ON**POINT** / A legal update from Dechert's Financial Services Group

The Central Bank's CP86 Day of Reckoning – What You Need To Know

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Dechert LLP

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For many in the funds industry, the issue on 20 October 2020 of the Central Bank of Ireland's (the "**Central Bank**") Industry Letter (the "Industry Letter") relating to the Central Bank's Thematic Review of Fund Management Companies' Governance, Management and Effectiveness (the "**Thematic Review**") was a "Day of Reckoning" in relation to the Central Bank's review of the operational model for many fund structures in Ireland.

In this article, we look at the content of the Industry Letter and its impact on fund structures and fund managers in Ireland.

A Brief Recap

When the UCITS Directive[1] was first introduced in 1985, it was a product-only EU Directive, and it did not stipulate that a fund management company ("**FMC**") should be appointed. FMCs were used extensively in other jurisdictions and, in Ireland, for non-corporate fund structures such as unit trusts.

In Ireland, the prevailing structure for a UCITS was a variable capital investment company structured as a public limited company. This corporate structure has largely been overtaken by the Irish Collective Asset-management Vehicle ("**ICAV**"), a bespoke corporate vehicle for investment funds introduced by the Irish Collective Asset-management Vehicles Act in 2015.

While FMCs were widely used, they were not subject to harmonized pan-EU regulation. The fact that managers of collective investment schemes were not subject to uniform EU regulation in the same way that investment managers under MiFID were regulated was a significant regulatory gap.

This gap was filled by the UCITS Management Company Directive[2] (the "**UCITS ManCo Directive**") which was implemented in 2001 in tandem with the UCITS Product Directive.[3]

In Ireland, the prevailing approach to the requirements of the UCITS ManCo Directive was to treat the UCITS as being self-managed or internally managed (i.e. a self-managed investment company or "**SMIC**"). The Central Bank developed guidance, which was a precursor to the Fund Management Companies – Guidance issued in December 2016 (commonly known as "CP86"), which mapped out how management companies including SMICs should be run.

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[1] Council Directive 85/611/EC.

[2] Directive 2001/107/EC.

[3] Directive 2001/108/EC.

The main tenet of this initial guidance required the FMC to appoint designated persons to carry out prescribed managerial functions. The concept of designated persons and managerial functions has remained at the heart of the regulatory model for FMCs.[4]

In the case of SMICs, the managerial functions were typically delegated by the SMIC to designated persons employed by consultancy firms and, over time, these consultancy firms have evolved to become FMCs in their own right.

Following the implementation of the UCITS ManCo Directive, there were abortive efforts by industry participants to move the Irish fund industry to more fully embrace the FMC model, but the SMIC model was entrenched and the FMC model was considered by many to add an additional and unnecessary layer of cost.

AIFMD

Following the global financial crisis of the late 2000s, regulators took steps to try to prevent similar crises occurring in the future. One such step was the implementation of the Alternative Investment Fund Managers Directive[5] ("**AIFMD**"). One of the main objectives of AIFMD is to increase the transparency of Alternative Investment Fund Managers ("**AIFMs**") vis-à-vis investors and competent authorities. The European Securities and Markets Authority ("**ESMA**") noted that the financial crisis highlighted the range of risks to which investors in investment funds are exposed, and accordingly, AIFMD was introduced to regulate AIFMs and to introduce safeguards to ensure that, amongst other things, investors in alternative investment funds ("**AIFs**") are well informed and adequately protected.

AIFMD differs significantly from the UCITS regulatory framework in that it is manager based; there is no equivalent of the UCITS Product Directive and no requirement for AIFs to be regulated.

Like the UCITS ManCo Directive, AIFMD made provision for SMICs, but early experience showed that regulators were not favorably disposed to self-managed AIFs. Many feared for the future of the SMIC at that point and they have been a 'rare bird' under AIFMD.

As a result of AIFMD, many of the consultancy firms providing designated persons and existing FMCs (e.g., those with existing Luxembourg operations) sought to provide third-party AIFM services. The extension of this service offering to UCITS was an obvious next step as an alternative to the provision of designated persons.

The proliferation of FMCs gave rise to detailed consideration by the Central Bank of their "effectiveness" and thus began the CP86 journey with the publication by the Central Bank of CP86 – its Consultation Paper on Fund Management Company Effectiveness in September 2014.

The 2014 Consultation Paper has long since morphed into the Central Bank's Guidance on Fund Management Companies but the moniker "CP86" remains and will be used in this *OnPoint*.

