



20 October 2020

## Re: Thematic review of fund management companies' governance, management and effectiveness

Dear Chair,

As you will be aware the Central Bank of Ireland recently completed a thematic review assessing how Fund Management Companies (FMCs)<sup>1</sup> have implemented Central Bank requirements<sup>2</sup> and related guidance<sup>3</sup> in relation to the organisation of FMCs.<sup>4</sup> This framework, which was introduced in 2017 for firms seeking new authorisation and in mid-2018 for existing firms, sets out the standards to be met by these firms in respect of their governance, management, control and resourcing. When we introduced the framework we made clear that we would be reviewing how firms were implementing it. This letter sets out the findings of that review.

The Central Bank's fund management company framework sets out a comprehensive set of rules and guidance on the effective governance, management and organisation of these entities. Underpinned by legislative requirements designed to deliver high levels of investor protection, market integrity and systemic resilience, the framework was introduced to provide increased clarity as to the standards to be met by firms in this sector. The framework details the standards that apply across a range of aspects of fund management company activities. These include: organisational effectiveness, the performance of managerial functions, delegate oversight, resourcing, etc.

From our in-depth analysis, this review found that when applied correctly by firms, the rules and guidance provide a framework of robust governance, management and oversight arrangements. Furthermore, the review evidenced that some FMCs were able to demonstrate that they were largely compliant with the framework and met the Central Bank's expectations in many respects. These FMCs had resourcing and operational structures in place that underpinned a considered, well-planned approach to implementation of the framework. These findings align with our experience in respect of the large number of recent applications for authorisation, where the application of the framework has provided a strong basis for firms to identify and retain the level

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<sup>1</sup> "Fund Management Company" refers to a UCITS management company, an authorised Alternative Investment Fund Manager (AIFM), a self-managed UCITS investment company and an internally managed Alternative Investment Fund which is an authorised AIFM.

<sup>2</sup> The requirements are contained in the Central Bank UCITS Regulations and the Central Bank's AIF Rulebook.

<sup>3</sup> The requirements are supported by the Central Bank's Fund Management Companies – Guidance, dated December 2016 ("the Guidance").

<sup>4</sup> Central Bank requirements in relation to the organisation of Fund Management Companies came into full effect on 1 July 2018.

and nature of resources needed and to put in place the required governance, management, systems and controls.

The review found however that a significant number of previously authorised FMCs have not yet fully implemented the framework. Many were able to evidence the introduction of only limited changes following implementation of the Guidance. Two years after its coming into force, it is expected that every FMC should have critically assessed their operations against the new requirements and made the necessary changes to ensure compliance.

The review consisted of three distinct phases comprising 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. By targeting these core areas it allowed the inspection teams to examine in detail how FMCs had implemented the framework. The review was a significant undertaking for the Central Bank. It covered all 358 active FMCs and spanned 18 months, with in excess of 30 Central Bank staff involved over the course of the review. The industry questionnaire comprised 88 questions exploring all areas of the Guidance. Approximately 1,480 documents were reviewed for the purpose of the desk-based phase and 30 onsite engagement meetings held between December 2019 and March 2020.

The matters set out in this letter will be relevant to your firm as our review identified issues to be addressed across the full suite of firms reviewed. As Chair of the Board you should prioritise your Board's attention to evaluating your firm's arrangements in the context of the findings from this review. We expect all FMCs to take immediate action to critically assess their operations to identify the steps necessary to ensure that they meet the required standards. Set out below are the main findings from the review, all of which you should consider and take necessary action in the context of your firm.

## **Resourcing**

The review found many instances where FMCs authorised before the Guidance was introduced did not have appropriate levels of resources in place to ensure effective implementation of the framework. A FMC 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. It must be able to clearly demonstrate that its governance structure, including its entity-specific second line of defence, is sufficiently resourced to achieve this.<sup>5</sup>

The Central Bank's expectation is that all FMCs should have a minimum of 3 FTE<sup>6</sup>, each of whom should be suitably qualified and of appropriate seniority to fulfil the role. This number is of course a minimum expectation and only relevant to the smallest and simplest of entities. Other firms

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<sup>5</sup> In doing so it must also take account of the increased volume of regulatory obligations that have come into effect over recent years – e.g. under the Money Markets Funds Regulation, the European Market Infrastructure Regulation (EMIR), the Securities Financing Transactions Regulation (SFTR); as well as under guidance such as the ESMA guidelines relating to stress testing of liquidity risk in UCITS and AIFs.

<sup>6</sup> FTE refers to full time employee or equivalent to full time employee.

will be expected to have a level and quality of resourcing determined by the nature, scale and complexity of its operations.

