

The changing corporate governance scene in Ireland for offshore financial services

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ABSTRACT

Ireland has risen in prominence as a domicile for offshore financial products in recent years. The Irish Financial Regulator has adopted a principles-based approach that enables firms to install control environments tailored to their particular circumstances, but which, accordingly, placed greater importance on the proper corporate governance of such entities. This system

demonstrates great resilience in practice, as shown by a sectoral examination of Irish mutual funds. In addition to the Financial Regulator's regulations, such vehicles have a wide body of Irish corporate law on which they can rely.

Keywords: Ireland, corporate governance, principles-based regulation, Fit and Proper Requirements, individual questionnaire, outsourcing, Undertakings for Collective Investment in Transferable Securities (UCITS), UCITS management company, compliance, governance, non-executive director (NED), restriction, disqualification

BACKGROUND

In recent years, the Republic of Ireland has successfully positioned itself as an international financial services centre, leveraging off environmental advantages — for example, a well-educated workforce, low corporate taxation, a stable government — to develop a significant market share in certain market sectors, such as mutual fund and hedge fund servicing, aircraft leasing and reinsurance.

One spin-off from this activity has been a significant upsurge in the number of Irish-domiciled corporate entities related

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to international financial services activity. As a result of this increase, the Irish Financial Regulator has taken a number of steps to impose a regime of principles-based regulation so as to simplify the process of financial services regulation and to provide suitable flexibility for firms to develop appropriate self-regulating mechanisms. Key to such efforts is the ability of the regulated firm's board of directors to set the compliance agenda.

The Financial Regulator has identified strong corporate governance cultures as the key to developing this process and it has invested considerable effort in framing requirements designed to produce suitable results in this area. The first area of consideration is the capability and probity of persons recruited to serve as directors and senior management. The Financial Regulator published its Fit and Proper Requirements in November 2006 and revised them slightly in April 2008. As the Regulator states:

The fitness and probity regime primarily fulfils a gatekeeper role in ensuring that entrants to the key approved positions at board level and senior management level are taken up by people of competence and integrity.¹

FITNESS AND PROBITY

The Fit and Proper Requirements operate on two levels. Applicants for board or senior management positions must obtain approval from the Financial Regulator, which involves the provision of personal background information and references. Firms applying for authorisation must supply '*sufficient information in respect of all directors to enable the Financial Regulator to be satisfied that they have appropriate expertise and are of good reputation*'.

This is achieved through extensive dis-

closure — a firm applying for authorisation must describe, in its business plan, its intended directors and senior management, and must also set out the role to be played by each in its operations.² The applicants for their part are required to complete an individual questionnaire and provide a detailed curriculum vitae (CV). The individual questionnaire contains an extensive series of attestations regarding the applicant's good character — for example, no unspent convictions, no court-imposed disqualifications, no previous refusals to authorise for a regulated activity, etc.

Importantly, the firm involved must also endorse the applicant. This is part of the Financial Regulator's principles-based approach, under which the existence of a strong governance and control culture enables the Financial Regulator to place a degree of reliance on the appointing firm's own investigations.

As the Fit and Proper Requirements put it:

The appointing firm is best placed to judge whether an individual has the competence, experience and ability to understand the technical requirements of the business, the inherent risks and the management processes required to conduct the operations of the firm effectively.³

The Financial Regulator does not set out explicit prescriptive provisions regarding the capabilities and prior experience of the directors. This is what is logically to be expected under a principles-based regime. Broad attributes under which candidates should be assessed by the appointing firm are, however, set out, as follows:

- honesty, integrity, fairness, ethical behaviour;

- financial soundness;
- convictions;
- tax compliance.

