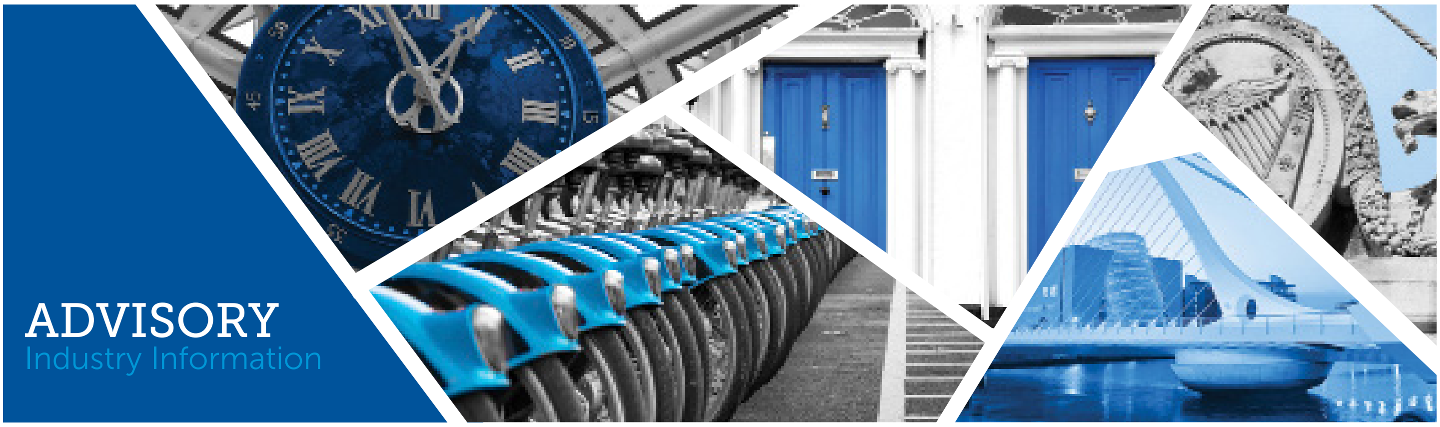

CP86 2.0 – Worth the wait?

October 2020

The Central Bank's Fund Management Companies – Guidance (the "**Guidance**") took effect on 1 July 2018 for entities in existence at the time of its publication following the completion of an extensive period of consultation (CP86) with industry between September 2014 and August 2016. The Guidance is applicable to Irish authorised UCITS management companies, AIFMs and self-managed UCITS and AIFs ("**FMCs**") and details the Central Bank's expectations in relation to the governance of FMCs, how they should comply with their regulatory obligations and its ability to supervise FMCs without undue constraint and in times of crisis.

Swiftly following implementation, on the 5 July 2018, the Central Bank announced its intention to begin assessing how FMCs "have implemented and embedded the new requirements and related guidance in their organisations". The review, which covered all 358 active FMCs, consisted of three phases comprising of an industry questionnaire, a desk-based review and culminating with onsite reviews. It focused on three aspects of FMCs' responsibilities - investment management, risk management and organisational effectiveness.

On 20 October 2020, the Central Bank issued a letter to the chairperson of the board of directors (the "**Board**") of all FMCs accompanied by a high level findings document (the "**Industry Letter**") setting out the findings of their review and identifying actions that FMCs need to take immediately.

The Central Bank set out six findings for all FMCs to consider in the context of their firm:

1. Resourcing and Organisational Structure

The Central Bank identified a noticeable difference between the levels of resourcing of FMCs authorised before and after the Guidance was introduced. It determined that many FMCs authorised before the introduction of the guidance did not have appropriate levels of resources in place to ensure effective implementation of the framework and FMCs with less resources are typically overly reliant on group entities and/or delegates.