Brexit

The next stage in the evolution toward the primacy of the FMC model was Brexit.

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[4] The Central Bank has identified six key managerial functions for FMCs: Capital and Financial Management; Operational Risk Management; Fund Risk Management; Investment Management; Distribution; and Regulatory Compliance.

[5] Directive 2011/61/EU.

Brexit gave rise to fears that UK managers would lose access to EU markets as a result of the loss of passporting rights. It was thought that the loss of passporting rights might be avoided by those UK managers relocating to EU countries such as Ireland, provided those UK managers could meet the 'substance' requirements stipulated by the Central Bank.

So while AIFMD gave rise to the mantra that, for new entrants to the Irish fund market at least, you must have an FMC, Brexit gave rise to the mantra that your FMC must have substance.

This led to an evolution of the Central Bank's approach to CP86, which was underpinned by the Opinion issued by ESMA on Supervisory Convergence in the area of investment management (the "**ESMA Opinion**").

There had always been a sense that ESMA has heavily influenced many of the CP86 initiatives and the ESMA Opinion would seem to reinforce this sentiment.

Following the publication of the ESMA Opinion, fund managers who were engaging with the Central Bank with regard to Brexit applications from July 2017 began to notice a significant increase in the Central Bank's substance requirements for FMCs. This ESMA-informed approach is referred to in this *OnPoint* as the "**Brexit Framework**".

The Brexit Framework applied to all new FMC applications, so while AIFMD accelerated the decline of self-managed AIFs, one of the many unintended consequences of Brexit is its impact on self-managed UCITS.

The Brexit Framework approach to FMC applications relating to Brexit was accompanied by a notable increase in staffing by the Central Bank to put them in a position to be able to cope with the number of FMC applications. As a result, the Central Bank acquired significant experience and expertise along the way, giving rise to more detailed and comprehensive review processes.

AIFMD Review

Since issuing the ESMA Opinion, the views of ESMA have been further amplified in its August 2020 Letter to the European Commission on the Review of the AIFMD (the "ESMA AIFMD Letter"). The ESMA AIFMD Letter highlighted the direction of travel that ESMA wishes the European Commission to take in relation to issues such as substance, delegation, and use of seconded and support staff, not only under AIFMD but also under the UCITS Directive.[6] This policy orientation is reflected in the approach adopted by the Central Bank during the Thematic Review.

Waiting and Seeing

While new FMC applications were being subjected to greatly increased substance requirements, many existing FMCs and SMICs were waiting to see the outcome of this well flagged Thematic Review.

FMCs updated their business plans for the purpose of complying with CP86 but may not necessarily have taken account of the enhanced requirements under the Brexit Framework.

On 20 October 2020, the Central Bank released the Industry Letter arising from the Thematic Review which focused on a number of discrete areas, that we will address in turn.

[6] Directive 2009/65/EC.

In the words of Central Bank Director General Derville Rowland at the 2020 Irish Funds Annual Conference, "*CP86 was intended to bring about a step change in the sector. Our findings are that this has not been achieved to date. It now needs to be*."

Resourcing – Full Time Staff

The Industry Letter states that the Central Bank's "*expectation is that all FMCs should have a minimum of three [full-time employees or equivalents ("**FTEs**")], each of whom should be suitably qualified and of appropriate seniority to fulfil the role*". It goes on to state that this is a "*minimum expectation and only relevant to the smallest and simplest of entities*."

This requirement essentially mirrors the ESMA Opinion which provided that National Competent Authorities such as the Central Bank *"should apply additional scrutiny to situations where relocating entities, even those of smaller size employing simple investment strategies and having a limited range of business activities, do not dedicate at least three locally-based FTE (including time commitments at both Senior Management and staff level) to the performance of portfolio management and/or risk management functions and/or monitoring of delegates*."

While well flagged, the consequences of the Central Bank's expectations will be far reaching and significant for many funds and SMICs, in particular. While many SMICs had anticipated the direction of travel that the Central Bank would take and had engaged either an internal or third-party manager or moved to a platform, many of those who had adopted a "wait and see" approach were doing so because the move to an FMC, with the attendant costs, having regard to the scale required, could not be justified.

These funds will now have a decision to make. Some may decide to move to a third-party FMC or to a platform, but a few might decide to wind up or re-domicile the fund. Other SMICs may decide to retain their existing structure and address the substance requirements on an internally managed basis or to establish a proprietary FMC.