FMCs must appoint locally based persons who conduct managerial functions (Designated Persons) and other staff with sufficient time dedicated to their roles in order to fulfil their duties, which include oversight of delegated activities. For larger firms, Designated Persons are expected to be full time roles. Resourcing levels should be kept under review, particularly as the FMC's business grows in scale and complexity. The Central Bank expects that such growth is reflected in appropriate resourcing.

The large number of FMC authorisation applications received as a result of the decision of the UK to leave the EU allowed the Central Bank to examine in detail the resources that new entities require to comply with their obligations. The application of the framework to the authorisation of firms following its introduction in 2017 has resulted in appropriate and effective overall levels of resourcing in those firms. However, the review highlighted material divergences from this resourcing standard in the firms whose authorisation pre-dated the framework coming into force. The review also found that where a FMC employs less resources, this is often symptomatic of an over-reliance on group entities and/or delegates, resulting in deficiencies in the legal entity-specific second line of defence.

### **Designated Persons**

Significant shortcomings were identified in relation to how some Designated Persons discharge their roles. Deficiencies were identified regarding the level of review carried out on the monthly reports received from delegates and the independent analysis thereof and ultimately the quality of the information provided by the Designated Person to the Board. In many cases, the Designated Persons did not commit sufficient time to their role and/or have sufficient support available to enable them to discharge their responsibilities appropriately.

Evidence of constructive challenge by Designated Persons and interrogation by them of information received from other FMC staff and delegates is an indicator of a well-managed FMC which takes compliance with its obligations seriously. As outlined in the Guidance, Designated Persons should have enough time available to them to carry out their roles thoroughly and to a high standard. Designated Persons should be able to clearly evidence the value they bring to that oversight through documented Board reporting.

### **Delegate Oversight**

Many FMCs failed to fully implement the Guidance in the area of delegate oversight. Some firms were unable to evidence that they had carried out the appropriate level of due diligence on their delegates, both initially, for the purpose of determining appointment, and on an ongoing basis thereafter. While many FMCs rely on the policies and procedures of delegates/group, not all could demonstrate that they had reviewed and approved delegate/group policies and procedures as being fit for purpose when applied to the firm. The Central Bank expects that due diligence reviews are conducted by the FMC at initial take on and annually thereafter. Where reliance is placed on delegates' policies and procedures, the FMC should have a formalised

process to review all delegates' policies and procedures. This should be done both on appointment and on an ongoing basis for the duration of the relationship to ensure they remain fit for purpose.

The Central Bank found a significant number of cases where there was a lack of effective engagement with delegated investment managers. In these cases, issues arose but were not resolved in a timely manner. In some cases, delegate reports received were not of sufficient quality to allow for a meaningful review of the situation by the FMC, and steps were not taken to address this. This was of particular significance where there was a high number of appointed investment managers. Where such issues arise, the FMC should challenge the delegate and where necessary take further action. It should be able to evidence such challenge and action.

Furthermore, as identified in previous reviews, some FMCs did not have documented Service Level Agreements (SLAs) for each of their third party arrangements. All delegate arrangements should be governed by way of formally documented SLAs.

### **Risk Management Framework**

Deficiencies were identified in the risk management framework and components thereof for a significant number of FMCs. Many firms did not have in place an entity specific framework, an entity specific risk register and/or defined risk appetite. In many cases, this was a result of over-reliance on group frameworks. The Guidance specifies that all FMCs are required to have a robust Board approved, entity specific risk management framework which should include, inter alia, a risk register and risk appetite statement. The Board should be satisfied that the risk management framework is fit for purpose and reviewed regularly but no less than annually.

### **Board approval of new funds**

Not all FMCs could evidence approval by the Board of the launch of sub-funds. It was also found that in some instances, even where the guidance was being complied with, this was done in such a way that the Board was approving the investment fund / strategy just prior to launch.<sup>7</sup> Often there was no evidence of earlier discussions to set or agree the proposed strategy of the fund prior to submission of the application to the Central Bank.

The Central Bank expects evidence of robust discussion and challenge by the Board in relation to proposed new fund strategies/structures and their attendant risks. The Board should be involved early in the process, for instance when first formulating the investment strategy of a new fund or prior to the submission of a fund application to the Central Bank.

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<sup>7</sup> PART I, Delegation Oversight, Section A (Investment Management), paragraph 24 of the Guidance sets out that: *The board should seek a report or presentation from the investment manager prior to the issue of the prospectus and launch of the investment fund or sub-fund (the "relevant fund" in this Part) to inform it of the investment approach the investment manager proposes to take. It should approve the proposed investment approach, taken as a whole.*

### **Director for Organisational Effectiveness (OED)**

The Guidance sets out that the OED should be a change leader and bring to the Board proposals to improve the effectiveness of the FMC. Weaknesses were identified across a large number of FMCs in how the OED performs the role. In many cases the OED could not evidence that meetings were conducted and no formal records of meetings with the Designated Persons were kept. Many OEDs failed to provide evidence that they had given any consideration to conflicts of interest and personal transactions and there was an absence of formal reporting to the Board.

