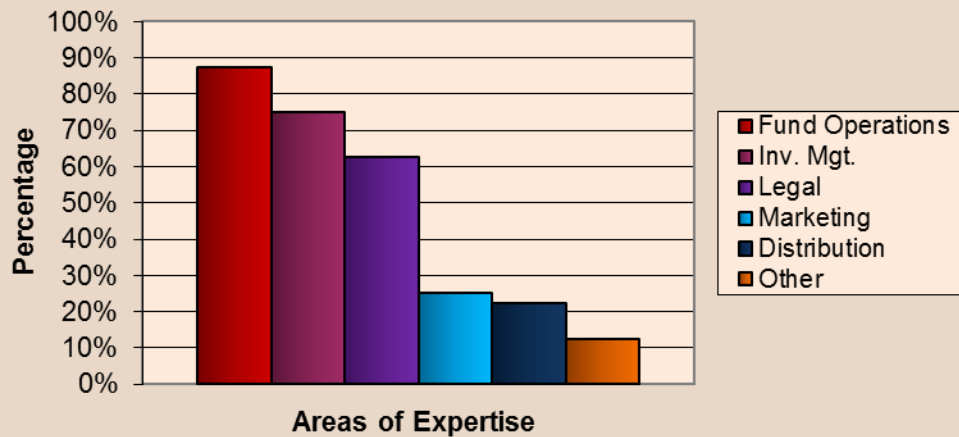
Given the requirement for two Irish resident directors and the significant number of Ireland domiciled funds participating in the exercise it is noteworthy that a majority of the funds (54%) had boards with three or more, not just two, directors who were independent of the asset manager. Those funds with just one independent director were all established outside of Europe.



Board Expertise

Increasingly we are told that Boards require directors to bring a range of complementary skills. This view is supported by the expertise we now see on fund boards. Boards' external directors normally possess specific expertise in fund operations i.e. fund administration and custody (87%), investment management (75%) and legal (62%). Less common are boards with marketing or distribution expertise, only about 25% of boards claim to have expertise in these areas.

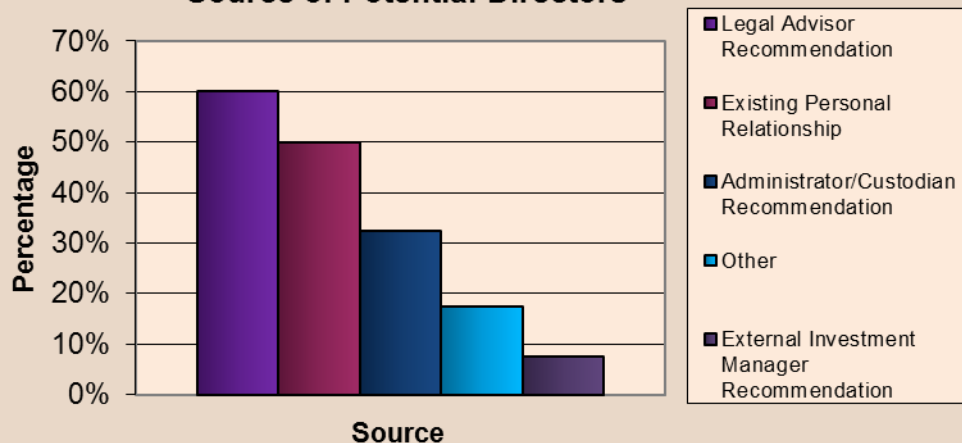
Areas of Expertise of External Directors



Identification of Potential Directors

Managers identified two key sources upon which they rely when identifying potential directors, i.e. legal advisors and administrators/custodians. Existing personal relationships are also very important with half of managers surveyed relying on such relationships to identify external directors.

Source of Potential Directors



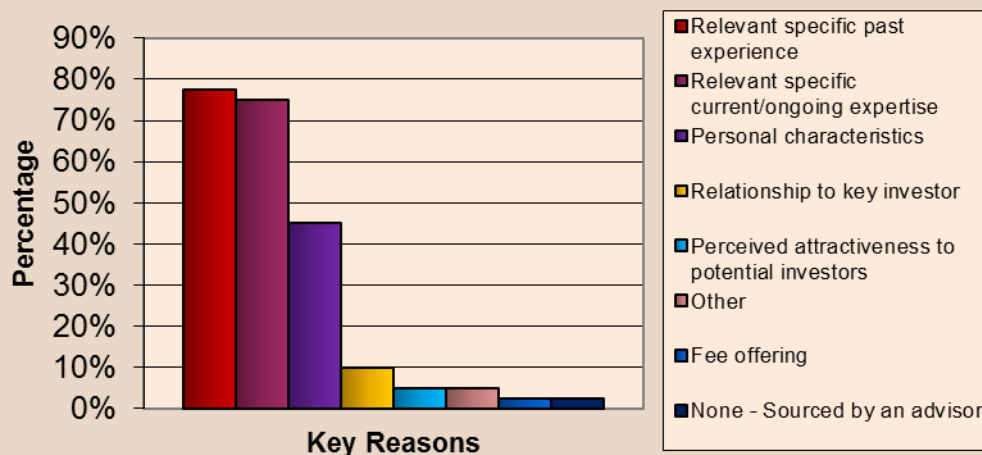
Appointment of Directors

The main factor managers noted as important when appointing directors was relevant experience. Past and/or present experience was mentioned by 75% of managers. Something that should not be overlooked however is the fact that personal characteristics were identified as a key factor by 45% of managers. In contrast perceived attractiveness to potential investors was mentioned by only 5% of managers.

