



# Fund Management Company Effectiveness

**Final rules and guidance are issued**

**Regulatory**

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# Background

**With the issuance of its third and final feedback statement on the effectiveness of fund management companies of Undertakings in Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs), the Central Bank has provided a clear picture of its expectations and the nature of the arrangements that need to be put in place.**

The issuance of these final rules and guidance follow on from a third consultation paper issued in June 2016. Two earlier consultation papers (CP86) issued in 2014 and 2015 led to the publication of guidance on a number of key areas including delegate oversight, organisational effectiveness and directors' time commitments. This final feedback statement sets out rules and guidance on other key areas including managerial functions, various operational issues and procedural matters.

The new rules include a final determination on a controversial proposal on the location of directors and Designated Persons carrying out managerial functions and others including the streamlining of managerial functions to six managerial functions, the performance of the organisational effectiveness role and the rule on retrievability of records. They will be included in amended Central Bank UCITS Regulations and in forthcoming Central Bank AIF Regulations and will take effect from 1 July 2018.

The final guidance amalgamates the earlier guidance on delegate oversight, organisational effectiveness and directors' time commitments with new guidance on managerial functions, various operational issues and procedural matters.

It is apparent that the accountability of directors and Designated Persons is a key area of focus for the Central Bank. In putting this effectiveness framework in place, it is seeking to improve fund governance, compliance and supervisability, whilst giving funds more flexibility in sourcing directors and Designated Persons.

Fund management companies are defined as either a UCITS management company, an authorised Alternative Investment Fund Manager, a self-managed UCITS investment company or an internally managed AIF which is an authorised AIFM, all of which have been authorised in Ireland.

Existing fund management companies are advised to look closely at how this new guidance and the new rules will impact on their operations, while new fund management companies will need to ensure that their application for authorisation to the Central Bank demonstrates compliance with the basic tenets. We are here to assist you and discuss potential impacts on your organisation and can provide insight on complying with these new requirements.

# Governance. Compliance. Supervisability.

These are the three core aspects of effectiveness, set out by the Central Bank. The Central Bank has expressed the view that a fund management company that can demonstrate its strength in these areas indicates both substance and the ability of the company to better protect investors. The Central Bank has also emphasised that fund management company board meeting minutes are a key way of demonstrating compliance with these principles.

Governance is primarily concerned with how the directors of fund management companies perform their roles.

It focuses on the oversight and governance responsibility of the board of directors as well as director's time commitments, which were previously discussed in the earlier consultations.

Compliance focuses on the central role that Designated Persons play in the ability of fund management companies to demonstrate compliance with their regulatory obligations. The Central Bank's expectations of designated persons are communicated in the managerial functions guidance.

The Central Bank's third focus is on requirements which enable it to fulfil its supervisory oversight of fund management companies. Accordingly supervisability relates to the fund management company's ability to react to a crisis and to respond and engage with the Central Bank in an efficient and effective manner.



# The Designated Person

## Key managerial functions

The Central Bank has identified six key managerial functions which must be carried out by a Designated Person. These are:



## Who may be a Designated Person?

The guidance sets out who may be appointed a Designated Person by a fund management company. For the first time a Designated Person outside Ireland, who is not a director of the fund, may be appointed, although the Central Bank has put in place a restriction which requires at least half of a fund management company's Designated Persons to be located within the European Economic Area (EEA) – the EU's 28 Member States as well as Norway, Iceland and Liechtenstein.

This change in the rules on the location of a Designated Person, even with the restriction in place, is welcome as it opens up the possibility of senior executives outside Ireland in the risk management, investment management, compliance, distribution and other functions of a fund promoter acting as a Designated Person.

The Designated Person can be a director or employee of the fund management company, or alternatively, can be seconded to the fund management company, on a full or part-time basis, from another firm such as the investment manager or a firm which specialises in the provision of Designated Persons. To the extent that such appointment is considered to represent a conflict of interest or subsequently gives rise to a conflict of interest such conflict should be managed in accordance with the applicable regulatory obligations of the fund management company.

The Central Bank expects that Designated Persons should be senior executives and have a clear understanding of Irish regulatory requirements in order to be able to effectively engage with the Central Bank as part of the bank's supervisory process. The Designated Person is also expected to have the relevant expertise, management experience and sufficient authority in order to review the performance of delegates on an ongoing basis.

## Is it possible for someone to hold more than one Designated Person position?

The Central Bank has clarified that it is possible for a Designated Person to oversee more than one managerial function, and the same Designated Person may carry out the managerial functions of fund risk management and operational risk management. However, the Designated Person who performs at least one of these risk management functions may not also perform the investment management managerial function.

The guidance also provides that a director can act as a Designated Person. If this is the case, then two separate letters of appointment will have to be issued. Given the additional oversight and responsibilities that are envisaged, it may be challenging for one individual to hold both roles.