It is worth considering whether long-standing fund structures which are not growing or not actively marketed might be permitted "to see out their days" as SMICs noting the Central Bank's general expectation that all FMCs *should* have a minimum of three FTE. Similar considerations might arise for newly established funds for whom the costs of a structural change might impact its viability.

While the Irish fund industry is largely resigned to the resourcing requirements set out in the Industry Letter, some consideration should be given by the Central Bank to legacy funds, especially SMICs for whom the costs of compliance will impact viability. For example, it might be worth considering if such funds could be granted a special designation (*e.g.*, as a sub-scale fund) and be permitted an extended time frame (*e.g.*, five years) to comply. During that period, the fund could plan either to scale up or wind down its operations.

CP86 on Support and Resourcing
Fund management companies need to have sufficient resources at their disposal to enable them to carry out their functions properly, taking into account the nature, scale and complexity of their business. It is the responsibility of the board to determine in the light of its particular circumstances the appropriate resourcing of these functions and to satisfy itself that responsibilities for undertaking delegated tasks are allocated accordingly.

CP86 is not explicit nor prescriptive when it discusses resourcing and the Industry Letter notes that the change in approach did arise from the Brexit Framework. It will be interesting to see if the Central Bank updates CP86 to take account of the Industry Letter. It is worth noting that CP86 was not updated following the industry letter on closet indexing (see Dechert's *OnPoint* on the Central Bank of Ireland's Thematic Review on Closet Indexing: A Shot Across the Bows for UCITS Boards?) which contained the additional requirement to include suitability and viability in board reviews.

Resourcing – Designated Persons

Whither the Location Rule

One of the most hotly debated parts of CP86 was the so-called "Location Rule" which provided that, for most FMCs, half of the designated persons should be resident in the European Economic Area (the "**EEA**"), meaning that the other half of the designated persons did not need to be resident in the EEA and could be in other jurisdictions such as the United States. The Location Rule was codified in the form of a statutory instrument and this left the door open for the UK to be included as an equivalent jurisdiction.

Despite the fact that non-Irish-resident designated persons were permitted under the Location Rule, the Brexit Framework indicated a policy orientation, most likely based on the ESMA Opinion, toward the predominant use of locally based designated persons and this is demonstrated by the statement in the Industry Letter, "*FMCs must appoint locally based persons who conduct managerial functions (Designated Persons) and other staff...*" (emphasis added).

Increasingly, the role of designated persons is expected to be a full-time one for larger firms, although not all managerial functions require the same amount of dedicated time – *e.g.*, the Investment Management function is likely to require a higher time commitment than, for example, the Financial and Capital Management function. The Central Bank will often require future commitments in relation to staffing levels as part of the authorization process and treat these commitments as enforceable.

Keeping Resourcing Levels Under Review

The Central Bank expects resourcing levels to be kept under review, "*particularly as the FMC's business grows in scale and complexity*" and the Industry Letter states that it expects growth to be reflected "*in appropriate resourcing*."

For many FMCs who have made the decision to establish in Ireland and who have put the necessary infrastructure in place, growth in the Irish office is likely to occur organically and compliance with the requirements of the Central Bank will not be problematic.

For other FMCs, the substance requirements in Ireland are inimical to their global or group operating models and compliance with the requirements of the Central Bank is likely to be problematic. When FMCs are being approved, most discussion takes place around the level of resourcing and time commitments. In these instances, the FMC's business plan will outline future resourcing levels against expected growth.

FMCs whose approval predated the Brexit Framework will not have had their resourcing decisions subject to pre-approval by the Central Bank. Rather, it will be a matter for the FMC's board to consider. Boards should consider the Central Bank's minimum expectation of three FTEs and one designated person for each managerial function for larger firms as the basis for any discussions on resourcing. Most professional and advisory firms hold good data on the Central Bank's expectations with regard to resourcing based on the Brexit Framework.

Shortcomings Identified

Time Commitment

One of the principal shortcomings identified by the Central Bank in the Industry Letter relates to the time committed by designated persons to their roles. Following the Brexit Framework, time commitments have hugely increased and it will be incumbent on all legacy FMCs to increase the time commitment of their designated persons in line with the new requirements.

Level of Review

The Central Bank was critical of the level of review carried out, the independent analysis and the quality of information provided to the board by designated persons. However, it was interesting to note the Central Bank's acceptance of monthly delivery of reports from delegates as being suitably frequent.

CP86 on Capacity of Designated Person
A Designated Person should have enough knowledge in the area they are managing to interrogate the information being provided to them and constructively challenge the employees or delegates.

