Banc Ceannais na hÉireann
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Enforcement Action

Central Bank of Ireland

and

Sarasin Funds Management (Ireland) Limited

Sarasin Funds Management (Ireland) Limited fined €385,000 and reprimanded by the Central Bank of Ireland for breaches of investment restrictions and inadequate supervision of delegates

On 27 September 2021, the Central Bank of Ireland (the **Central Bank**) reprimanded and fined Sarasin Funds Management (Ireland) Limited (the **Firm** or **SFMIL**) €385,000 in respect of four admitted breaches of investment funds regulations which occurred between 25 May 2017 and 2 March 2018 (the **Relevant Period**).

The Central Bank determined the appropriate fine to be €550,000, which was reduced by 30% to €385,000 in accordance with the settlement discount scheme provided for in the Central Bank's Administrative Sanctions Procedure.

The Firm is authorised by the Central Bank as a UCITS fund management company and is managed by a board of non-executive directors (the **Board**). The Firm uses a delegation model, whereby a number of fund management functions are delegated to external service providers, subject to ongoing monitoring by specific directors (the **Designated Directors**) and the Board. Among its delegations, the Firm delegates investment management services to an investment manager (the **Investment Manager**) and delegates the depositary function to a depositary (the **Depositary**).

The Central Bank's investigation commenced following a disclosure in August 2017 by the Depositary, in accordance with its statutory reporting obligation, about an advertent breach of

investment restrictions. In the course of investigating the circumstances surrounding the advertent breach of investment restrictions, the Central Bank found the following:

Advertent Investment Restriction Breaches

- The Firm's appointed Investment Manager, while conducting a merger of two funds managed by the Firm (the **Merger**), and while acting as a delegate of the Firm, deliberately breached certain investment concentration restrictions which the Firm (and by extension its delegates) are obliged to comply with under relevant fund regulations. The investment concentration restrictions in question mitigate risk to investors by reducing exposure to the possible failure of a single investment. Notwithstanding the delegation of investment management services to the Investment Manager, the Firm is at all times responsible for compliance with its regulatory obligations either through its own actions or those of its delegates.

Governance and Oversight of Delegates Breaches

- The Firm's governance, oversight and monitoring of its delegates was deficient:
    - The Firm was not consistently receiving all delegate reports and other information mandated under its own procedures to oversee its delegates. In relation to the Advertent Breach, both the exception control mechanism and the escalation control mechanism failed. The Board only learned of the advertent breach of investment restrictions 8 weeks later, on 1 September 2017.
    - The Board confirmed during its quarterly board meetings that it had received certain delegate reports which it had not in fact received.
    - The Designated Director for monitoring compliance went on sabbatical from 1 June 2017 until 27 September 2017. The Firm had no alternate Designated Director for monitoring compliance in place until 17 August 2017.
    - In the context of the Merger, the Board was aware of the potential difficulties in transferring some of the assets from one fund to another and therefore should have been aware that this could expose the Firm to regulatory and investment risks. The Firm failed to tailor its oversight and monitoring programme appropriately in respect of the Merger and in particular did not follow up with the Investment Manager as to the progress of the Merger at any point between its approval and completion.

Seána Cunningham, the Central Bank's Director of Enforcement and Anti-Money Laundering, has commented as follows:

"Each fund management company is authorised by the Central Bank on the basis of its business plan, which sets out how the Board will meet its legal and regulatory obligations. Regardless of any delegation of its functions, a fund management company remains responsible for compliance with its regulatory obligations.

The Central Bank expects Boards and designated directors to proactively challenge the activities and scrutinise the actions taken by their delegates, to be able to adequately oversee and monitor their delegates at all times, and to tailor their governance, oversight and monitoring programme appropriately when risks arise. SFMIL failed in this regard.

The Firm did not seek updates from its delegate on the progression of the merger of two funds, despite the merger's attendant risks. More generally, the Firm and its delegates were not following the reporting and communication procedures outlined in the Firm's own business plan. The Board did not challenge its delegates' failure to provide it with adequate information and did not act to correct these deficiencies. It is a particularly troubling finding of this investigation that the Board had confirmed on a number of occasions in the minutes of its own meetings that it had received certain delegate reports when in fact it had not. This falls well below the level of challenge and scrutiny required of the Firm to meet its regulatory obligations.

Effective compliance with the regulatory requirements placed on fund management companies is key to ensuring good governance, effective management and good organisation for the protection of investors, the integrity of the market and to promote systemic stability. Compliance by the industry with these requirements will continue to be an area of focus for the Central Bank."