Only one manager identified fees as a factor in deciding which directors to appoint.

A majority of managers (57.5%) conducted formal interviews prior to appointing fund directors.

Key Reasons for Appointing Directors

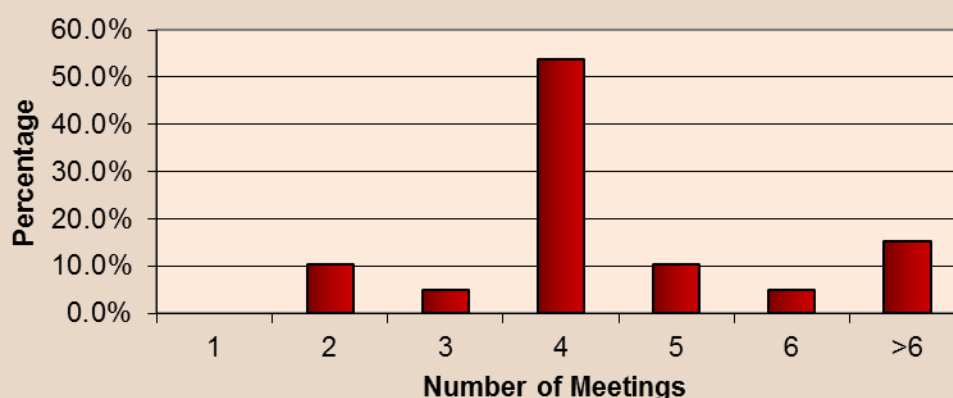


Board Meeting Frequency

A majority of fund boards meet four times per annum with only a small number (15%) meeting less regularly. Again it is noteworthy that, with one exception, the fund boards meeting three times or less per annum were all domiciled outside of Ireland.

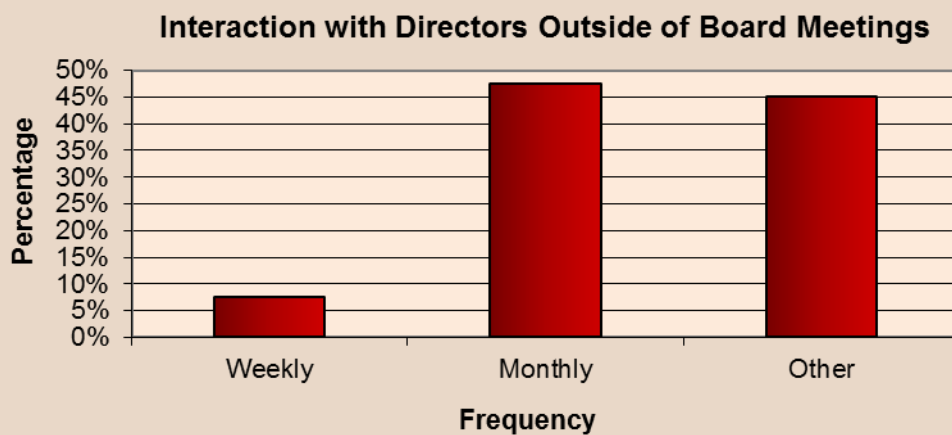
Perhaps surprisingly 30% of boards met more than four times each year with 15% of funds meeting more than six times per annum.

Number of Meetings Per Annum



Manager, Director Interaction

Directors are increasingly required to address fund issues outside of regular scheduled board meetings. A majority (55%) of managers noted that they interact with directors at least monthly. All participants noted some interaction with directors outside of board meetings.



Directors and Investor Due Diligence

A significant number of managers, over 40%, indicated that potential investors had requested information on directors as part of the pre investment due diligence process. While in most instances direct interaction between potential investors and directors did not take place in a meaningful minority of instances (12.5%) direct contact between potential investors and directors occurred.

KBA Observations

- ▶ In considering the above findings it is important to bear in mind the UK/European focus in terms of fund domicile, asset manager location and targeted investors. Our experience has been that US managers operating hedge funds in non-European jurisdictions will tend to place less emphasis on the role of fund boards as part of the overall fund governance structure. Notwithstanding the small number of non-European funds included in this exercise the results noted above, particularly in terms of board composition and meeting frequency, support our experience.

- ▶ The increasing use of structured interviews as part of the director selection process, the wide range of different skill-sets that most fund boards now possess and the increased interaction between managers and directors outside of scheduled board meetings, while not surprising, are all welcome developments as fund boards play an increasingly important role.

- ▶ It is sometimes suggested that boards' independent directors rarely possess investment management expertise. With three quarters of funds having independent directors with investment management expertise it appears that this is not the case. It is also often suggested that fees are a critical factor in the appointing of directors. Our experience at KBA has been that director fees are rarely, if ever, a decisive factor in the selection of fund directors. The results of this survey support that view. Again we believe that the existence of investment management expertise at fund board level and the relative unimportance of fees in the selection of directors are positive findings which indicate that managers are genuinely focussed on assembling fund boards that best serve investors' interests.

- ▶ One surprising finding is that only two managers identified "perceived attractiveness to potential investors" as a factor when appointing directors yet sixteen managers noted that investors had requested information on directors as part of a pre investment due diligence process. As investors' due diligence becomes increasingly thorough and more potential investors actually wish to speak with independent fund directors prior to making an investment we anticipate that managers will in the coming years place greater emphasis on the "perceived attractiveness to potential investors" of fund directors.

KB Associates will continue to monitor fund governance developments. We await with interest the finalisation of fund governance codes in various European jurisdictions.