Best practice for distribution oversight

ACOLIN & Mason Hays & Curran LLP

Foreword

Distribution oversight is a key priority for asset managers and significant resource and activity is being allocated to support this. In light of recent statements on CP86 and CP 138 by the Central Bank of Ireland (CBI), what should asset managers be considering as best practice?

This white paper provides a summary of the points highlighted during the webinar held in partnership with ACOLIN and law firm Mason Hayes & Curran LLP (MHC) and aims to explain key areas IFMs need to consider when distributing funds cross border.

Agenda

- Recent CBI guidance regarding Distribution Oversight
- Structure of Distribution
- Best practices in Distribution Oversight
- Where do we go from here?

Recent CBI guidance regarding Distribution Oversight

Sara O'Reilly

Fund Management Companies Guidance

Let us remind ourselves what was contained in the Fund Management Companies Guidance (the "Guidance") introduced by the Central Bank of Ireland in 2017 regarded distribution oversight.

One of the key focusses of the Guidance was on the role of the board where significant tasks are delegated. The definition of "delegate" in the Guidance specifically names the distributor as a delegate as well as the administrator and investment manager.

The ultimate responsibility for delegates rests with the board of directors of the Fund Management Company. The Central Bank's framework sets out key responsibilities that should be retained by the board which in the context of distribution oversight include the following:

- satisfying itself that there are arrangements in place to ensure compliance with applicable laws and regulations.
- ensuring appropriate Policies and Procedures in place

- understanding the distribution strategies in the jurisdictions where the funds are marketed

At the time of the launch of a new fund formally approving the proposed distribution strategy. The board also at each of its quarterly board meetings is required to consider quarterly reports on distribution from the Designated Person with responsibility for Distribution.

Role of DP with responsibility for Distribution

The Distribution function is one of the six key management functions that the CP86 framework requires be put in place by the fund management company. Given that distribution is a key management

function, this should give enough of an indication of the importance the Central Bank attaches to this management function. The designated person with responsibility for distribution is a pre-approved controlled function (PCF-39) so needs to be approved by the Central Bank under its fitness and probity regime.

The Central Bank expects the designated person with responsibility for distribution to:

- carry out due diligence on new delegates to be appointed.
- ensure contractual arrangements are put in in place with each of the delegates.
- carry out effective oversight of the delegates by having regular calls, meetings and carrying out on-site visits.
- Review the reports and information received from delegates with healthy scepticism and not accept information at face value. There should be evidence maintained of constructive challenge of the information received.
- ensure compliance with regulatory obligations; and
- report to board on a quarterly basis and escalate issues to the board where necessary between meetings.

The CP86 framework specifically requires that the Distribution Report provided to the board on a quarterly basis, include:

- patterns of distribution, current progress and development, and resourcing.
- sales flows in the period and current pipeline.
- any proposed new developments and initiatives; and
- any local legal, regulatory, tax or other compliance issues.

CP86 Dear Chair Letter and its key findings

The key findings of the implementation review of CP86 that are most relevant to distribution oversight relate to:

<u>Resourcing</u>
The Central Bank reminded fund management companies' of the need to be sufficiently resourced to implement the CP86 framework. They need to be able to demonstrate high quality and effective oversight of delegate activities and ensuring that the governance structure is sufficiently resourced to achieve this. Resourcing should be kept under review as the business grows in scale and complexity. The Designated Person with responsibility for distribution needs to have sufficient time to fulfil his/ her duties.

<u>Designated Persons</u>
The Central Bank found deficiencies in how Designated Persons perform their roles, in particular in the level of review carried out on monthly reports and the quality of information provided to the

board. DPs did not commit sufficient time to their role or have sufficient support available. There was also lack of evidence of constructive challenge and interrogation of information received. Designated persons need to be able to demonstrate the value they bring to oversight though documented board reports.

Delegate Oversight
There was a failure to evidence that an appropriate level of due diligence of delegates was carried out initially and on an on-going basis. Where reliance is placed on delegates policies and procedures, there should be a formalised process to review all the delegates policies and procedures. This should be done at appointment and on an on-going basis.

The Central Bank found that some fund management companies did not have documented SLAs in place.

Therefore, in terms of summarizing the key points from the Dear Chair letter, DPs need to dedicate sufficient time to their role, challenge information received from delegates and due diligence needs to be carried out initially and on an ongoing basis.

Cross-Industry Guidance on Outsourcing – Consultation Paper 138

On 25 February 2021, the Central Bank published draft Cross-Industry Guidance on Outsourcing in the form of Consultation Paper 138 to apply to all regulated financial service providers, including Fund Management Companies.

The draft guidance is relevant to any regulated firm that uses outsourcing as part of its business model so is relevant to Fund Management Companies. The Central Bank stipulates that the Guidance does not supersede existing legislation, regulations or guidance but rather sets out good practice with respect to effective management of outsourcing risk.

- Highlights that the board and senior management of regulated firms are ultimately responsible for effective oversight and management of outsourcing risk.
- Refers to outsourcing chains becoming long and complex and that appropriate governance and risk management arrangements need to be in place in respect of sub-outsourcing.
- Establishment of outsourcing register to identify and facilitate oversight.
- Good practice to include in contractual arrangements and SLAs, data privacy, rights of inspection and audit, termination rights, indemnification to mention a few.
- Detailed outline of in the draft Guidance of what it expects firms to consider when conducting initial due diligence reviews which will be helpful in assisting firms drafting its due diligence questionnaire as there is currently no industry standard due diligence questionnaire.