BACKGROUND

The Firm is authorised by the Central Bank as a UCITS[1] fund management company. The Firm does not have any employees but is managed by a Board of non-executive directors.

The Firm's Business Plan dated 20 September 2016 (the **Business Plan**) set out how it intended to comply with its regulatory obligations which included the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (the **UCITS Regulations**) and the Central Bank (Supervision and Enforcement) Act 2013 (Section

[1] A UCITS (Undertaking for Collective Investment in Transferable Securities) is an investment fund that pools cash subscribed by investors and invests in a range of assets in accordance with its investment objective and policies. A UCITS is marketable to retail investors.

48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2015 (as amended)(the **CBI UCITS Regulations**). The Business Plan stated that, while the Board of Directors were jointly responsible for all the activities of the Firm, the monitoring of certain functions was assigned to the Designated Directors.

The Firm delegated certain day-to-day functions to a number of service providers, including the investment management function to the Investment Manager, the depositary function to a Depositary, and the administration function to an Administrator (the **Delegates**).

The UCITS Regulations permit the delegation by Irish fund management companies of certain tasks to external delegates. However, such a delegation does not reduce the management company's responsibility to comply with its regulatory obligations.

While the Board is responsible for all activities of the Firm, the Firm allocated responsibility for monitoring the management functions to specific directors, the Designated Directors. Each director of the Firm was responsible for at least one management function.

The Business Plan stipulated that separate reports from the Investment Manager, Depositary and Administrator were required to be provided to the relevant Designated Directors on a monthly basis (the **Monthly Reports**). In addition, separate reports from the Investment Manager, Depositary and Administrator were required by the Business Plan to be provided to the Board of the Firm on a quarterly basis (the **Quarterly Reports**).

The Business Plan also set out the procedure in respect of exception reporting and escalation reporting. If an issue arose between Monthly Reports, the relevant Delegate was to contact the relevant Designated Director on an exceptional basis to determine whether the issue was material. If the issue was deemed material, the Designated Director would escalate the matter by bringing it to the attention of the Board at the next quarterly meeting or, where appropriate, convene an immediate Board meeting. It is of particular significance that an advertent investment breach was provided in the Business Plan as an example of a material issue.

The Merger and the Advertent Breach

The Investment Manager prepared a Business Case, dated 10 April 2017 (the **Business Case**), which proposed that a specific Sub-Fund (the **Merging Fund**) be closed and merged into a specific Fund (the **Receiving Fund**) in July 2017 (the **Merger**). This Business Case was provided to the Board on 16 April 2017. It was subsequently approved by the Board via email on various dates up to 16 May 2017.

The Business Case approved by the Board of the Firm stated that the Merger would be on the basis that assets would transfer *in-specie*, a process through which the ownership of the underlying assets of one fund can be transferred to another, without the need to convert the assets to cash. The Board of the Firm were apprised, within the Business Case, of the operational risk that an in-specie transfer for some assets might not be possible (meaning that those assets would be liquidated prior to the resultant cash amount being transferred to the Receiving Fund). However, the Board failed to put in place any risk mitigation plans to avoid any scenarios whereby a conversion to cash could jeopardise fund compliance with regulatory obligation or investment objectives.

In or around June 2017, the Investment Manager decided to convert the vast majority of assets in the Merging Fund to cash in the days leading up to the Merger so that only cash would be transferred to the Receiving Fund, to be subsequently re-invested by the Receiving Fund in the relevant assets. This meant that investors would effectively be "*out of the market*", and would not benefit from any market movements, while their investments were held in cash.

On 5 July 2017, the Investment Manager (having sold the vast majority of the Merging Fund's assets to cash in the days leading up to the Merger) then took the decision, in order to recreate market exposure for the Merging Fund, to invest 94.49% of the assets of the Merging Fund into a UCITS exchange traded fund (the **ETF**). This was an advertent breach[2] (the **Advertent Breach**) of the investment restrictions set out in both the UCITS Regulations and the prospectus of the Merging Fund.

