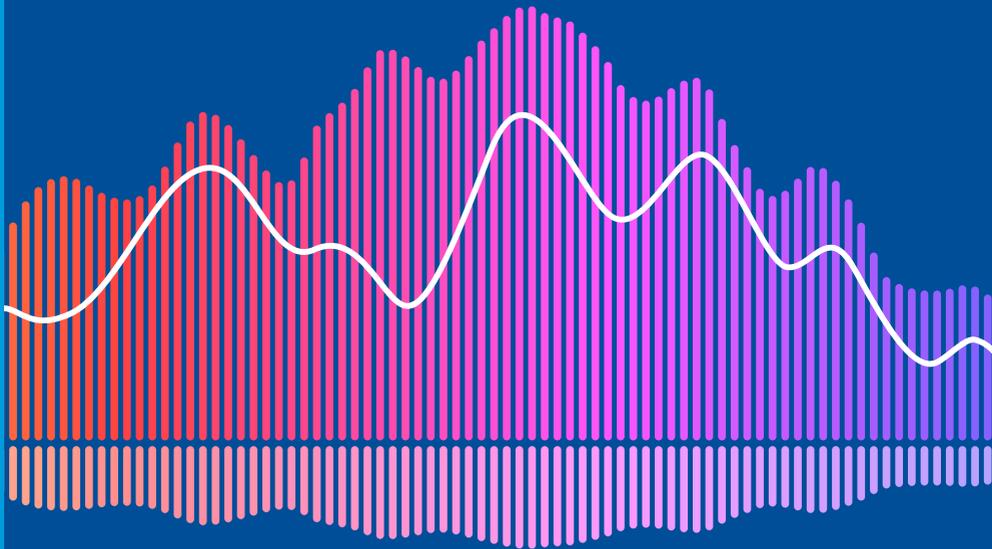




CP86 Implementation Considerations for Fund Management Companies



The issue of substance has received much attention in the fund management space in the EU in recent times. In an opinion issued by ESMA, national competent authorities have been cautioned against the authorisation of “letter-box entities” in a post Brexit scenario. The Central Bank of Ireland (the “Central Bank”) has addressed substance requirements in their final rules and guidance on fund management company effectiveness issued in December 2016, effective for all fund management companies from 1 July 2018. In a further development, the CSSF has introduced similar substance requirements in Luxembourg, based on a circular issued in August 2018.

The Central Bank’s final rules and guidance on the effectiveness of a fund management company (UCITS Managers and AIFMs including self-managed UCITS/AIF) or “CP86” as it is known within the industry, amalgamates previous guidance on delegate oversight, organisational effectiveness and directors’ time commitments with the new guidance on the performance of managerial functions, various operational issues and procedural matters. Governance, compliance and supervisability are the three core aspects of effectiveness, set out by the Central Bank in CP86. The Central Bank has expressed the view that a fund management company that can demonstrate its strength in these key areas indicates both substance and the ability of the company to better protect investors.

The Board and Organisational Effectiveness

CP86 introduces the requirement for an independent Chairman or an independent board member to perform an “organisational effectiveness” role for the fund management company.

The role is designed to ensure that an independent director, who does not carry out a managerial function, is tasked with keeping the effectiveness of the organisational arrangements of the company under continuous review. CP86 provides a non-exhaustive list of focus areas to be considered as part of the performance of the role; however responsibility lies with the fund management company to ensure this role is appropriately implemented in practice.

The individual appointed to the role must report to the board on the performance of his/her duties. The board should be able to demonstrate constructive challenge of management/ delegate information received. An important point to bear in mind is that the Central Bank’s expectation is that this discussion is evidenced and has emphasised that fund management company board meeting minutes are a key way of demonstrating the board’s consideration of compliance with the principles outlined in CP86.

The Location Rule and Brexit

The Central Bank has introduced a new “Location Rule” linked to the 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, assessing the risks they pose to the economy and consumer and mitigating the risks the Central Bank deems unacceptable. The final Location Rule has now been put on a legislative footing and is included in Central Bank UCITS Regulations 2017¹.

Under the Central Bank UCITS Regulations 2017, the location rule has been expanded to include residency in the EEA or an equivalent country. It is anticipated that the updated location rule will be reflected in the AIF Rulebook in due course. The final Location Rule states that:

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



** or such other country as the Central Bank may, taking into account criteria regarding effective supervision, determine and advise by notice published on its website.*

The forthcoming withdrawal of the United Kingdom from the EU following the Brexit referendum could have proved problematic for UK investment managers. However the Central Bank has indicated that the UK would be considered as being equivalent to an EEA jurisdiction for these purposes.

It is worth noting that, in relation to director’s time commitments, the Central Bank has indicated that a reasonable commitment is 20 directorships and 2,000 working hours per year and that anything above this indicates a risk of a director’s duties not being performed properly. Not only should individuals consider the number of directorships they have, they should also take into consideration the number and complexity of underlying sub funds within one investment fund and the number of different client relationships they have entered into when assessing time commitments.