To conclude the CP86 Guidance, Dear Chair Letter and now the CP138 Guidance, provide a comprehensive framework on how to ensure proper oversight of delegates appointed to distribute the Fund. Fund management companies now need to follow it.

Structure of Distribution

Lorcan Murphy

20 years ago, the focus of distribution oversight was primarily country registration and reconciling trail fee payments, or a monthly review of which country team is selling – this has evolved into a focus on the risk and responsibility of maintaining distribution networks.

- Today, we have a greater understanding of the regulatory requirements of intermediaries, understanding and controlling of the fund managers relationship with their clients – product appropriateness, cost transparency.

- Institutional versus Retail – what is retail, a direct investor in your fund? This is very rare in UCITS distribution, where now compared to the past, the majority of investors, if not all, on a fund register are entities such as intermediary platforms, or custodians, who are holding assets for their clients, who can be pensions, wealth managers, individual clients, etc.

- There are typically multiple Layers in intermediary relationships with chains of Distribution Agreements, sub-registers, CSD like Clearstream, custodian banks/platforms, regional banks, wealth managers.
- Multiple organization types involved are:
    - distributor – appointed by the AIFM and named in the Prospectus (often the Investment Manager also acts as distributor).
    - regional Sub-Distributors – appointed by the Distributor/AIFM.
    - intermediaries – Brokers/Family Office/Portfolio managers who manage discretionary portfolios for clients.
    - distribution Platform Providers.
    - third party marketers, who sit alongside or instead of an in-house sales team.
- omnibus accounts are a concern for oversight, with an increasing expectation that we can look through these and get information on underlying investors.
- finally, the key observation would be that this is an evolving area, both from a regulatory perspective and operationally.

Best practices in Distribution Oversight

Sara O'Reilly

- Firms need to understand the chain of distribution from end investors through to intermediaries by carrying out due diligence, oversight and monitoring of the activities of the distributors appointed to the Fund.
- In terms of determining where risk and responsibility lies along this chain, the Board is ultimately responsible but relies on the Designated Person to carry out day to day oversight of the delegates appointed to distribute the fund. This oversight needs to be actively carried out, sufficient time devoted to the role and as the Central Bank highlighted in the Dear Chair letter it is not enough to simply take the reports from the distributor at face value, the reports need to interrogate and challenged.
- As part of a robust control framework, all distribution agreements and other intermediary agreements should be subject to careful legal review. Agreements with delegates should have appropriate AML provisions, GDPR provisions, liability provisions for any sub-distributors appointed, rights of access and audit and compliance with all laws and regulations in the jurisdictions where they market the fund.
- Finally, the Board of the Fund management company needs have a full understanding of the distribution chain so that the board can effectively oversee and manage distribution risk.

Best practices in Distribution Oversight
Lorcan Murphy

There are two perspectives that are closely linked:

The Board:

- Ongoing review of the details by the Board and a clear understanding of who is delegated day to day responsibly for distribution oversight *and activity* in the fund structure.
- Linking risk appetite at the Board level with distribution practices on the ground.
- Change management, and consideration of new jurisdictions/distributors is expected, staying ahead of evolving distribution activity.
- At the time of the launch of a new investment fund (including any sub-fund), the board should approve the proposed distribution strategy, including:
    - who will undertake the tasks associated with distribution and any proposed delegation;
    - the marketing strategy and approach;
    - target markets and channels, including the competitive landscape;
    - the jurisdictions into which distribution is proposed, whether immediately or in due course;
    - the control framework for compliance with any local legal, regulatory, tax or other compliance requirements;
    - the control framework for marketing in a manner consistent with the terms of the prospectus.

The Global Distributor (often the Investment Manager):

- Meeting the needs of the Board to be in control of the delegated distribution responsibilities.
- Understanding what is really going on – like you would investments in your portfolio, expectation of complete and accurate information on end investors.
- Building in-house capabilities and outsourcing where appropriate.
    - utilizing best of breed external service providers where appropriate to support oversight – for instance outsourcing the distribution agreement network to ACOLIN
    - outsourcing the distribution analytics to companies like Global Fund Analytics, who can help managers understand what the full picture of their distribution activity is.
    - the best managers are looking at this as a revenue maximisation opportunity as well as a risk management exercise.

Where do we go from here?

Lorcan Murphy

- Automation & process engineering – as expectations grow, and processes mature, automation becomes more important. Distribution Analytics are becoming more common, where fund managers employ detailed database analysis of:
    - profitability analysis - Revenue and costs per product
    - AuM
    - regional sales
    - split by distributor or client type
    - market data and trends
    - fine-tuned risk-based approaches – greater understanding of where risk lies, allows more focus within an organisation on high-return distribution activities, like more cash from the existing investors.

Where do we go from here?

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- Trends in AML, Fifth AML Directive, Enhanced DD for High Risk Third Countries, where interests in the fund are held by nominees on behalf of underlying investors. The fifth AML directive introduces requirements to seek additional information on beneficial owners located in high-risk countries – SOW and SOF, enhanced monitoring, approval of senior management.
- Distribution risk needs to be embedded in the Fund Management Company's Risk Management and Control Framework on the same basis as other key risks.
- The CBI's draft "Cross-Industry Guidance on Outsourcing" (CP138) will be the next CP86 and fund management companies need to take steps now to prepare for compliance with these requirements.

The webinar, Best practice for distribution oversight can be accessed here.