The UCITS Regulations and the Merging Fund's own prospectus restrict investment by a fund in a single UCITS or other collective investment undertaking fund to 20% of the value of the fund in the case of the UCITS Regulations and 10% of the value of a fund in the fund's prospectus. This diversification rule in the UCITS Regulations is specifically designed to mitigate risk to UCITS investors by reducing financial exposure to a single investment. The Investment Manager made the investment in the ETF in the knowledge that it would result in a breach of both the investment restrictions set out in the UCITS Regulations and the Merging Fund's prospectus (which in turn is a breach of the CBI UCITS Regulations). Notwithstanding the delegation to the

[2] The technical term for a deliberate breach of this nature is an "advertent breach". An advertent breach is a breach of the investment restrictions as defined in the fund's prospectus or applicable legislation, which is caused by factors under the control of the Responsible Party/Investment Manager. By contrast, an inadvertent breach is a breach of the investment restrictions as defined in the fund's prospectus or applicable legislation, which is caused by factors outside of the control of the Responsible Party/Investment Manager.

Investment Manager, the Firm remains at all times responsible for compliance with its regulatory obligations.

The Merging Fund returned to compliance on 7 July 2017, when the Investment Manager sold the units in the ETF and merged with the Receiving Fund.

The Central Bank was notified on 14 August 2017 of the Advertent Breach of investment restrictions following statutory disclosure by the Depositary. The Firm was notified of the Advertent Breach on 1 September 2017. The Depositary was satisfied with the Investment Manager's assessment that no compensation was payable to investors in respect of the investment in the ETF. This was accepted by the Firm.

PRESCRIBED CONTRAVENTIONS

1. **Breach of Investment Restrictions in the UCITS Regulations**

Regulation 73(1) of the UCITS Regulations permits a UCITS to acquire the units of other UCITS, provided that not more than 20% of its assets are invested in units of a single UCITS or other collective investment undertaking. This diversification rule is specifically designed to mitigate risk to UCITS investors by reducing financial exposure to a single investment.

The decision by the Investment Manager to invest 94.49% of the assets of the Merging Fund into the ETF between 5 July 2017 and 7 July 2017 caused an advertent breach of Regulation 73(1).

It was the responsibility of the Firm to ensure that the Merging Fund complied with the UCITS Regulations and CBI UCITS Regulations. It is of particular importance that this responsibility was in no way reduced, subordinated or otherwise affected by the fact that the Firm had delegated certain functions to various service providers.

2. **Breach of Investment Restrictions in the Merging Fund's Prospectus**

Regulation 50(1) of the CBI UCITS Regulations requires a management company to ensure that it, and the UCITS it is managing, comply with the terms of that UCITS' prospectus. This responsibility was not affected by the fact that the Firm had delegated certain functions to various service providers.

The Merging Fund's Prospectus included an investment restriction which stated *that "the Sub-Fund will not invest more than 10% of its Net Asset Value in units or shares of other UCITS or other collective investment schemes"*.

The Firm failed to ensure that the Merging Fund complied with the terms of its Prospectus between 5 July 2017 and 7 July 2017, thereby breaching Regulation 50(1).

3. Ineffective Reporting and Communication Procedures with the Firm's Delegates

Regulation 22 of the UCITS Regulations requires a management company to establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the management company as well as effective information flows with its delegates.

The Central Bank's investigation found that the Firm breached Regulation 22 and Schedule 4, part 1(d) of the UCITS Regulations for the period 1 June 2017 to 31 January 2018, with failings in the following areas:

Failure to ensure timely provision of Delegates' Reports

The Firm remains at all times responsible for compliance with its regulatory obligations and the Board must retain and exercise overall control of the Firm's management. The Firm's Business Plan set out the reporting arrangements which, in the Board's opinion, represented effective reporting and communication of information between the Firm and its Delegates. The Business Plan outlined the Monthly Reports and Quarterly Reports to be provided to the relevant Designated Directors and the Board by the Delegates. This included monthly and quarterly reports from the Investment Manager, and monthly and quarterly Depositary Oversight Reports from the Depositary, a third party entity responsible for safekeeping of the assets of the funds managed by the Firm. The responsibility for ensuring an effective information flow between the Firm and third parties lies with the Firm.

Quarterly reports were received in the Relevant Period. However, in the eight months between 1 June 2017 and 31 January 2018, Monthly Reports to the relevant Designated Directors by the Firm's Delegates, as required by the Business Plan, were not provided in all cases and were significantly delayed in others:

(i) During 2017, the Depositary submitted the monthly Depositary Oversight Reports to the Investment Manager, who then supplied them to the Board. However, there is no evidence of the May and June 2017 Depositary Oversight Reports ever being received by the Board, although these were provided by the Depositary to the Investment Manager on 12 June 2017 and 13 July 2017 respectively.

(ii) There is also no evidence of the monthly Investment Manager Reports for May and June 2017 being provided to the Firm.

