BRIDGE
CONSULTING

CP86- The 3 Year Journey

Fund Management Companies Guidance

Article 1 – Delegate Oversight

ISSUED: 16 MARCH 2017

www.bridgeconsulting.ie

CP86 – Overview

The scope of the new guidance as set out by the Central Bank of Ireland on 19 December impacts Investment Companies, UCITS Management Companies, Alternative Investment Fund Managers (AIFMs) and Alternative Investment Fund Management Companies incorporated and authorised in Ireland. As outlined in our introductory article it focuses on 6 key areas that are linked to effective Governance, Compliance and Central Bank of Ireland supervision. A timetable for transition has been provided in our previous article. This article addresses "Delegate Oversight".

Delegate Oversight – "Part 1" of the December 2016 Guidance

Fund structures in Ireland will generally utilise an externally delegated service model e.g. functions such as Investment Management, Depositary, Administration are delegated, however such delegation is limited to disallow "Letterbox Entities". "Substance" is a core focus of CP86 yet it requires an appropriate governance framework. In this respect the Guidance refers management tasks that may be delegated but ultimate responsibility remaining with the Board of Directors. The Board is required to ensure that funds are compliant with both regulatory requirements and Irish / European legislation e.g. UCITS, AIFMD, Companies Act, Market Abuse Directive, Criminal Just Act etc.

In examining delegation, the scope of the Guidance includes the following;

A) Investment Management

B) Distribution

C) Risk Management (Operational & Investment Risk)

D) Operational & Administration

E) Support & Resourcing

F) Boards of Externally Managed Companies

In setting out the Guidance the Central Bank emphasises that the governance framework needs to be further designed so as to be "appropriate and commensurate to the business of the relevant company and, where applicable, the investment funds it manages".

General Observations:

- Good governance comes with clarity around the allocation of responsibilities e.g. through fund documentation such as the Business Plan / Programme of Activity, policies & procedures, plus internal structures, as well as the appropriate culture and environment (tone from the top)
- Open dialogue is required between the board and its delegates with the effective provision of appropriate information to allow the board carry out "effective management" and the discharge of its duties
- The Guidance references the previously documented topic of time commitments required by Directors and the need for Directors to be engaged with sufficient time allocated to their duties
- Co-operation of all parties / delegates – this for the common good and in the best interests of the investors
- Dialogue – Delegates should expect board questions & constructive criticism as these are viewed as being in the best interests of the company
- The board may take on advice when discharging its duties but it is not obliged to take this advice. Decisions taken should be clearly minuted (a sample list of decisions made by Directors is listed in the Guidance)

Delegated Tasks:

- The board needs to exercise skill, care and diligence when selecting delegates and ensure the delegate has sufficient capacity to undertake the tasks required to a sufficient standard
- The board should be satisfied with the reporting provided by the delegate, noting compliance with legal and regulatory standards, any errors, breaches or any decline in service levels
- The delegate should provide information on any changes in its own circumstances, internal developments, corporate changes, internal audit reviews, regulatory inspections, BCP projects etc.

Section A – Investment Management

The Guidance details the information for which the Board should receive documentation and presentations e.g. prior to the issue of the Prospectus and the launch of a fund the Investment Manager should present to the Board. It describes how the Board should be fully satisfied with and approve the proposed investment approach. A sample list of details required by the Board is provided e.g. the assets invested in by the fund, any derivatives that will be used, investment policy, limits and restrictions, any securities lending that will be undertaken and use of collateral, leverage etc. The Board needs to be satisfied with the compliance processes put in place by the Investment Manager and to insure that investment rules and regulations are being adhered to as outlined in the fund documentation. It is necessary for the board to receive sufficient reporting (at least quarterly) so it can monitor the progress / performance of the Investment Manager. A list of information regarding the investment policy is provided. This should be submitted to the Board and any changes in investment approach require prior Board approval. The Investment Manager should be available to answer any questions from the Board.

The Guidance also refers to the benefit derived from periodic on site reviews of the Investment Manager.

Section B - Distribution

The Guidance outlines the information the Board needs to be aware of prior to any marketing activity taking place. These include the following;

- **The Distribution Strategy** – Marketing Strategy & Approach, who will be distributing, in which locations, to which types of investors, local compliance requirements, tax requirements, control framework for Risk Management
- **Distribution Reports –** Market trends, progress in specific markets, sales flows, developments, new investors, compliance, tax, regulatory updates
- **Marketing Materials –** The Board should receive upon request marketing materials prepared by the distributor e.g. fact sheets, presentations, elaboration on the fund strategy.

Adherence to the Prospectus is emphasised.

Section C – Risk Management

The Guidance details the requirement for a risk framework that contains a risk appetite statement, a register of applicable risks and the mitigants against such risks. Documentation such as policies and procedures need to be in place to ensure risks are measured, managed and monitored on an ongoing basis. Risk reporting should have agreed by the Board with clear procedures including thresholds for reporting breached limits to the Board.