The lack of Board reporting was especially apparent in the area of resource evaluation. Many OEDs stated that they were satisfied with resourcing levels within the FMC, but were then unable to evidence how this conclusion had been reached. They were also unable to evidence the extent to which they challenged the existing resourcing levels and, ultimately, how they reported their finding to the Board.

A key responsibility attributed to the role of OED is monitoring the adequacy of the FMC's internal resources. To achieve this, the Central Bank expects there to be meaningful, regular interaction between the OED, the Designated Persons and the Board. All of these interactions should be formally documented and available to the Central Bank upon request. Interactions between the OED and the Designated Persons should be at least quarterly or as necessary. OEDs should be particularly cognisant of the findings in relation to Designated Persons and delegate oversight noted above.

The OED should report to the Board at least annually and this report should include detail on how conclusions with regard to resourcing were reached. It is also expected that the OED ensures that a documented Board effectiveness evaluation is conducted on an annual basis. This review should include findings and time specific actions.

Furthermore, all OEDs are required to consider conflicts of interest and personal transactions on an ongoing basis. A detailed report should be presented to the Board of the FMC at least on an annual basis which should encompass, at a minimum, information pertaining to each of the matters prescribed in the Guidance.

### **Governance and Culture trends identified**

The review also identified a number of findings on matters not specifically covered by the current guidance, including:

- The vast majority of FMCs have not appointed a CEO. It is especially unclear how larger firms can be considered to have appropriate demonstrable substance while lacking a senior executive with responsibility for the day to day running of the business. The Central Bank expects that all but the smallest FMCs should have a CEO.
- The review found that two-thirds of FMCs have at least one Independent Non-Executive Director (INED) with a tenure greater than 5 years, while 28% of FMCs have at least one INED with a tenure greater than 10 years. The Central Bank expects that tenure and

ongoing independence be considered as part of the OED's review of Board composition and forms part of related reporting to the Board. OED reviews need to consider the appropriateness of the continued use of the INED designation where the INED is in place for such a prolonged period of time. This review needs to consider how to achieve a sufficiently regular rotation of Board members to ensure independent challenge at Board level. The review should be available to the Central Bank upon request.

- Information obtained from firms in the course of this review shows that there is a significant gender imbalance on the Boards of FMCs. Of the 1,654 directorships across 358 FMCs, only 266 or 16 % of director roles are held by women. Firms should consider gender diversity as part of the governance review as detailed in the "Actions Required" section below.

### **Action Required**

As a result of these findings, the Central Bank has commenced supervisory engagement with FMCs where specific concerns have been identified. This engagement will for many firms result in risk mitigation programmes on these specific matters. We are also reviewing some of the more serious findings and we will have regard to the full suite of tools available under the Central Bank Act 1942 and the Central Bank (Supervision and Enforcement) Act 2013 to resolve the matters identified in this review. In addition, findings from the review will also inform our consideration of policy development and potential future enhancements to the existing regulatory framework.

Whether or not a FMC receives a specific risk mitigation requirement from the Central Bank, all FMCs are required to critically assess their day to day operational, resourcing and governance arrangements against all relevant rules and guidance, taking into account the findings of this review. The FMC is also required to implement a time-bound plan for making the necessary changes to ensure full and effective embedding of all aspects of the Guidance.

The assessment and implementation plan should at a minimum consider 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;
- How resources and operational capacity will need to increase to deal with a market and/or operational crisis.



Firms should also continually evaluate their arrangements to ensure they remain fit for purpose.

The Central Bank expects that this letter will be discussed and considered by the Board. The firm's analysis should be completed and an action plan discussed and approved by the Board by end Q1 2021.

In circumstances of non-compliance by any firm with any regulatory requirements, the Central Bank may, in the course of future supervisory engagement, or when exercising its supervisory and/or enforcement powers in respect of such non-compliance, have regard to the consideration given by a firm to the matters raised in this letter. As well as our continued supervisory engagement with firms on these issues in 2021, we plan to conduct a further industry wide review of these matters in 2022 to assess firms' actions on foot of these findings.

Please direct any queries you may have regarding the contents of this letter to [cp86queries@centralbank.ie](mailto:cp86queries@centralbank.ie).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Gerry Cross'.

**Gerry Cross**

Interim Director of Asset Management and  
Investment Banking Supervision

A handwritten signature in blue ink, appearing to read 'Colm Kincaid'.

**Colm Kincaid**

Director of Securities and Markets Supervision