The Central Bank is looking for evidence of such constructive challenge, principally by documented board reporting, as an indicator of a well-managed FMC which takes compliance with its obligations seriously.

Delegate Oversight

Delegate oversight was the first "module" of the CP86 and, given the delegation model employed by most FMCs, it is not surprising that this is an area of focus for the Central Bank. The Central Bank points to a failure to fully implement CP86 in this regard.

In its thematic review of Irish-domiciled UCITS on the subject of closet indexing, the Central Bank raised a number of concerns about delegate oversight, which are amplified here.

In our closet indexing *OnPoint*, we outlined the issues that boards should consider when overseeing their delegates, particularly investment managers.

The delegate oversight requirements were the first "output" from CP86, but the Central Bank is still dissatisfied with the level of compliance.

As set out in the Industry Letter, the Central Bank's view is that boards should conduct a gap analysis of their board processes against the detailed delegate oversight requirements which are set out in Part 1 of CP86 and the additional "Viability and Suitability" requirements set out in the industry letter issued following the thematic review on closet indexing.

In the Industry Letter, the Central Bank focuses on the level of (initial and ongoing) due diligence carried out on delegates (and the evidence of same) and over-reliance on group policies and procedures.

Investment Manager Oversight

The Central Bank expects to see:

- More effective engagement with delegated investment managers;
- The timely resolution of issues identified;
- Quality board reporting to enable meaningful board review;

- Evidence of challenge and action; and
- Documented service level agreements (SLAs) with all delegates.

A higher the number of delegate investment managers results in a more significant impact on resourcing.

Risk Management

CP86 on Risk Management
The board should adopt a risk management framework which: • Identifies the applicable risks; • Confirms the risk appetite; • Identifies any appropriate risk mitigants; and • Incorporates appropriate policies for the measurement, management and monitoring of risk, including the implementation as appropriate of any risk mitigants.

The Industry Letter identified deficiencies in the risk framework with required components not in place.

The Industry Letter states that boards should conduct a gap analysis of their compliance with the risk management provisions of CP86 which are set out in Part 1 C, noting the Central Bank's requirement that this periodic review be undertaken no less than annually.

The Industry Letter refers to an entity-specific risk management framework, which we take to mean an FMC-level framework as opposed to a group level framework.

Board Approval of New Funds

CP86 on Investment Management
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. For this purpose, the board should be provided with information about at least the following matters: • The investment objective and policies; • Any benchmark against which the relevant fund's performance will be presented to investors and/or used in the calculation of performance fees; • The range of assets into which it is proposed the relevant fund should invest; • The portfolio management team's credentials for the task; • The investment processes to be adopted by the portfolio management team;

CP86 on Investment Management
• The type of restrictions and limitations imposed on the management of the relevant fund, additional to those specified in the prospectus, for example those dealing with large exposures or leverage, and the related control arrangements; • Frequency of unit dealing, the basis for pricing relevant fund units, and any anti-dilution measures; • The investment manager's trading protocols, including order management, best execution, allocation of business to brokers and commission sharing; • The basis on which any securities lending is undertaken, including fees, counterparty risk and collateral management; • The extent to which it is proposed to use financial derivative instruments, the controls to which such use will be subject and applicable policies in respect of collateral management, counterparty risk and leverage management; and • Processes for the management of liquidity risks, including the potential for liquidity mismatches between assets and liabilities, and the actions to be taken to mitigate them.

The Industry Letter found that not all FMCs could evidence compliance with the above requirements with regard to the launch of new sub-funds.

The Central Bank now insists that (in the case of UCITS) new fund approval be obtained from boards prior to filing for approval with the Central Bank.

The Industry Letter states that 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*". This reference to structuring and risks is not highlighted in the main body of CP86 referenced above but is likely to be a development resulting from the increasing complexity of structures that might be employed for AIFs.

Director for Organizational Effectiveness

CP86 on Organizational Effectiveness
The independent director who undertakes this task will be on alert for organizational issues and will escalate these to the board. They will be change leaders who bring proposals to improve effectiveness to the board. They will champion these proposals and will drive through the change agenda to ensure that agreed actions are implemented.

The organizational effectiveness role was one on the novel features of CP86 and it is understandable that the Industry Letter identifies some teething problems with the role, especially as the level of detail set out in the Industry Letter is not mirrored in CP86.

Organizational Effectiveness Directors ("**OEDs**") should ensure:

- That formal records of meeting held are kept and made available to the Central Bank on request;

- That in addition to the matters set out in CP86, particular consideration is given to conflicts of interest and personal transactions;
- Formal interaction between the OED, the designated persons and the board;
- Interaction with the designated persons at least quarterly;
- They report to the board at least annually and include conclusions on resourcing in the report; and
- That a documented board effectiveness evaluation on conducted.