(iii) The monthly Depositary Oversight Reports for July, August, September, October, November, and December 2017 were not provided to the Board until a Board meeting on 31 January 2018, although each had been provided by the Depositary to the Investment Manager within two weeks of each month end. Similarly, the monthly reports from the Investment Manager for each month between July to December 2017 were only provided to the Board on 31 January 2018.

The Central Bank's investigation found no evidence that the Firm identified the fact that it had not received all monthly reports, specified in the Firm's own business plan as being part of reporting arrangements necessary to ensure "effective reporting and communication of information" between the Firm and its Delegates. The Central Bank found no evidence that the Board of the Firm raised any objections to, or took any steps to rectify, this deficient practice in the supply of information during the Relevant Period.

At each of the Quarterly Board Meetings in 2017, each member of the Board confirmed that they had received not just quarterly, but also monthly, Investment Manager and Depositary Oversight Reports for the previous quarter. This was not the case:

- At the Board meeting in September 2017, the Board confirmed it had received all monthly reports. The Board did not receive monthly reports from the Investment Manager and Depositary for both May and June 2017, and did not receive the monthly reports from the Investment Manager and the Depositary for July 2017 and August 2017 until 31 January 2018.
- At the Board meeting in November 2017, the Board confirmed it had received all monthly reports. The Board did not receive monthly reports from the Investment Manager and the Depositary for September 2017 and October 2017 until 31 January 2018.

The use of monthly reports are one of the key controls in place to monitor and oversee the Firm's Delegates. As such, the Board's confirmations that it had received certain delegate reports, that

it had not, are very concerning to the Central Bank as they indicate that the Board was not ensuring this control was in operation.

Failure in Exception Reporting and Escalation Reporting

The Firm's Business Plan set out exception reporting procedures whereby the delegated service provider should notify the relevant Designated Director of an event which arises between monthly reports. In the case of the Advertent Breach, the Firm's Delegates did not bring this to the attention of the relevant Designated Director to determine whether the issue was material or not. This rendered the escalation reporting channel ineffectual.

It is the responsibility of the Firm to ensure that reporting mechanisms are embedded, understood by all parties and adhered to. In relation to the Advertent Breach, both the exception control mechanism and the escalation control mechanism failed.

Failure to keep a Designated Director for Monitoring Compliance in place

The Central Bank's investigation found that the Designated Director in the Business Plan for monitoring compliance of the Firm with its various regulatory obligations went on sabbatical from 1 June 2017 until 27 September 2017. The Firm had no alternate or substitute Designated Director for monitoring compliance in place until 17 August 2017. This left the Firm with no Designated Director for monitoring compliance for several months despite the Firm being on notice prior to May 2017 of the planned sabbatical.

4. Ineffective Supervision of the Firm's Delegates

Regulation 23(1)(b) and (f) of the UCITS Regulations permits a management company to delegate activities to third parties, provided that:

(i) the delegation does not prevent the management company from acting, or the UCITS from being managed, in the best interests of its investors; and

(ii) measures are put in place which enable the management company to monitor effectively at any time the activity of its delegates.

Regulation 98(1) of the CBI UCITS Regulations requires a management company to designate a specific director of that management company (or other individual) in respect of individual delegated activities, identify them in the business plan of the management company, and require them on a day-to-day basis to monitor and control each of the relevant delegated activities.

The Central Bank's investigation found that the Firm breached Regulation 23(1)(b) and (f) of the UCITS Regulations and Regulation 98(1)(b) of the CBI UCITS Regulations during the period from 25 May 2017 until 2 March 2018 (the date the Business Case for the Merger was approved by the Board to the date the Firm sought a formal report from the Investment Manager in relation to the Advertent Breach), as follows:

Failure in ongoing supervision and monitoring of the Firm's Delegates

The serious deficiencies outlined in the third prescribed contravention above meant that the Board did not have the necessary information to effectively monitor the activities of its delegates, which was the sole function of the Board.

- Essential information in relation to delegated functions was not being shared with the Designated Directors and the Board on a timely and ongoing basis. The provision of the Monthly Reports to the relevant Designated Directors by the Firm's Delegates, as required by the Business Plan, did not happen at all in some cases and was significantly delayed in others.
- This meant that Designated Directors were not in a position to escalate any issues identified by the Delegates that may have been included in the Monthly Reports.
- The absence of the Firm's Designated Director for monitoring compliance between 1 June 2017 and 17 August 2017 undermined the Board's ability to consistently and effectively monitor and supervise its Delegates.

