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Continued Regulatory Focus on Governance and Substance

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The Central Bank of Ireland ("**Central Bank**") has continued to focus on compliance by fund management companies ("**FMCs**") with its FMC framework, which includes requirements and guidance regarding the sound organisation and governance, effective management and appropriate oversight of FMCs. The Central Bank has now issued a Dear Chair letter setting out its findings from an industry survey conducted earlier this year.

The European Securities and Markets Authority ("**ESMA**") has also published its report following a peer review into national competent authorities' ("**NCAs**") handling of relocation to the EU in the context of the UK's withdrawal from the EU, which sets out recommendations for improving the authorisation process going forward with a focus on governance and substance.

Central Bank Dear Chair Letter

Following the completion of a thematic review in 2020, the Central Bank conducted an industry survey to assess how the governance, structure and resources available to FMCs had evolved as a result of the actions arising from the Central Bank's industry letter of October 2020, which set out the findings of the thematic review. The Central Bank notes that the survey results do not constitute a review of the actions taken to ensure full and effective compliance with all aspects of the guidance, but the results give an indication of progress achieved in areas such as substance and resources.

The key findings of the survey, as set out in the Dear Chair letter, are set out below.

- Notable increase in the resources available to FMCs.
- Progress in areas such as:
  - **CEO appointments.** The Central Bank reiterates its expectation that all but the smallest FMCs have a CEO appointed.
  - **Director time commitments.** The Central Bank will continue to monitor the number of directorships held by individual directors to ensure that this is sustainable, particularly in light of the increased time committed to individual directorships.
  - **Resourcing of managerial functions.** The Central Bank reiterates its expectation that the level of FMC resourcing must be continuously monitored and should grow in line with the nature, scale and complexity of the business.

- Material change in the sector in terms of scale, structure and complexity has resulted in a shift in the risk profile of the sector.
- Significant decrease in number of FMCs (including a 90% decrease in total number of self-managed investment companies or SMICs) despite sizeable growth in assets under management ("**AUM**").
- Third party FMCs must have capacity to take on the additional business represented by the significant growth in AUM since 2019 without compromising the expected standards set out in the framework or reducing investor protection. The Central Bank expects to see corresponding increased resources and expertise as the nature, scale and complexity of third party FMCs grows. This will be a continued area of focus for the Central Bank.
- Growth in the level and extent to which FMCs are providing MiFID services such as individual portfolio management. FMCs must be fully aware of and understand their obligations under MiFID and ensure that these obligations are integrated into their risk and compliance frameworks.
- In relation to the tenure of independent non-executive directors ("**INEDs**"), the Central Bank expects that tenure and independence be considered as part of the Organisational Effectiveness Director's review of board composition and forms part of related reporting to the board.
- A significant gender imbalance still exists at FMC board level. Diversity should continue to be considered as part of the ongoing internal governance reviews.

ESMA Peer Review of Relocations Post Brexit

The day after the Dear Chair letter was issued, ESMA published its peer review into NCAs' handling of relocation to the EU in the context of the EU's withdrawal from the EU, which focused on two key areas that, in ESMA's view, would benefit from further convergence work: governance and substance. The review notes that, in the context of relocations to the EU from the UK, NCAs allowed for an extensive use of outsourcing and delegation arrangements and in some cases for limited technical and human resources to be relocated.

The review looked at: (a) MiFID firms; (b) trading venues; and (c) fund managers. The key findings and recommendations related to fund managers are set out below. While the peer review was conducted in the context of Brexit, the recommendations set out are aimed at strengthening the authorisation process of NCAs, without being limited to the Brexit one-off event.

Governance

- There was a lack of a thorough review of **conflicts of interest management**. It is recommended that all NCAs introduce a more systematic and thorough approach to reviewing potential and actual conflicts of interest during the authorisation stage.
- Further work is required with respect to the application of the **principle of proportionality** to ensure supervisory convergence and a level playing field. Both Ireland and Luxembourg should review the current quantitative thresholds applied to determine proportionality.

- NCAs should introduce a more systematic and thorough approach to reviewing the key **policies and procedures** of applicant firms.
- NCAs should scale up efforts to review the establishment and strong role of **internal control functions**.

Substance

- The review found that NCAs had authorised applicant firms for which the overall number of senior managers and **human and technical resources** appeared insufficient. NCAs should introduce a more thorough review of human and technical resources.
- None of the NCAs reviewed had performed a comprehensive review of **delegation arrangements**, in particular the objective reasons for delegation and compliance with due diligence requirements. NCAs should introduce a more systematic and thorough supervisory approach in reviewing delegation arrangements.

A statement from the Central Bank published in the report noted that the "*Peer Review findings for Fund Management Companies do not accurately represent the high standards applied by the CBI or the positive outcomes achieved by the rigorous and substance-focused authorisation process that evolved significantly over the course of Brexit.*" The Central Bank noted the limited number of sample cases per sector and that the governance and resources of the two Central Bank-supervised FMC sample cases had already been amended prior to the peer review.

Comment

Both the Central Bank's Dear Chair letter and ESMA's peer review report are indicative of a continued regulatory focus on governance and substance, of which FMCs should take note. FMC boards should consider the Dear Chair letter and consider any areas requiring improvement to ensure that robust and appropriate governance arrangements are in place.

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