Accordingly, the appointing firm is expected to have developed recruitment and selection procedures that will properly examine and screen candidates. In particular, the appointing firm is expected to verify independently the information provided by the applicant. Taken together with a final right of approval by the Financial Regulator, this provides a system of checks and balances that is designed to admit only those capable of operating in and supportive of a regulated environment. This philosophy extends beyond the initial approval process. The Financial Regulator has clearly stated an expectation that applicant firms will foster a system that supports continuing adherence to the values underlying probity. Firms are stated to have a responsibility to adopt policies and procedures that detect instances in which ethical behaviour is under threat.⁴ Mindful of prominent corporate governance examples elsewhere, the Financial Regulator expects firms to have systems that will detect instances of unethical behaviour and that will support those who stand up for ethical behaviour within the firm. In practice, however, this latter expectation may be more difficult to effect.

FORM AND SUBSTANCE

The effect of these requirements and expectations has been to increase the governance apparatus within the regulated firm, from the board of directors down. Previously — particularly in firms that existed solely as ‘packaging’ vehicles, such as mutual funds and securitisations vehicles — there was a tendency for the board of directors to place almost complete reliance on external serv-

ice providers. Increased standards over recent years have seen such unquestioning reliance reduced. While the external service provider continues to carry out the role of management and provide appropriate staffing effectively, its reporting to the board is increasingly augmented by a feedback and control mechanism, such as mapping achieved performance against agreed metrics set out in a service level agreement (SLA).⁵

GOVERNANCE AND OUTSOURCING — A SECTORAL EXAMPLE

Perhaps the most extreme examples of outsourcing to external service providers can be found in the area of mutual funds. As well as a variety of contractual forms, these may also be constituted as investment companies. Contractual entities such as unit trusts may have a specially created Irish company acting as its manager. Both the investment companies and the management companies are subject to regulation by the Financial Regulator, as well as the requirements of Irish company law. Mutual funds will delegate practically every function to external service providers:

- investment management to an investment manager;
- fund accounting, administration and transfer agency to an administrator;
- asset safe-keeping to a trustee/custodian.

This extensive degree of outsourcing is explicitly permitted under the regulations governing mutual funds: ‘*A management company may delegate activities to third parties for the purpose of the more efficient conduct of the company’s business.*’⁶

While the ability to outsource extensively provides a very efficient solution, it raises obvious governance and control

issues, a matter acknowledged elsewhere in the same Regulation:

Neither the management company's nor the Trustee's liability shall be affected by the fact that the management company has delegated any functions to third parties, nor shall the management company delegate its functions to the extent that it becomes a letterbox entity.⁷

This unease at the concept of total delegation, with the consequent risk to oversight and control mechanisms, meant that the European Commission omitted any further management company liberalisation proposals when first unveiling the Undertaking for Collective Investment in Transferable Securities (UCITS) IV initiative in June 2008, referring the matter instead to the Committee of European Securities Regulators (CESR) for further consultation, before eventual adoption.

Notwithstanding the role of these mutual fund vehicles as an efficient, cost-effective package for collective investment, there remains a strong regulatory imperative that they self-monitor through strong internal governance mechanisms, although this has cost implications. The Financial Regulator has set out well-defined expectations:

The management company is required to develop and maintain policies and systems to identify, monitor and control risk arising in respect of the management company's activities, including for example, market risk, foreign exchange rate risk, credit risk, operational risk and risk of fraud.⁸

These requirements raise very practical corporate governance considerations:

- who will define the firm's risk appetite,

how is it to be measured, and who is competent and willing to undertake risk assessment and management on an on-going basis?

- what is the board's responsibility for monitoring and assessing investment performance?
- while the investment manager will provide periodic performance information to the board, what steps will the board take to determine the acceptability of such performance and its capability?
- will the board periodically place the investment management mandate out for re-tender or otherwise consider the ongoing merits of retaining the incumbent?

This latter division of responsibilities could prove an interesting arena of development, because the investment manager or an affiliate will typically have promoted the mutual fund, and the majority of the fund board will typically be comprised of interested parties. Yet, under Irish company law, the mutual fund board is responsible to, and owes a duty of care only to the mutual fund company. The trustee/custodian will carry out its own independent enquiries into the operation of the fund, yet these are undertaken to discharge a separate fiduciary duty and the workings are not available to the fund's board of directors to place reliance on them.

