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SOME OBSERVATIONS ON THE CHANGES OF RESPONSIBILITIES OF FUND DIRECTORS AT TIME OF FINANCIAL CRISIS

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For many months, Luxembourg has been perceived as relatively immune from the surrounding financial crisis. While financial assets were being redeemed dramatically in many European countries as early as 2006, Luxembourg was still picking up new funds flows as recently as in September 2008. In fact, when analyzed deeper, Luxembourg was facing an usual phenomenon of "leads-and-lags" rather than a so-called economic "micro-climate" stemming from singular virtues: in fact, Luxembourg funds started being also affected by the market crisis as early as in June 2006 when the growth rate of net subscription started to decline from a high point close to 20% per annum. Market effect started taking their accelerating toll from December 2007 and most importantly, net annual new fund flows became negative for the first time in years from October 2008.

Then beyond powerful financial and credit market movements, the occurrence of other major financial events significantly shifted the working and judgmental frameworks of all fund professionals in Luxembourg namely the failure or the degradation of several large bank and financial counterparties followed by the Madoff affair, a massive and global fraud threatening the wealth, the pride and the trust of many investors and professionals.

This article does not aim at analyzing the current financial crisis, nor does it ambition to answer the key question of the economic and social utility of fund governance in time of crisis. Before daring to do so, one should be convinced that the crisis is "*behind us*" and that the effective contribution of fund governance to its resolution could be made, analyzed and understood. It would be also too early to draw any meaningful conclusion on what governance factors have made individual fund companies more or less resilient to the crisis. At this stage, thus, I simply propose to gather some conceptual and practical observations made in my position as an independent directors sitting on a diversified number of fund and company boards.

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On the duties of funds boards.
On the balance of regulation and governance in Europe.

Before all, let us get back to some fundamentals by reminding us of what are the duties of directors. From the 1999 OECD "Principles of Corporate Governance", the duties of the board of directors of companies should generally include [i] the **strategic guidance** of the company, [ii] the effective **monitoring** of the management and [iii] the **accountability** and loyalty to the company and the

shareholders. From further works of the OECD and from different IOSCO reports[1], one may add that in the case of fund investment and/or management companies, the nature of the collective investment activities calls for [iv] particular care in the identification and resolution of **conflicts of interest**. Finally, we would all agree that particularly in time of crisis, board directors should be collectively providing to the management [v] their **experience** and **judgment** in helping the company facing the unexpected.

Over the last decade, hundreds corporate governance initiatives were introduced all across countries and sectors for the purpose of sustaining economic development without overreliance on hard law and financial regulation, but rather on self-regulatory and governance initiatives. This **strategic balance between regulation and governance** is epitomized by the EU Action Plan for Modernizing Company Law and Enhancing Corporate Governance adopted in 2004. The plan has dealt with a wide variety of issues such as company mergers, transfer of seat, shareholders rights, directors remunerations, independent directorship and audit while at the same time calling for governance initiative from market participants. The scope and application of the EU body of CG laws does not cover all European companies. Rather it depends on criteria such as public listing or being a "public interest" company such as bank or insurance company. Unique among all economic sectors, the fund industry has negotiated with the European Commission a large number of "carve-out" exempting investment and management companies from the application of major corporate governance EU directives on the two grounds that (i) funds had had their own set of specific EU regulations that have proven to be effective enough and that (ii) funds that had adopted the form of company did so by convenience only while being in fact mere investment products of financial institutions. There should be no surprise then that in several European countries, form has been privileged over substance and governance of investment fund companies. In other countries like Italy and Germany, hard law have had to be adopted to impose on the market norms of composition and functioning of fund investment company boards looking more and more similar to those applicable to public listed companies, including the presence of independent board member[s] and the necessity of constituting audit, remuneration and nomination committees. But again, there is no single best solution in the delicate balance between state regulation and market self-regulation.

But let us now examine how fund board have been evolving in Luxembourg. I would identify four periods typified by their agendas, from extensive agenda in the pioneering years of the fund industry, then to a second period during which many fund companies simplifying their governance process into mere statutory agendas, then followed by a third period of growing governance awareness and adoption of substantive oversight agendas, to the current crisis period.

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[1] As reminder, IOSCO 2005 report on governance stated that Collective Investment Schemes [CIS] governance is *"a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated efficiently and exclusively in the interest of CIS investors, and not in the interest of CIS insiders".*

On the evolution of fund boards in Luxembourg.