In respect of resourcing, the Central Bank's expectations is that FMCs:

- must be able to clearly demonstrate ongoing and effective management of all activities, including high quality and effective oversight of those activities performed by delegates and that its governance structure is sufficiently resourced;
- should have a minimum of 3 full time employees or equivalent ("**FTEs**"). The Central Bank noted that this number is a minimum expectation and only relevant to the smallest and simplest of entities, what constitutes such an entity is not defined in the Industry Letter. Consideration needs to be given to the nature, scale and complexity of a FMC's operations;
- should ensure that those employees are suitably qualified and of appropriate seniority to fulfil their roles;
- must appoint locally based persons to perform each of the six managerial functions; and
- should have in place a formally documented succession plan.

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2. Designated Persons

The Central Bank noted that significant shortcomings were identified in relation to how some Designated Persons discharge their roles. Deficiencies in the following areas were specifically mentioned:

- the level of review carried out on the monthly reports received from delegates and the independent analysis thereof;
- the quality of the information provided by the Designated Person to the Board;
- the time dedicated by the Designated Person to their role and/or the level of support available to enable them to discharge their responsibilities appropriately; and
- evidence of constructive challenge by Designated Persons in relation to information received from other FMC staff and delegates.

3. Delegate Oversight

The Industry Letter states that many FMCs failed to fully implement the Guidance in the area of delegate oversight. The Industry Letter focuses on the following three key areas:

i. Due diligence

The Central Bank noted that a number of FMCs were unable to demonstrate that they had carried out the appropriate level of due diligence on their delegates in advance of the appointment and on an ongoing basis (at least annually) thereafter.

The Central Bank also noted that many FMCs rely on the policies and procedures of their delegates or of the wider corporate group. However, not all FMCs could demonstrate that they had reviewed and approved the delegate or group policies and procedures as being fit for purpose when applied to the FMC. The Central Bank stressed that where reliance is placed on delegates' policies and procedures, the FMC should have a formalised process to review these policies and procedures, both on appointment and on an ongoing basis for the duration of the relationship.

ii. Engagement with delegate investment managers

The Central Bank found a significant number of cases where there was a lack of effective engagement with delegate investment managers and that where issues arose they were not always resolved in a timely manner. They noted that delegate reports received were not always of sufficient quality to allow for a meaningful review of the situation by the FMC, and steps were not taken to address this. Where such issues arise, the Central Bank stated that the FMC should challenge the delegate and, where necessary, take further action (and be able to evidence such).

The Central Bank stated that this issue is of particular significance in circumstances where the FMC has appointed a high number of delegate investment managers.

iii. Service Level Agreements ("SLAs")

The Industry Letter stated that all delegate arrangements should be governed by way of formally documented SLAs and that this was not found to be the case in all reviews.

4. Risk Management Framework

The Central Bank identified further deficiencies in the area of risk management frameworks, noting that many FMCs did not have: (i) an entity specific risk framework; (ii) an entity specific risk register; and/or (iii) a defined risk appetite statement in place. The Central Bank noted that in many cases, this was a result of over-reliance on group frameworks. The Central Bank reiterated that, as per the Guidance, all FMCs are required to have a robust Board approved, entity specific risk management framework which should include a risk register and risk appetite statement and that these should be reviewed at least annually.

5. Board Approval of New Funds

The Central Bank noted that not all FMCs could evidence Board approval of new sub-funds. Even where the Board did approve the launch of a new sub-fund in compliance with the Guidance, the review found that this was often done in such a way that the Board was approving the investment fund/investment strategy immediately prior to launch and there was no evidence of earlier discussions to set or agree the proposed strategy of the new sub-fund prior to submission of the application to the Central Bank.

The Central Bank noted that it expects evidence of robust discussion and challenge by the Board in relation to proposed new fund strategies/ structures and their attendant risks early in the process, e.g. when the investment strategy is being formulated and prior to the submission of a fund application to the Central Bank.