Given the role of the UCITS vehicle as a relatively standardised vehicle suitable for pan-European retail distribution, there are more prosaic considerations for the board of directors to consider. With Ireland having established itself as a centre for the cross-border sales of UCITS products, the board must also decide on how best to assure compliance with marketing requirements in foreign jurisdictions. While this might be delegated to the investment

manager, the fund promoter, or other affiliated entity, the responsibility for compliance ultimately borne by the board cannot be avoided and may involve matters considerably more complex than those routinely encountered in domestic business affairs. Areas of criminal law attach to the operations of internationally traded financial services businesses. The board is responsible for securing compliance with anti-money laundering (AML) legislation, prevention of terrorist financing requirements and compliance with sanctions regimes.

Aside from the actual challenge of compliance with the various restrictions, the board will also be required to demonstrate to external interests how it has discharged its obligations:

A management company shall retain, in a readily accessible form for a period of at least six years, a full record of each transaction entered into by it ... and all records required to demonstrate compliance with the provisions of the Regulations including conditions imposed by the Financial Regulator.⁹

While outsourcing is explicitly accepted by the Financial Regulator as a solution, there are further limitations imposed, as follows.

- Where a management company contracts all or part of its record keeping to another, it must do so only in accordance with the provisions of a SLA.
- The management company must ensure that any such SLA does not conflict with any of its obligations under the regulations or conditions imposed by the Financial Regulator.
- The management company should be aware that it retains the ultimate responsibility for compliance with the provisions of the regulations and

conditions imposed by the Financial Regulator.¹⁰

Aside from these explicit provisions, there are more qualitative considerations for the board of directors to consider:

- is there a feedback mechanism verifying performance by the service providers and is it sufficient to discharge responsibility?
- what is the responsibility of the board of directors when significant operational difficulties manifest themselves at a service provider and the board suspects that the SLA requirements are not being met?

The Financial Regulator has clear opinions on the matter: *'The firm must notify the Financial Regulator as soon as it becomes aware of any breaches of the Financial Regulator's supervisory or reporting requirements.'*¹¹ and issued guidance on the subject in 2006.¹² There is also a requirement to notify the Financial Regulator of broader concerns:

This requirement includes, but is not limited to, an obligation on the management company to notify the Financial Regulator as soon as it becomes aware of ... breaches of other Irish legislation which may be of prudential concern to the Financial Regulator or which may impact on the reputation or good standing of the management company.¹³

In addition, the Financial Regulator has extended general codes of conduct, long familiar in investment management, to related sectors such as collective portfolio management. This extends to fund managers the obligation to act fairly and honestly in their business activities in the best interests of the collective invest-

ment undertakings under management, the investors in those schemes and the integrity of the market.¹⁴

The management company and, by extension, its board are required to ensure that it has, and employs effectively, the resources and procedures that are necessary for the proper performance of its activities, imposing not only an obligation to discharge obligations in a certain manner, but also to put in place an infrastructure for the regular carrying out of such duties. There is a duty to comply with both the letter and the spirit of all regulatory requirements applicable to its business.¹⁵

THE PENALTIES FOR FAILURE OF GOVERNANCE

As mentioned earlier, the various corporate conduit vehicles utilised in Ireland for packaging financial products benefit from the protection of the body of Irish company law. These laws contain a variety of sanctions to punish aberrant behaviour, ranging from restriction to imprisonment.