Failure in ongoing supervision and monitoring of the Merger

A merger is a significant event for a UCITS and falls outside the typical business activity of an investment manager. The Central Bank expects management companies to maintain effective oversight of, and ultimate control of all relevant aspects of mergers.

The Investment Manager had correctly identified the operational risk that in-specie transfers might not be possible for some assets, and included this in the Business Case presented to, and approved by, the Board. The Business Case stipulated that should this arise, such assets would be liquidated into cash. It also stated that the Investment Manager was working with the Depositary to assess if in-specie transfer would be possible in all markets.

The Central Bank's investigation found that the Firm was aware that the specifics of the Merger meant that there was a heightened risk of a regulatory breach as it may not have been possible

to move all holdings in-specie.[3] Despite this, there was no formal consideration by the Board of the attendant risks (which would include regulatory and investment risks) should it be necessary to liquidate significant assets to cash. There was no ongoing supervision or monitoring of the Merger by the Board. More particularly, the Board did not implement (nor did it request the Investment Manager to implement) any risk mitigation plans to ensure investment restrictions were not breached during the Merger process.

The Board did not seek (and did not receive) any update in relation to the Merger after approving it, other than receiving a notification, as part of the note to the financial statements approved on 16 August 2017, that it had taken place. Despite having considered the possibility that an in-specie transfer for some assets may not have been possible, and then approving the Business Case for the Merger, the Board neglected to make any enquiries as to the progress and outcome of the Merger or to ask had any of the risks set out in the Business Case or any other risks materialised.

The Advertent Breach was communicated to the Board of the Firm on 1 September 2017 and the matter was raised and discussed at the first Board meeting following that communication on 7 September 2017. However, it was not until 2 March 2018, after the Central Bank had issued an investigation letter, that the Firm sought a formal report from the Investment Manager in relation to the Advertent Breach.

REMEDIATION

The Central Bank is satisfied that the Firm has now remediated the failings identified during this investigation.

PENALTY DECISION FACTORS

In deciding the appropriate sanction to impose, the Central Bank considered the Administrative Sanctions Procedure Sanctions Guidance issued in November 2019. The following particular factors are highlighted in this case:

The Nature and Seriousness and Impact of the Contraventions

- The breach of investment restrictions underlying Contraventions 1 and 2 arose from deliberate action by the Investment Manager. In addition, during the Relevant Period

[3] The potential regulatory breaches foreseen by the Firm did not include the investment in an ETF by the Investment Manager.

the Firm fell well short of the standard required under legislation and the Central Bank's expectations in its monitoring and supervision of the Investment Manager and its compliance with its own Business Plan.

- The Firm operates under the delegation model, and the Central Bank's investigation has revealed serious weaknesses in its supervision and monitoring of its delegates.
- A breach of investment restrictions of this kind creates a risk of loss for investors through over-exposure to a single asset.

Mitigating Factor – Previous Record

The Firm has not previously come to the adverse attention of supervisors or been the subject of an enforcement action by the Central Bank.

Other Considerations

The Firm's financial position and the need to impose a proportionate level of penalty.

The Firm provided the expected level of co-operation with the Central Bank during the investigation.

The Central Bank confirms its investigation into the Firm in respect of this matter is closed.

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NOTES TO EDITORS

1. The fine imposed by the Central Bank was imposed under Section 33AQ of the Central Bank Act, 1942. The maximum penalty under Section 33AQ is €10,000,000, or an amount equal to 10% of the annual turnover of a regulated financial service provider, whichever is the greater.

2. This is the Central Bank's 144th settlement under its Administrative Sanctions Procedure, bringing total fines imposed by the Central Bank to over €166.5 million.

3. Funds collected from penalties are included in the Central Bank's Surplus Income, which is payable directly to the Exchequer, following approval of the Statement of Accounts. The penalties are not included in general Central Bank revenue.

4. The Central Bank's *Outline of the Administrative Sanctions Procedure* provides for an early settlement discount of up to 30% in order to promote early resolution of matters, which in turn leads to better utilisation of the resources of the Central Bank. The Outline is available here.

5. As of 31 August 2021, over €3.8 trillion in assets is managed within 8,315 Irish authorised investment funds. Of these €2.9 trillion is managed within 5,051 UCITS investment funds.

6. In December 2016, the Central Bank published "Fund Management Companies – Guidance", available here. This is generally referred to as "CP86". This guidance is fully applicable from 1 July 2018. In October 2020, the Central Bank published a 'Dear Chair' setting out the key findings arising from its Thematic Review of fund management companies' governance, management and effectiveness, here.