Central Bank's Securities Markets Risk Outlook Report and Key Areas of Focus for Funds and their Service Providers

February 2022

On 8 February 2022, the Central Bank of Ireland (the "**Central Bank**") published its second annual Securities Markets Risk Outlook Report (the "**Report**"). The Report highlights the conduct risks that the Central Bank has identified as key for securities markets in 2022, being misconduct risk, sustainable finance, governance, conflicts of interest, financial innovation, data, cyber security and market dynamics. The Report also outlines the Central Bank's expectations of regulated financial service providers ("**RFSPs**") and market participants in terms of identifying, mitigating and managing those risks in the context of their particular business activities. Finally, the Report sets out, at a high level, the Central Bank's supervisory priorities for securities markets in 2022.

While the scope of the Report is far reaching, we have sought to summarise the key points of relevance for funds and fund service providers in this update.

Supervisory Priorities for 2022

The priorities of the Central Bank of most relevance to funds and their service providers are:

- completing the Common Supervisory Action ("**CSA**") on valuations in the funds sector;
- following up on its review of its Fund Management Companies ("**FMCs**") Guidance of December 2016 ("**FMC Guidance**") and the CSA on UCITS Costs and Fees;
- continuing engagement with depositaries and fund administrators, including conducting targeted risk assessments focussing on governance, operational and capital risk;
- continuing with the planned supervisory review framework project for mandates of the Central Bank's Securities and Markets Supervision Directorate, focusing on the review of the PRISM impact rating model for funds and related supervisory engagement; and
- continuing to focus on supervisory convergence, which will involve working closely alongside ESMA and IOSCO.

Key Conduct Risks – A Specific Focus on those of Relevance to Funds and their Service Providers

Governance

Following on from its 2021 Securities Markets Risk Outlook Report where it highlighted the risks arising from failings related to Board oversight of delegates and third party intermediaries, the Central Bank has again identified ineffective Board governance as a key conduct risk in the securities market for 2022.

- Board Oversight, Governance Structures and Due Diligence

In the Report, the Central Bank highlights failures in board oversight, governance structures and due diligence as areas of particular concern. In this regard, the Central Bank notes that it expects boards to not only receive, but also challenge, the information they receive to effect good governance and management over the organisation as a whole. In addition, the Central Bank expects RFSPs to ensure that the board is accountable for all aspects of governance, including having a clear organisational structure that defines and clarifies responsibilities for operational, control and reporting processes and crucially identifies who within the organisation is responsible for making key decisions.

The Central Bank notes that it continues to see ineffective oversight of delegates and third party intermediaries by boards, specifically making reference to evidence of FMCs not undertaking sufficient due diligence of their delegates. Appropriate due diligence is seen by the Central Bank as an essential requirement before a fund or RFSP enters into a contractual relationship with another entity with all aspects of the proposed relationship requiring thorough scrutiny. Referring to its Cross-Industry Guidance on Outsourcing published in December 2021 (the "Outsourcing Guidance"), the Central Bank again confirms that it does not consider "delegation" and "outsourcing" as different concepts. The Central Bank expects firms to adhere to all legislative requirements on outsourcing and have regard to the Outsourcing Guidance.

» Fund Management Companies Guidance

The Central Bank also expresses its concern that a significant number of FMCs have not implemented a governance framework to the standard set out by the FMC Guidance. It highlighting specific deficiencies identified in its thematic review of the FMC Guidance such as failures by FMCs to have appropriate resources at their disposal to enable them to carry out their functions properly with staff lacking the required level of skills and experience. The Central Bank requires FMCs to clearly identify named individuals who are responsible for monitoring and overseeing the managerial function assigned to the individual and expects both funds and FMCs to consider and address how resources and operational capacity will need to change to take account of any increase in the nature, scale and complexity of funds under management.

» Investment Advisors Acting as Investment Managers

The Central Bank has noted an increased incidence of investment advisors acting in the capacity of de facto investment managers with more influence and control than it deems is appropriate. It states this can lead to an imbalance in the relationship between the management company, investment manager and investment advisor, often reinforced by other service providers, whereby interactions, reporting and the resolution of issues rests with the investment advisor rather than with the management company or investment manager. The Central Bank expects that the services provided by the investment advisor are non-discretionary in nature and that where investment advisors are appointed in respect of a particular fund, a detailed rationale is provided for the appointment. The Central Bank also highlights its expectation that boards regularly receive and scrutinise the investment manager's report, including any interaction with investment advisors during the period in question.

