



CSSF THEMATIC  
REVIEW ON THE  
DELEGATION OF THE  
PORTFOLIO  
MANAGEMENT  
FUNCTION BY  
INVESTMENT FUND  
MANAGERS (IFMs)

CSSF FEEDBACK REPORT

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## CSSF FEEDBACK REPORT

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## 1. Context

The CSSF performed a supervisory thematic review on the monitoring put in place by the investment fund managers (hereinafter “IFMs”) when delegating the portfolio management function (hereinafter “PM”). The aim was to assess the compliance of the IFMs with the relevant provisions of the UCITS and/or AIFMD framework and to ensure that the investors’ interests were well protected.

The CSSF selected a sample of IFMs domiciled in Luxembourg and managing regulated undertakings for collective investment (hereinafter “UCIs”) and UCIs that are non-authorised by the CSSF to complete a dedicated questionnaire via the eDesk portal. The CSSF then analysed the information collected. The present document intends to provide the market with feedback on the CSSF’s main findings.

While the overall analysis of the compliance of these IFMs is mostly consistent with the legal and regulatory requirements, the objective of the present feedback report is to inform the industry of the main observations that the CSSF made in the context of its supervisory work as well as about the related recommendations for improvement in view of the applicable legal and regulatory requirements.

The CSSF specifies that the below recommendations should be applied to other delegated functions, where relevant.

## 2. Observations

### 2.1. Establishment of procedures governing the IFM’s delegation framework

Sub-section 6.2.3.2 of Circular CSSF 18/698 (hereinafter the “Circular”) requires that an IFM implements a “delegation framework procedure” for the selection and monitoring of its delegates and provides details on the content of this procedure. Sub-section 6.3.1.1 further requires the implementation of a PM procedure with specific items to be taken into consideration.

On this basis and in accordance with the Circular, the IFMs retain the responsibility, irrespective of their size, to put in place operational procedures to monitor the delegation(s). The CSSF recalls that the procedures must clearly define “who does what, when and how” in the organisation of the IFM, as well as the documents retained to prove the existence of such controls. Moreover, the PM procedure should at least cover the specific items listed in points 477 and 478 of the Circular.

### 2.2. The initial, periodic due diligence and ongoing monitoring of the delegates

Section 6.2.3 of the Circular requires that an initial and periodic due diligence as well as an ongoing monitoring shall be performed for each delegate. All these steps should be formalised in written reports.

In this context, the CSSF wishes to point out that IFMs remain fully responsible for demonstrating that each delegate is qualified and capable of undertaking the PM Function and that they were

selected with all due care. IFMs should perform their own analysis to establish *written reports*, as required by points 461 to 463 and 469 of the Circular. A similar requirement applies to the ongoing monitoring of the delegated functions as foreseen in point 474 of the Circular, for which each IFM should determine its own key performance indicators.

The CSSF also underlines that due diligence processes cannot rely solely on the reception of self-assessment questionnaires or on onsite visit memos.

The reports should at least consider the elements required by the Circular. The conclusions should be validated, dated, and signed by the staff members empowered to validate according to the delegation framework procedure.

Finally, in the case of an announcement of termination, the monitoring of the exiting delegate should be maintained – in compliance with all procedures – until the effective date of termination.

### **2.3. Governance and decision-making process**

The delegation framework procedure as described above (section 2.1) should identify who are the staff members empowered to validate the selection or change of a delegate/delegates. The applicable voting process including the possible use of veto rights, should also be clearly defined.

The conclusions of the written reports of the initial and periodic due diligence reports must be validated, dated, and signed. The reasons for approving/rejecting or continuing/terminating the relationship with a delegate should be documented.

### **2.4. Obligation to draw up a contract**

Section 6.2.2 of the Circular requires a written contract to be concluded between the IFM and each delegate, setting out the rights and obligations of each party. Any contract should only be signed after the initial due diligence is effectively completed, in accordance with point 463 of the Circular.

The CSSF expects IFMs to ensure and to control that:

- the IFM obtains from the delegate all the requested information in compliance with point 436 of the Circular. This information should enable IFMs to effectively monitor the activity of the delegate at any time, as required by the laws, i.e. Article 110(f) of the Law of 17 December 2010 relating to undertakings for collective investment (hereinafter "2010 Law") and Article 18(f) of the Law of 12 July 2013 on alternative investment fund managers (hereinafter "2013 Law");
- the contract indicates the investment policy, investment limits and other elements mentioned in point 492 of the Circular;
- the contract contains a clear clause giving the IFM the right to withdraw the mandate given to the delegate with immediate effect when justified by the investors' interests. The determination of the law/jurisdiction should be subject to a risk assessment taking into consideration the UCIs'/investors' interests.

## 2.5. Business continuity plan (hereinafter “BCP”)

Point 440 of the Circular requires that the IFM and the delegates shall establish, implement, and maintain a BCP.

The CSSF expects that the IFM – including its internal control functions – will verify on a regular basis that the BCPs of the delegates/subdelegates are adequate and that regular testings will be performed *between* the IFM and the delegates, as foreseen in the above-mentioned point. If the results of the BCP are not satisfactory, the IFM should ensure a proper follow-up of the improvements.