## The role of the Designated Person

The role of a Designated Person is a pre-approved control function under the Central Bank's fitness and probity regime.

The Central Bank has provided extensive guidance on the role of Designated Persons and accordingly it will be important for fund management companies to take this guidance into account when appointing Designated Persons and updating their letters of appointment

The guidance covers the following areas:

- an overview of the role of the Designated Person, including their ongoing day-to-day responsibility for the management of delegates and the obligation on the Designated Person to act in the best interests of investors
- the seniority, expertise and experience of the Designated Person
- supervision of delegates by Designated Persons, including the review of policies and procedures of delegates and the group where they are to be relied upon by the fund management company
- reporting from delegates to Designated Persons; frequency and format of interaction with delegates, including conference calls, physical meetings and site-visits and the appropriate level of challenge and engagement with delegates.

The fund management company should create a monitoring and oversight framework that allows Designated Persons to receive the information necessary to carry out their roles. Furthermore the Designated Person should not over-rely on this information and should consider additional confirmation/verification mechanisms

- reporting from Designated Persons to the board, including escalation procedures and the steps that may be taken when service levels do not meet contractual requirements
- how the Designated Person ensures oversight of all regulatory obligations, whether compliance is a matter of fact (e.g. minimum capital requirements) or complying with requirements which require the exercise of judgement (e.g. suitability of cybersecurity arrangements). Also must oversee regulatory obligations other than UCITS and AIFMD, e.g. European Markets Infrastructure Regulation (EMIR) or the Markets in Financial Instruments Directive (MiFID)
- the proportionate responsibility of the Designated Person for designing, implementing and reviewing policies and procedures required in respect of each managerial function. The guidance acknowledges that Designated Persons may require third party assistance in this regard and that ultimately it is the responsibility of the board of the fund management company to ensure that there are appropriate structures or limits or policies and procedures in place.

The Central Bank has identified the obligations placed upon fund management companies under the UCITS and AIFMD regimes and provides a suggested allocation of these to individual managerial functions. This checklist should assist fund management companies in formulating the duties and responsibilities of individual Designated Persons and help the Designated Person to fulfil their duties.



## Impact on fund management companies

Following the consultation, the Central Bank removed a proposal, the so called **co-location rule**, which would have required Designated Persons to either be located in the same country or be employed by the same group as the one running the fund. This facilitates both external and internal appointments being made, which gives a group greater flexibility.

The Central Bank has stated that where fund management companies themselves are required to have specific policies in place they **cannot rely solely on the policies of entities to which key functions have been delegated by the Designated Person** or on group policies. Where the fund management company is heavily reliant on the substance of delegate or group policies and procedures, they must formally record why this reliance is appropriate and how it is being managed.

The Central Bank also expects that fund management companies put in place **reporting arrangements that are regular and not simply exception-based**. This will involve closer monitoring of information supplied by delegates or those reporting to them than has previously been the case. The guidance also envisages Designated Persons having external and/or internal reporting lines to fulfil their functions.

The guidance also specifically refers to a fund management company **mapping its regulatory obligations against those of the delegate**. This may not be an issue for firms who delegate to entities within the EU, but it may pose challenges when the delegate is from a non-EU jurisdiction given that the obligations between EU and non-EU may not be for like-for-like. This may also present a challenge for EU executives, who may have to enhance their knowledge of non-EU regulation.

These new requirements **will create different implementation challenges for industry participants and will have specific impacts depending on the structure of the fund management company**. All fund service providers will need to review their governance, delegation and outsourcing frameworks to ensure compliance. They will need to amend current arrangements or change the roles of key personnel. Self-managed investment companies may require greater "substance" and may make greater use of independent directors or third party management companies. These third party management companies will need to consider the optimal method of servicing many types of funds.

# Operational Issues

## The Location Rule and “PRISM”

The Central Bank has introduced a new “Location Rule” linked to its Probability Risk and Impact System (PRISM) rating of each fund management company. PRISM is the Central Bank’s risk-based framework for the supervision of regulated firms, judging the risks they pose to the economy and consumer and mitigating those risks the Central Bank judges unacceptable.

The final rule, which has been a topic of much debate, states that;

### A management company shall conduct a preponderance of its management in the EEA.

A fund management company which has PRISM rating of **Medium Low or above** will be required to have:

Three directors resident in the State or at least two directors resident in the State and one Designated Person resident in the State



Half of its directors resident in the EEA, and;

Half of its managerial function performed by at least two Designated Persons resident in the EEA.



A fund management company which has a PRISM rating of **Low** will be required to have:

Two directors resident in the State



Half of its directors resident in the EEA, and;

Half of its managerial function performed by at least two Designated Persons resident in the EEA



The final rule deviates from the proposed rule in that the ratio of directors and managerial functions in the EEA has been reduced from ‘at least two thirds’ to ‘half’. The Central Bank accepted the argument made by industry, in the course of the consultation, that there may not be the requisite level of expertise within the EEA to comply with a two thirds rule. It did not find arguments concerning increased costs or Ireland’s competitive position convincing.