Market Dynamics (Fund Liquidity and Leverage)

The Central Bank expects funds and FMCs to have an appropriate risk management framework in place to identify, manage and mitigate the potential risks arising from the use of leverage and liquidity risk within a fund's portfolio. It also expects Funds and FMCs to perform frequent stress testing of liquidity and leverage positions against plausible shock scenarios and assess their impact on the fund's performance and investors' redemption requests. The Central Bank also expects regard to be given to a number of letters and reports relating to liquidity published by the Central Bank and ESMA in 2020 and 2021[1].

Sustainable Finance

Sustainable finance has, unsurprisingly, been highlighted by the Central Bank as a key priority for 2022. The Central Bank expects capital markets to play a central role in the transition toward a carbon neutral economy. The rapid growth of the sustainable finance market in recent years has brought with it an increase in the risk of greenwashing as firms try to meet investor demand by selling products marketed with sustainable credentials which in reality do not meet such criteria. The Central Bank therefore expects firms to be cognisant of their responsibilities in this area, with investor interests and market integrity to be protected. The Central Bank also expects firms to devote sufficient resources and management focus to ensure that their obligations under the ever evolving sustainable finance framework continue to be successfully implemented. Finally, the Central Bank expects firms to have regard to the supervisory expectations set out in its climate risk letter.

Conflicts of Interest

As part of the Central Bank's consideration of the risks associated with conflicts of interest, the Report highlights certain shortcomings observed with regard to compliance with the Central Bank's Connected Parties Transactions Rules (the "CPT Rules") including depositaries and designated persons not performing their duties in this regard with adequate rigour. The Central Bank expects that robust engagement with depositaries and designated persons takes place when such transactions are being contemplated to ensure that all parties fulfil their obligations in accordance with the CPT Rules and that the interest of investors is always protected.

1 ESMA's report of 12 November 2020 on the ESRB recommendation on liquidity risks in funds, the Central Bank's letter of 10 March 2021 relating to ESMA's report, ESMA's public statement of 24 March 2021 and the findings set out in the Central Bank's letter to UCITS FMCs on 18 May 2021.

Financial Innovation

Noting the recent increase in queries relating to investment by UCITS or AIFs in crypto-assets, the Central Bank again restated its current position on such assets, as outlined in its UCITS Q&As and AIFMD Q&As, that it is highly unlikely to approve a UCITS or a Retail Investor AIF proposing any exposure (either direct or indirect) to crypto-assets, having regard to the specific risks attached to crypto assets and the possibility that retail investors may lack the adequate expertise to carry out an appropriate risk assessment.

In the context of the influence of third parties on new products, the Central Bank notes the increasing influence yielded by index providers in fund product design as well as the fact that the sale of funds through platforms or distributors can result in dealing and settlement times which are inappropriate for the particular liquidity profile of the fund. The Central Bank states that it expects fund managers to maintain adequate autonomy over product design and oversight on the selection of index providers, including seeking evidence of initial and ongoing due diligence by the investment manager and understanding the method and nature of index methodologies, including rebalancing. In addition, the Central Bank states that if the requirements for on-boarding with a platform or distributor are not consistent with the characteristics and profile of the relevant investment fund portfolio, the Central Bank does not consider it appropriate to distribute through these means.

Misconduct Risk

Those funds and their service providers subject to the Market Abuse Regulation should, in particular, take note of the Central Bank's expectations in terms of suspicious transaction and order reports and insider lists.

Data and Cyber Security

In the context of the final two risks highlighted by the Central Bank, data and cyber security, the Central Bank notes the importance of the quality of data used by RFSPs and makes reference to the Central Bank's Cross Industry Guidance on Operational Resilience published in December 2021, stating that RFSPs need to take steps to understand critical business services and ensure they are able to withstand disruption from operational and cyber risks.

Action to be taken

The Central Bank expects all securities markets participants including FMCs to review the risks and supervisory priorities outlined in the Report and to update their risk assessment and mitigation programmes, as needed, to align with the Central Bank's expectations. It should be noted that in its Report, the Central Bank warns that supervisory action will be taken where securities market participants have not considered the risks set out in the Report or fall short of its expectations in this regard.

If you have any queries relating to any of the points highlighted above, please reach out to your usual contact in Walkers or connect with:

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