## 2.6. Contingency Plan

To anticipate cases where IFMs would have to withdraw the mandate of a delegate with immediate effect, IFMs should put in place contingency plans should be put in advance. The CSSF recommends that:

- the contingency plan should describe the exit strategies developed by the IFM, consisting of transferring the delegated function either to another delegate or by integrating the function within the IFM itself;
- the IFM should assess the substitutability of the delegated function by identifying an alternative delegate. If no alternate is found, the IFM should describe the measures allowing it to perform the function itself;
- the IFM should evaluate the impacts of the exit strategy, notably by estimating the exit costs, resources and time required for a transfer to a new delegate or to the IFM itself;
- the contingency plan should describe the different steps of the delegation’s exit and transfer process;
- the contingency plan should identify the person(s) who will be responsible for its implementation in the event of termination of the mandate;
- the IFM should proceed to a periodic reassessment of the feasibility of each exit strategy developed.

## 2.7. Conflicts of interest

According to the responses received, all IFMs within the survey scope have implemented a written conflict of interest policy, which also covers all delegates to whom the PM activity has been delegated. 55% of the IFMs reported having received disclosures of conflict of interest by the delegates in the last two years.

The CSSF would like to point out that an IFM must ensure that the potential and effective conflicts of interest arising from the delegation are identified. This includes cases that may result from the establishment of reporting lines or intra-group relationships.

All reviewed IFMs keep a register of the conflicts at IFM level. The CSSF recalls that it is the IFM’s responsibility to establish the register, which should at least contain the elements of the point 381 of the Circular.

From a good governance point of view, the persons concerned by such conflicts should refrain from participating in the discussions and decisions relating to the delegates concerned.

## **2.8. Rules of conduct**

With the exception of one case, no breach regarding the rules of conduct, as provided for in Article 111 of the 2010 Law and Article 11 of the 2013 Law, was reported by the delegates to the IFMs during the last two years.

The CSSF also noted that 73% of the IFMs reported that the compliance with the rules of conduct in the context of the PM delegation was verified by their internal audit.

The CSSF reminds the IFMs that they should monitor the compliance with the rules of conduct in the context of the PM delegation and recommends that the rules of conduct should be covered by their internal audit plan.

## **2.9. Personal transactions**

With the exception of one case, no breach regarding the personal transactions as provided for in Article 14 of CSSF Regulation No 10-4 and Article 63 of Commission Delegated Regulation (EU) No 231/2013 was reported by the delegates to the IFMs during the last two years.

The CSSF also noted that 73% of the IFMs reported that a review of the adherence to the rules on personal transactions in the context of the PM delegation was performed by their internal audit.

The CSSF reminds IFMs that they should monitor compliance with the requirements on personal transactions in the context of the PM delegation and recommends that the personal transactions be covered by their internal audit plan.

## **2.10. Appropriate resources**

As foreseen in point 119 of the Circular, the IFMs should have adequate human and technical resources to monitor the delegated functions. The CSSF expects that the human resources employed by the IFMs to the monitoring of the delegated functions are proportionate to the number of delegates. It is also the responsibility of the IFMs to ensure that the internal control functions have sufficient resources to perform qualitative and quantitative controls on the delegated PM function.

The following criteria should at least be considered in determining whether the resources are sufficient:

- the number of delegates;
- the volume of assets under management where the PM function has been delegated;
- the number of UCIs/sub-funds concerned by such delegation;
- the nature and the complexity of the investment policies of the UCIs/sub-funds.

## **2.11. Internal audit**

The CSSF noted that the IFM's internal audit function covered in all cases the review of the ongoing monitoring and the periodic due diligence of the delegates, while the approval process of new delegates was reviewed in 64% of the sample. In 82% of cases, the internal audit reviewed the management of the conflicts of interest.

In accordance with points 270 and 299 of the Circular, the CSSF would like to highlight that the internal audit of the IFM should include in its internal audit plan the monitoring of the delegated activities, covering *all aspects* of the delegations.

## **3. Other considerations**

### **3.1. Objective reasons for delegation**

IFMs should define the risk appetite in terms of delegation, i.e. what is acceptable or not and under what conditions. They should avoid any excessive reliance on delegates from the same group.

AIFMs should be able to demonstrate the objective reasons for delegation as foreseen in point 430 of the Circular. They should ensure that the objective reasons for delegation are properly documented and that the analysis is made available upon request.

It is recommended to apply the same principle in the case of UCITS Mancos as stated in point 432.

### **3.2. Clear understanding of the initiator's role**

The CSSF expects IFMs to acquire a clear understanding of the role(s) played by the UCIs/sub-funds initiators. In particular, the following items should be monitored: possible conflicts of interest, advisory role, participation with /without voting rights in an investment committee, management of personal transactions.

### **3.3. Review of the multi-year plan**

Most IFMs presented a multi-year plan for the periodic due diligence as required by point 449 of the Circular. The CSSF recalls that the staff members of the IFM empowered to validate the initial and periodic due diligence should examine on a regular basis the effective execution of the periodic due diligence reviews. Hence, it should receive the multi-year plan, consider whether that the elements to apply the proportionality principle are adequate, adapt the next review date and, if applicable, the rating of each delegate. The existence of sub-delegates should also be taken into consideration in the plan - if applicable.

### **3.4. Feedback on the work of the internal control functions of the delegates**

The IFMs should verify, in accordance with point 460 of the Circular, that the organisation of the control functions within the delegates (i.e., the compliance, the risk management, the internal audit functions) is satisfactory. If they cannot obtain any control results, the IFMs should escalate the issue to the governing body of the delegates and assess if issues exist that may affect the adequate performance of the PM function for the relevant UCIs/sub-funds.

More specifically IFMs should also reinforce their controls in case a “key person” risk exists at the level of the delegate, the delegate has limited resources or a weak “three lines of defence” organisation.