The Board should ensure that each delegate has a "shared understanding" of their own part in monitoring and managing risk and of their reporting responsibilities to the Board. Both the risk framework and the risk appetite should be appropriate and proportionate to the complexity of the fund management company and each sub fund under its control. External delegation / advice on implementation of risk management policies is permitted with the requirement that comprehensive reporting be made available to the Board.

The Guidance provides details on **Investment Risk** (market risk, portfolio risk, liquidity risk, counterparty risk, leverage to mention but a few) and provides clarity on the focus of the investment risk appetite statement including the investment objective and strategy of the products, the disclosure of risks to investors and the liquidity of the assets within the portfolio as well as any potential for asset / liability mismatch.

It also provides details on how the Board should address **Operational Risk** i.e. how delegates are effectively managed and controlled ensuring their own appropriate risk management policies are in place e.g. IT, errors, breaches, fraud, pricing and dealing. Given the Central Bank's previous and separate correspondence on Outsourcing and Cyber Security these are also areas for consideration by the Board. Business Continuity is referenced as part of Enterprise risk and a caution is provided to consider whether or not relying solely on the BCP policy of delegates is sufficient. Other risks detailed apply to the fund management company and it's underlying funds e.g. large deals, key person risk, failure of a delegate, reputational risk, regulatory risk, capacity constraints (systems and personnel).

The Guidance emphasises that ongoing review and consideration of the risk policies is required.

Section D – Investment Operations and Administration

This sections deals with the considerations required when appointing a delegate. It examines operational resilience, risk management procedures, capacity and confidentiality / security of information. It also addresses the delegate reporting required by the Board e.g. Administrator, Depository, performance reporting, breach reporting, outsourcing arrangements, AML and resourcing of the fund management company. It also deals with the valuation policy and how illiquid instruments are priced as well as consideration for stale prices and fair valued securities.

Budgets over and above the investment management fees should be monitored.

Section E – Support and Resourcing

Fund management companies need to ensure they are adequately resourced based on the size, scale and complexity of their business. Support services (separate to that of the Company Secretary) are listed and include the following;

1) Ongoing monitoring of day to day developments
2) Management of board meetings
3) Management of other meetings
4) Management of documentation
5) Preparation of reports / materials
6) Annual / semi Annual accounts

Support can come in different forms e.g. secondees, service providers and it remains the Board's decision as to what is deemed most relevant. Individual Directors can maintain responsibility for management functions provided they have the skills and experience, sufficient support & resources and when carrying out the function it does not compromise the ability of the individual or the Board and independence is not impacted.

Where support is in place, the Board is required to ensure it maintains overall control and the Board's control is outlined in the documentation relevant to that service.

The Guidance again makes reference to the fact that the Board has the option to seek "occasional" independent advice.

Section F – Boards of Externally-Managed Investment Companies

This section deals with structures where an external fund management company has been appointed to an investment company / fund (UCITS & AIFs). The reason for this can be numerous but generally it allows a fund promoter concentrate on core activities such as investment management and distribution with substance for fund governance and regulatory compliance being dealt with by an appointed Management Company (a growing trend in the Irish market).

The Guidance outlines how both companies will work together;

- **Ultimate Responsibility for Management –** Remains with the Board of the externally managed company. The Board needs to satisfy itself that the external fund management company is performing at the correct level and that any conflicts of interest are identified and managed.
- **Publication of Prospectus / Audited Financials –** Remains the responsibility of the Board of the external managed company
- **Reporting –** The external management company should provide reporting on each of the sections listed in this document with additional reporting from that company's delegates if required.

Impact Assessment

The Guidance provides a comprehensive list of key requirements for fund management companies / investment companies, the bulk of which may be in place today for existing companies and which should be captured in the updated Business Plan, Programme of Activity and Policies and Procedures. There are a number of specific requirements listed below that we feel beneficial to highlight;

Investment Management:

- There is a requirement for a presentation from the Investment Manager prior to the issue of the prospectus or the launch of a new fund as well as an annual presentation / update from the Investment Manager. Site visits to the Investment Manager should also be considered.

Risk Management:

- The emphasis on ensuring a Risk Framework is in place that is appropriate and proportionate to the nature, scale and complexity of the business / funds under management. Risk Registers and Risk Appetite Statements are required.
- Consider the reporting by delegates of any outsourcing arrangements. Consider Cyber Security, Risk Management, Conflicts of Interest or any Internal Audit items of note when reporting on such arrangements.
- Consider drafting a Fund Data Protection Policy.

Retention of Records:

- A record retention policy should be considered (5 years of historical data required). A record management policy should be considered.

Email Address:

- A dedicated email address for the Company needs to be put in place. Whilst the deadline is 30 June 2017, the Central Bank has requested fund boards for confirmation of the dedicated email address by 28 April 2017. This is to facilitate the transition process.

Distribution Reporting:

- Consideration should be given to the level of reporting.

DATE Published: 16 March 2017