Fraudulent trading

‘Fraudulent trading’ is defined as a person knowingly being a party to the carrying on of any business of a company to defraud its creditors for any fraudulent purpose. In such instances, a court is empowered to make a director personally liable for the company’s liabilities. Conviction carries liability for imprisonment for up to seven years and/or fines of up to €63,480.¹⁶

Reckless trading

Slightly less serious than fraudulent trading is reckless trading. This is where a person ought to have known that his or her actions, or those of the company, would cause loss to the creditors, having regard to the general knowledge, skill and

experience that might reasonably be expected of him or her, or a director being party to the company contracting a debt despite not honestly believing on reasonable grounds that the company would be able to repay such debt.

While reckless trading is aimed at directors and firms overtrading beyond their working capital base, the issues for directors of leverage buyout vehicles — particularly those with final bullet payments that will require a future refinancing — are obvious. The penalties for reckless trading include the imposition of personal liability. Furthermore, it does not have to result from a criminal prosecution: a liquidator, examiner or creditor may apply to the court to have a director held personally responsible.¹⁷

Disqualification

The Companies Act 1990 provides a range of circumstances in which a person may be disqualified, by court order, from acting as a director. Disqualification may arise if:

- the director is convicted of an indictable offence in relation to the company, or an offence involving fraud or dishonesty;
- the conduct of the director makes him or her unfit to be concerned in the management of the company;
- the director is guilty of fraud in relation to the company’s members or creditors;
- the director has been declared personally liable for the company’s debts on the grounds of fraudulent or reckless trading;
- the director has been persistently in default in relation to filing requirements at the Companies Registration Office.

Restriction

The Director of Corporate Enforcement,

a liquidator or a receiver may apply to court for a restriction order against any director of an insolvent company.¹⁸ This was further strengthened in 2001, when the obligation on liquidators to apply for a restriction was made mandatory.¹⁹

Restriction bars persons from acting as a director for companies under certain capitalisation limits for a period of five years. Contravening a restriction order is an offence liable to imprisonment of up to five years and fines of up to €12,696.

Notwithstanding the capitalisation limits, there are obvious reputational consequences for non-executive directors (NEDs) in suffering a restriction. This was borne out in the July 2004 High Court judgment in *Tralee Beef & Lamb Ltd (in liq)*.²⁰

In this case, the firm in question became heavily insolvent and was placed into liquidation. The firm had one executive director and three NEDs, one of whom was the nominee of external investors appointed to represent their interests. This individual was a partner in a Dublin-based firm of chartered accountants. The four respondent directors were found to have acted honestly, but not responsibly, and were each restricted for five years.

As mentioned above, the liquidator was legally obliged to apply for a restriction order, but had applied to the Director of Corporate Enforcement for leave not to do so in the case of the investor representative director. The Director of Corporate Enforcement did not grant this leave and the individual was duly restricted.

The restriction was overturned by the Supreme Court on appeal in February 2008. The Court set out a number of useful concepts for board conduct, which are equally applicable to financial services vehicles:

- the court focused on the level of knowledge of each director regarding the affairs of the company;
- it was held that merely seeking (and not receiving) financial information was insufficient;
- executive directors must bring to the board meeting sufficient information in relation to the affairs of the company that the NEDs can inform themselves and thereby supervise the affairs of the company.
- NEDs must not follow such information blindly;
- the Court had no difficulty with directors delegating particular functions, and trusting the competence and integrity of those individuals to whom they have delegated, but only to a reasonable extent;
- delegation does not absolve a director from his or her duty to supervise;
- the Court accepts that NEDs are a part of commercial life.

SUMMARY

The increased importance of Ireland as a venue for domicile of offshore financial services has been met by an increase in corporate governance expectations at the Financial Regulator. This is seen as the cost of applying a principles-based regulatory regime that permits firms to tailor controls to their particular circumstances.

NOTE

The purpose of this paper is to summarise current trends in corporate governance of financial services entities in the Republic of Ireland. This paper is not intended to provide legal advice or a complete overview of relevant issues, and the reader is urged to seek professional advice regarding the application of issues to his or her business. The opinions expressed in this paper are the author's

own and not those of Compliance Ireland Regulatory Services Ltd.

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