How a Manager Can Reduce Potential Conflicts of Interest Among a Fund’s Manager, Trustee and Custodian

Increased Regulatory Concern over Conflicts of Interest between a Manager and its affiliated Fund Service Providers

Regulators across the world have, for some time, required that key service providers to a fund be sufficiently independent from the Manager so as to ensure that all parties, including the Manager, act in the best interests of investors in the Fund.

In Hong Kong, the rule which requires that the Manager and Trustee be independent of each other is provided for in Paragraph 4.7 of the Code of Unit Trusts and Mutual Funds and also section 46 of the MPF Schemes (General) Regulation.

As the global funds industry continues to evolve, the complexity of managing and operating an investment Fund has also increased, meaning that the need to ensure the proper segregation of duties between a Fund’s Manager and key service providers – and in particular the robust supervision and oversight of each party – is all the more critical. This can be extremely problematic to demonstrate, where the Manager and its Trustee/Custodian are all connected parties, as any operational error by one party is likely to attract heightened regulatory scrutiny and potentially trigger additional regulatory issues as to unfair dealings between connected parties, secret profits and breach of fiduciary oversight duty. The push by regulators to ensure proper segregation of duties and independent oversight can be seen by a number of recent regulatory circulars being issued to heighten the standards expected of Managers in addition to penalties and sanctions being taken against Managers across the globe in relation to, e.g., FX, interest rates, commissions and fair valuation dealings by a Manager.

Citi APAC Trustee Services currently acts as Trustee to over 1600 funds across APAC with US$25 bn of assets under trusteeship.
By having Citi APAC Trustee Services act as an independent Trustee, a Manager can reduce its potential conflict of interest risk when dealing with its affiliated service providers to a fund, whilst continuing to benefit from the operational efficiencies it enjoys between those parties.

**How to Better Structure a Fund to Minimize Regulatory Issues as to Connected Party Dealings**

Many global financial institutions offer fund management, trustee, custody and fund administration services and, as such, the fund management arm will typically appoint its affiliates as the other key service providers to the fund (see diagram below).

![Diagram](chart.png)

However, a Manager can reduce its overall institutions’ (“Global FI”) conflict of interest and fiduciary risk by appointing an independent third-party Trustee to sit between the Manager and its affiliate service providers whilst still availing of its affiliated service providers (e.g. Custodian) expertise and connectivity (see diagram below).

![Diagram](chart2.png)

**How Citi APAC Trustee Services can help Managers and their Connected Parties Manage Conflicts Risk**

Citi APAC Trustee Services currently acts as Trustee to over 1600 funds across APAC with US$25 bn of assets under trusteeship. Citi Trustee Services is also approved to act for SFC, MPF and private unit trusts in Hong Kong.

Citi APAC Trustee Services can provide independent Trustee services to select Managers. Independent Trustee Services involves Citi Trustee acting only as the Fund’s trustee and in turn appointing the Fund’s service providers by entering into the fund’s Trust Deed with the Manager and Custody Services Agreement with the Custodian, thereby providing an independent contractual and regulatory layer between the Manager and its affiliates without removing the operational connectivity advantages Managers enjoy with their affiliate Custodian and/or other affiliate service providers.

In order to fulfil the independent Trustee role between a Manager and its affiliate service providers, Citi APAC Trustee Services will perform the below oversight processes on both the Manager and Custodian to further demonstrate independent oversight of dealings between the Manager and its affiliated Custodian:
### Manager Oversight Processes

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<th>Manager Oversight Processes</th>
<th>Custodian Oversight Processes</th>
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<tr>
<td>✓ Review and provide best practice commentary on Manager’s key control policies</td>
<td>✓ Exercise care and diligence in choosing and appointing Custodian</td>
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<td>✓ Ongoing compliance with Operating Guidelines requirements</td>
<td>✓ Ensure the Custodian has the expertise, competence and standing appropriate to discharge the responsibilities</td>
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<td>✓ Quarterly Confirmation Checks as to core regulatory and investment operation requirement</td>
<td>✓ Maintain an appropriate level of supervision over the Custodian and make appropriate inquiries from time to time to confirm the obligations of the agent continue to be discharged</td>
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<td>✓ Annual Due Diligence</td>
<td>✓ Ensure legal separation of non-cash assets held under custody and that the assets are segregated from the Trustee’s own assets</td>
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<tr>
<td>✓ Sub-Investment Manager Approval and Oversight</td>
<td>✓ Ensure that the Fund has legal entitlement to the assets</td>
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<tr>
<td>✓ Cash payment approval processes</td>
<td>✓ Ensure that there are internal controls to maintain proper records of the nature and amount of all assets under custody, the ownership of each asset and where documents of title to assets are located</td>
</tr>
<tr>
<td>✓ Cash deposit reviews</td>
<td>✓ Ensure that any sub-custodians hold the assets in accordance with standards applied to the Global Custodian</td>
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<tr>
<td>✓ Fair valuation policy review and ongoing checks</td>
<td>✓ Ensure that dormant/inactive cash accounts are monitored and closed</td>
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<tr>
<td>✓ Liquidity management policy review and ongoing checks</td>
<td>✓ Review Custodian interest rates on an ongoing basis</td>
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<tr>
<td>✓ Major currency FX reviews</td>
<td>✓ Oversee the correct processing of corporate actions in accordance with the Manager’s instructions</td>
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By having Citi APAC Trustee Services act as an independent Trustee, a Manager can reduce its potential conflict of interest risk when dealing with its affiliated service providers to a fund, whilst continuing to benefit from the operational efficiencies it enjoys between those parties. The independent role and oversight that Citi APAC Trustee Services can provide will greatly assist Managers in the management of their regulatory and fiduciary compliance.

### Other “Value Add” Services Citi APAC Trustee Provides Managers

As part of Citi APAC Trustee Services standard offering, a Manager will also receive additional “value add” services. Citi APAC Trustee Services provide Managers with practice notes such as “Cititrust Bulletin” and publications such as “Global Trustee and Fiduciary Services News & Views” in which regulatory and/or market developments are not only discussed but also set out the action Managers are expected to take in light of the development in order to comply with any ensuing regulatory requirements.

Citi also provides regular client meetings to discuss any topical issues and, should a Manager require, we can also arrange for training to be provided to your teams by our Hong Kong Trustee Services and/or Global Regulatory Services team in which we can share our local and global expertise on what are the current or forthcoming focus areas for regulators and what are the best practices being employed by Managers in order to meet the ever increasing regulatory expectations. Through such bulletins, publications, regular client meetings and training workshops, Citi can further help Managers in fulfilling their regulatory obligations by applying best market practices.
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