In the **early days** of the fund industry [early to mid 80's] in Luxembourg, the board was a vital component of the design and strategy of any fund. Board members were carefully selected for their potential contribution to the board, including to the placement of the fund shares/units. The chair of the board was reserved a high-ranking executive of the investment business line. Board packs were well documented with **extensive agendas**. Meetings were held in chosen places and well attended. This did not represent any major execution difficulties since the whole Luxembourg fund industry was then counting a few hundred units weighing the equivalent of a few billions Euro. This state of governance virtue became harder and harder to be respected as the fund industry had to face new major challenges, such as (i) managing capacity demand growth at annual compounded growth rate of 30% to 50% for more than a decade, (ii) facing increased fund competition from internal and external sources, (iii) dealing with the emergence of third party service providers competing on administrative cost and delivery and (iv) being influenced by the business model of domiciliary companies traditionally providing lighter services to private wealth structures. Those governance simplification trends were not offset by regulatory initiatives, not even EU UCITS III directive that only dealt laterally with some elements of fund board governance.

So progressively, over the prosperous years of **the nineties** and with a few notable and historical exceptions, many Luxembourg fund boards became themselves lighter and lighter . They devoted their time and duties among an exploding number of corporate entities handling the incompressible elements of fund board **statutory agenda** such as approval of accounts, dividends and major corporate events. Circular resolutions were more and more utilized. To improve their competitive standing, depositary banks started proposing to handle all matters including the providing of fund investment directors. To make matters more complicated still, some depositary banks were brought to accept to act as co-promoters of fund investment companies or as providers of third-party management companies solutions. As a consequence, some related fund boards became populated with a majority of members representing the depositary bank creating an enhanced liability of the depositary but weakening the effective competence and role of the board of directors.

The **third phase** of development of fund governance in Luxembourg started from the time of the Enron and Parmalat scandals [2001-2002]. Then political and business leaders became more aware of the importance of corporate governance mainly on public listed companies. In Luxembourg, several initiatives were taken, including the adoption by the Stock Exchange of Luxembourg of its principles of corporate governance for listed companies and the creation of the Luxembourg Institute of Directors. In parallel, market pressures mainly exercised by institutional investors and by the financial press stimulated the transformation of a significant number of fund boards from pure compliance with statutory obligations towards more and more professional "oversight" mission while the UCITS III Directive created a new breed of fund professionals: the "conducting persons" often elected as board members. Independent directors from Luxembourg and abroad were recruited. Specialized companies were created for the purpose of providing both directors and conducting persons with optimal resources, preparation and documentation. Typical agenda would cover not only statutory items but indeed all relevant management issues, A typical **professional agenda** would include items such as (i) investment management report, (ii) performance review, (iii) sales, distribution and marketing reports, (iv) product management, (v) operations including valuation, (vi) transactions and counterparty risks, (vii) risk management report: financial, operational, counterparty, reputational,

…risks, (viii) legal and compliance report, (ix) internal control and (x) audit. Over those years, four surveys of fund governance have been carried out in Luxembourg among European cross-border fund leaders. They demonstrated significant change towards more substantive fund board activities.

Finally, the current and **fourth** phase of development of fund governance and practice in Luxembourg can be clearly identified as a consequence of the current market crisis. Fund board were called not only to handle statutory and professional agendas as described above but mostly to handle **market crisis agenda.** This situation led to many changes in the way fund board are held. Seasonal boards (often quarterly) are complemented by 24 hours notice boards. Physical venues of meetings are proving to be no longer feasible, especially among directors coming from several continents. Rather board meeting are held mostly by conference calls. Issue at hand being of such vital importance, meetings are better attended and the tone of discussion is now more vibrant. The usual thick board documentation is often replaced by thinner reports often of high technical or legal complexity. The time for board preparation that has traditionally been of a few days (including a week-end) is now much shorter. Facts and documents are often presented at last minutes. Under those circumstances, the leadership of the chairman has become even more important than before to ensure informed and collective board decision making.

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What could be the consequences of the current crisis on fund board in Luxembourg?

As stated earlier, it is too early to draw any conclusion on the consequences of the current market crisis on the fund governance practices in Luxembourg. Professional associations have just called on task forces to discuss those questions and frame durable solutions. Yet on a personal basis, I would dare to share a few thoughts. On the composition and functioning of fund board, I am already observing in the Luxembourg market a much greater awareness that directors' responsibilities are necessarily equating to directors' liabilities and that liabilities must be properly understood and formally covered. In particular, the liabilities of the chairman will emerge from the crisis as not being equal to the one of other directors. Similarly, one observes that there is a new market understanding that if the majority of seats in a board may secure voting power [although seldom used], it also leads to a considerably increased global liability in case of failure. I also think that generally and for avoidance of conflicts of interests, most institutional services providers of international stature will adopt internal procedures banning company executives to be elected to boards of serviced fund clients. This would be particularly applicable to depositary banks and consulting firms.

Those elements could lead to a redesign of funds governance structure ensuring a better segregation of duties between investment management and depositary in order to ensure a clearer interpretation of the forms and spirit of EC regulations, including UCITS III as it relates to conflicts of interest. They could also lead to better convergence of the company governance and regulatory frameworks of fund investment and management companies, affecting the relationship between members of the board of directors and UCITS III conducting persons.