6. Organisational Effectiveness

The Central Bank identified weaknesses across a large number of FMCs in how the director responsible for organisational effectiveness (the "OED") performs the role. Among the weaknesses specified were the following:

- absence of evidence that regular meetings were conducted with the Designated Persons. The Central Bank noted that interactions between the OED and the Designated Persons should be at least quarterly or as necessary;
- absence of evidence that the OED had given any consideration to conflicts of interest and personal transactions;
- absence of formally documented meaningful, regular interaction between the OED, the Designated Persons and the Board in relation to the adequacy of the FMC's internal resources;
- absence of formal reporting to the Board, especially in the area of resource evaluation. The Central Bank noted that the OED should formally report to the Board at least annually and this report should include detail on how conclusions with regard to resourcing were reached;
- absence of a documented board effectiveness evaluation on an annual basis. The Central Bank noted that this review should include findings and time specific actions; and
- absence of a detailed report to the Board, at least annually, encompassing at a minimum, information pertaining to each of the matters prescribed in the Guidance (including conflicts of interest and personal transactions).

Governance and Culture Trends Identified

The Industry Letter identified three key trends for FMCs to consider:

Appointment of a CEO – The Central Bank noted that the vast majority of FMCs have not appointed a CEO and they would expect that all but the smallest FMCs should have a CEO.

Tenure – The Central Bank identified that the majority of FMCs had at least one independent non-executive director ("INED") with a tenure greater than 5 years and over a quarter have at least one INED with a tenure greater than 10 years. The Central Bank expects that the OED's documented review of the FMC's Board composition should include consideration of each INED's tenure and an assessment of ongoing independence, as well as considering how to achieve a sufficiently regular rotation of Board members to ensure independent challenge at Board level.

Gender Balance – The Central Bank has highlighted a significant gender imbalance on the Boards of FMCs with only 16% of director roles held by women and has recommended that FMCs consider gender diversity as part of their board review.

Action Required

Further to the review, the Central Bank has commenced supervisory engagement with FMCs where specific concerns have been identified. The Central Bank expect that for many this will result in risk mitigation programmes, however, more serious findings may require the Central Bank to use their statutory enforcement powers.

In addition, the Industry Letter requires action on behalf of all FMCs. Each FMC must critically assess their day to day operational, resourcing and governance arrangements against all relevant rules and guidance, taking into account the findings of the review.

An action plan must be prepared for consideration and approval by the Board of each FMC before the end of the first quarter of 2021. The action plan must give consideration to the following:

- the time commitment, skills and expertise of available resources;
- the FMC's retained and delegated tasks, including how ongoing independent challenge of all delegates can be ensured;

- the tasks required by the framework, including those that must be completed on a fund by fund basis;
- how resources and operational capacity will need to increase to take account of any increase in the nature, scale and complexity of the funds under management since authorisation or the last time the FMC critically assessed its operations; and
- how resources and operational capacity will need to increase to deal with a market and/or operational crisis.

The Central Bank plan to conduct an industry wide review of FMCs' engagement with the recommendations of the Industry Letter and should an FMC become subject to Central Bank supervisory engagement or enforcement regard will be had to the FMC's level of engagement with the recommendations.

Conclusion

Although the Central Bank has found that a significant number of FMCs have not fully implemented the Guidance and that action is required, the Industry Letter does not in itself create many additional requirements that are not otherwise contained within the Guidance or have not been flagged by the Central Bank as part of its ongoing engagement with industry over the last 24 months. The most significant item would appear to be the codifying of a minimum requirement of 3 FTEs for all FMCs no matter how small in size and this is likely to be the most impactful requirement for many self-managed FMCs. However, it should be noted that a similar expectation was outlined by ESMA in its Brexit related opinion on supervisory convergence in the area of investment management when issued in July 2017 so the inclusion of this requirement in the Industry Letter is not entirely unexpected. It remains to be seen whether the Industry Letter will have the effect of moving self-managed FMCs to an externally managed model or other broader implications for FMCs more generally.

Key Contacts

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