¹ The Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) (Amendments) Regulations 2017 (S.I. No. 344 of 2017)

Delegate oversight

CP86 covers, in detail, the relationship between the fund management company and its delegates, where significant tasks are delegated externally and sets out a framework for good practice in relation to the monitoring and oversight of delegates, delegated tasks and retained tasks.

A key aspect of CP86 is making sure that while activities may be delegated, the ultimate responsibility for any delegated functions remains with the board. In that regard, CP86 specifically highlights the supervision of delegates performing investment management, distribution, risk management and investment operations and administration functions. Consideration needs to be given to the on-going review of competencies and performance of delegates and to the appropriateness of the frequency of on-site visits and meetings.

Under CP86 fund management companies must have sufficient resources and capability to adequately supervise delegates. This will be an area of particular interest to the Central Bank to ensure tasks are not delegated back to the UK, in a post Brexit scenario, to the point that the fund management company in Ireland becomes a "letter box" entity.



Designated Persons

CP86 outlines the six managerial functions that designated persons must be appointed to. The role of a designated person is a pre-approved control function ("PCF") 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 is important for fund management companies to take this guidance into account when appointing designated persons and updating their letters of appointment.

The key skill set and competence of each designated person must be matched to the appropriate function, for example, the designated person for distribution should have appropriate knowledge and experience relating to distribution of funds. The individuals appointed as designated persons should have appropriate seniority to enable them to appropriately challenge delegates when issues or potential issues arise. The Central Bank

has highlighted that the designated persons who conduct managerial functions are the management layer between the board and delegates and they ensure that the strategies, policies and directions issued by the board are acted upon and complied with.

Operational Matters

CP86 also addresses a number of operational matters such as record retention and retrievability. Fund management companies must keep all of their records in a way that makes them immediately retrievable in or from the State. When the Central Bank request a document from a fund management company, it expects to receive it within strict timelines. This could prove a major challenge, for example if the document in question is held by a US delegate how will it be retrieved within the timeline?

Fund management companies must also operate a designated email address for communication with the Central Bank. Fund management companies must ensure that this email address is monitored on a regular basis to allow for a timely response to any Central Bank requests.

Looking forward

In a notice published in July 2018, the Central Bank clarified that its supervisors will begin assessing how fund management companies have implemented and embedded the new requirements and related guidance into their organisations and the appropriateness of the resource and organisational structure in place. The Central Bank has indicated that an area of interest will be the assessment work performed by the organisational effectiveness role holder, generally the independent non-executive director, and in particular, how the boards have implemented any proposals to improve organisational effectiveness.

The Central Bank has outlined that due to Brexit it is seeing a substantial increase in fund management company applicants and that the work completed in relation to these new applications is providing useful insights into how these applicant firms have incorporated CP86.

The Central Bank has highlighted that it believes that CP86 has put it in an effective position when it comes to the requirements outlined in ESMA's Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union. The Opinion looks at the key areas of authorisation, governance and internal control, delegation and effective supervision.

The Central Bank has outlined that, in 2019, the intention is to carry out a more detailed assessment on how existing firms have implemented CP86 and following that review further changes or additional guidance may be required. Existing fund management companies should now be critically assessing their operations against the new requirements and the guidance and making any necessary changes, for example, to the time assigned to carrying out of the designated person roles.

The Central Bank has also been clear on the expectation that documentation is available to evidence how a fund management company has effectively implemented CP86.

CSSF circular

Other national competent authorities may follow suit and introduce comparable measures. For example, in August 2018, the CSSF in Luxembourg issued Circular 18/698 addressed to Luxembourg based Fund Managers (UCITS Managers and AIFMs including self-managed UCITS/AIF). The circular sets out the fundamental governance and organisational structures that are expected in terms of substance for Luxembourg based fund managers. The new Circular is a useful compilation of guidance on the required level of local substance and on how the core business activities and internal controls functions should be organised, including the conditions for delegation of activities as well as on the concept of proportional application of the rules.

The Circular provides clarity on a number of key areas including, but not limited to:

- The roles and responsibilities of Directors and thresholds on their professional time commitments. Directors are in principle limited to 20 mandates and 1,920 hours, however, there is some flexibility including for mandates on Special Purpose Vehicles held by the funds and for mandates within the same umbrella of funds;
- The responsibilities and location of Senior Management including their time commitments, other mandates and responsibilities. The CSSF expects a fund to have at least two full time Senior Managers located in Luxembourg, although gives flexibility to Managers with less than €1.5bn in assets under management;
- Substance and organisational requirements, including a minimum of 3 full time equivalents (FTE) employed and located in Luxembourg as well as guidance on staff secondments;
- Requirements for initial and ongoing due diligence on delegates, including criteria to be used for the selection of delegates, the risk based approach, permanent monitoring, periodicity and follow-up; and
- The requirement for a person, to have responsibility for AML/KYC requirements, at board level with experience and effective capabilities and based in Luxembourg

Unlike the Central Bank, the CSSF prescribes a minimum number of full time staff it expects to be located in Luxembourg.

The 101 pages of the new Circular came into immediate effect on 23 August 2018.

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