There is a prevalence of US and UK based fund providers in Ireland who will be affected by this new rule. For US groups, the impact depends on the extent of their presence in the EEA, but the reduction in the ratio is welcomed.

The forthcoming withdrawal of the United Kingdom from the EU following the Brexit referendum is a complication for UK investment managers. If, on completion of the withdrawal negotiations, the UK is not an EEA country or deemed to be equivalent, the location rule will mean that just less than a half of directors or Designated Persons could be from the UK.

However, in terms of equivalence, that Central Bank has flagged that if directors and Designated Persons are not resident in the EEA then a number of other factors may be considered in determining whether that jurisdiction has some level of equivalence. These include but are not limited to considerations such as physical proximity, demographic, cultural and historical ties and ease of travel. It remains to be seen, as with much of Brexit, what the results of an equivalency assessment will be.

With the introduction of this rule, the Central Bank is attempting to balance expertise with location and supervisability.

### **Operational Issues – Retrievability of Records Rule**

The Central Bank is requiring fund management companies to maintain their records in a way that makes them immediately retrievable and to produce these records immediately on request. In this context, the Central Bank has defined 'immediately' as meaning that documentation requested before 1pm (Irish time) should be provided to the Central Bank on the same day and documentation requested after 1pm (Irish time) should be provided to the Central Bank before 12 noon on the following day on which the Central Bank is open for business.

The guidance sets out a non-exhaustive list of records which must be maintained including board minutes, policies and procedures, letters of engagement, contracts with delegates and reports to Designated Persons.

Fund management companies will need to have a records retention policy, which is subject to audit, and will need to maintain a clearly defined records retention schedule outlining where records are stored. Systems and controls will need to be reviewed in order to comply with this new requirement.

### **Operational Issues – Monitored Email Address Guidance**

In order to expedite responses from fund management companies to information requests from the Central Bank, the guidance requires fund management companies to set up and monitor a dedicated email address for this specific purpose. This could be either a single email address for all investment funds under management or a dedicated email address for each individual fund provided that these are monitored on at least a daily basis. It is noteworthy that fund management companies will have to comply with this particular guidance from 30 June 2017.

# Procedural Matters

The guidance includes a section on procedural matters dealing with applications for authorisation from fund management companies - both UCITS and AIFs - and the information that the Central Bank will require where a fund management company proposes to use its management company passport.





# Next steps

The majority of new requirements take effect from July 2018. This is to be welcomed as it will allow fund management companies sufficient time to consider the impact on their board composition and the allocation of managerial responsibilities. There will also be some work to be completed in revising business plans and / or programmes of activities.

The implementation of these new arrangements and the implementation of MiFID II will require groups with UCITS, AIFMs and MiFID firms to consider how they will comply with complementary requirements in specific areas. These include Distribution and Product Governance, particularly in relation to the provision of product information to distributors to satisfy target market management information requirements. Firms should also holistically consider senior management competency as there is a requirement in MiFID II for investment firms to assess the knowledge and competence of staff providing relevant services, such as advice or information about financial instruments, investment services or ancillary services, to clients on behalf of investment firms.

## Existing fund management companies

Existing fund management companies are strongly advised to consider the impact that these new requirements will have on their business. At the very least they should consider whether they have the appropriate governance framework in place in Ireland and within a wider group context and these arrangements need to be reviewed by 1 July 2018.

## Key questions include;

- Do you have adequate resources already in place in Ireland or within the Group or will you need to bring in additional resources?
- Will reporting lines and oversight arrangements need to be amended?
- Do you have policies and procedures in place in Ireland which will meet the Central Bank's expectations?
- Do you have systems and controls in place that are adequate to meet operational requirements and are these adequate to meet the Central Bank's increasingly rigorous requirements on the immediate retrievability of records?

## New fund management companies

The Central Bank will only approve applications for authorisation from new fund management companies, submitted on or after 1 July 2017, where the fund management company is organised in such a way that it is compliant with the new requirements. New fund management companies – whether they are UCITS or AIF – will need to carefully consider these requirements and ensure that they incorporated into their organisational structure, business plans and programme of activities if they want to demonstrate “substance” in Ireland. This “substance” requirement will be a key consideration of the Central Bank when they are assessing applications for authorisation.

# How KPMG can help

We can help in assisting fund management companies and other industry participants to understand the impact of CP86.

In particular, we can;

- Assist in assessing the impact and changes required to ensure compliance; and
- Review arrangements for implementing the new requirements; and
- Provide support in establishing appropriate oversight and governance for fund management companies that decide to delegate their responsibilities.

**For more information on regulatory issues impacting you, log on to our website at [www.kpmg.ie/regulatory](http://www.kpmg.ie/regulatory)**





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