Given the importance the Thematic Review attaches to resourcing, it is noteworthy that the Industry Letter states "*a key responsibility attributed to the role of OED is monitoring the adequacy of the FMC's internal resources*", noting that the Central Bank was "*unable to evidence the extent to which [they] challenged the existing resourcing levels"*.

OEDs will be concerned at the imposition of this specific responsibility with regard to resourcing on an independent director (in addition to the enhanced role with regard to board composition identified below) and this may lead to a reluctance among directors to undertake this role. Many will argue that what is required to be an independent role is becoming a quasi-executive role, with the Central Bank requiring OEDs to significantly increase their time commitment and OEDs expecting their compensation to match.

Governance and Culture Trends

Most FMCs have not appointed a CEO

The Central Bank expects a chief executive officer ("**CEO**") or other senior executive with responsibility for day-to-day running of the business to be appointed to all but the smallest FMCs as the central point of contact between the Central Bank and the FMC.

Directors Tenure

The Central Bank has been flagging possible action on rotation of directors for a number of years, noting that two-thirds of directors have tenure of more than five years and just over a quarter have tenure of more than 10 years.

The Central Bank is again looking to the OED to "*consider the continued use of the INED designation where the INED is in place for such a prolonged period of time*" (which we take to be 10 years) and to "*consider how best to achieve a sufficiently regular rotation of board members to ensure independent challenge at Board level" with the review available to the Central Bank*" as part of its board composition review.

The obligation on the part of the OED to review board composition would not have been considered by most to be a requirement that would have led to the requirement of rotation of directors. Indeed, for many OEDs, it might be akin to 'turkeys voting for Christmas'. Many directors will argue that it is their tenure and seniority that gives them the standing to challenge the operations of the FMC and that this will be lost by introducing compulsory rotation.

Given the impact that changes in board composition may have in terms of personal relationships and livelihoods it might be preferable for the Central Bank to recommend the introduction of explicit guidance on the topic *e.g.*, via the Irish Funds Corporate Governance Code for Collective Investment Schemes and Management Companies.

Gender Imbalance

The Thematic Review showed a significant gender imbalance on boards, with just 16 percent of independent director roles held by women. Again, gender diversity has long been flagged as an issue of concern by the Central Bank and one that is being actively addressed by new FMCs when constituting boards. For legacy FMCs, ensuring gender balance may require asking male directors to step down.

Position of Fund Boards

CP86 on the Board of externally managed companies
The fund management company is responsible for ensuring that it and its investment funds under management comply with regulatory obligations. The board of an externally managed investment company should ensure that it supports the ability of the fund management company to comply with all regulatory obligations. But it also needs to satisfy itself that the delegation to the fund management company is working effectively for investors.

Whilst the Industry Letter provides great detail on its application to FMCs, it is notably silent with regard to its application to boards of externally managed funds. If the recommendations set out in the Industry Letter were to apply to boards of externally managed funds, they would be particularly impacted by the governance issues raised by the Central Bank. It is a matter for debate whether these provisions apply equally to externally managed funds on the basis that FMCs have responsibility for ensuring "*that it and its investment funds under management comply with the regulatory obligations*".

Fund boards should also be challenging their FMCs on their compliance with CP86 and, in particular, whether it is involved in a risk mitigation program ("**RMP**") as a result of the Thematic Review.

Action Required

Specific Concerns

Where the Central Bank identified specific concerns, it has already commenced supervisory engagement with these FMCs and it will issue a RMP to many of these FMCs. It is reserving its rights to use its other enforcement powers for more serious findings, including 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 the Industry Letter.

Future Enhancements of the Regulatory Framework

Findings from the Thematic Review will also inform the Central Bank's consideration of policy development and potential future enhancements to the existing regulatory framework. We assume that this will include a formal update to CP86 and consideration of the status of the Irish Funds Corporate Governance Code.

Application to all Fund Management Companies

FMCs have been anticipating the publication of this Industry Letter for more than a year and most are well prepared for its implications.

The Industry Letter states that:

"*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 authorization 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*."

The first, fourth and fifth of these bullet points go to the question of resourcing which has been covered in detail above and by those with experience of the Brexit Framework.

For most SMICs, these tasks are most likely to be implemented by the engagement of a third-party FMC or, alternatively, by moving to a fund platform.

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