



Delegate Due Diligence

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PURPOSE

This document has been prepared in response to questions raised by our member firms in respect of delegate due diligence and oversight and where possible agree consistency in our approach. It is not the intention for this document to be exhaustive or cover all relevant regulations or processes on this subject matter. Members have the opportunity to raise any additional questions to be added to this document at the quarterly plenary meetings.

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REGULATORY BACKGROUND

The following are some of the key regulations in relation to Delegate Due Diligence: -

EBA Guidelines on outsourcing arrangements (EBA/GL/2019/02)

- These Guidelines provide a definition of outsourcing and specify the criteria to assess whether or not an outsourced activity, service, process or function (or part of it) is critical or important.

Law of 17 December 2010 on undertakings for collective investment, as amended from time to time.

CSSF Circular 18/698

- It defines the scope and the obligations of the management company and Chapter 6 is focusing on the controls to apply to the delegates.

CSSF Circular 22/806

- It defines the scope and the obligations of the management company in case of outsourcing arrangements and is focusing on the controls to apply to delegates.

CSSF FAQ - Circular CSSF on outsourcing arrangements

- It clarifies the relation between the two aforementioned Circulars and explain which Circular applies under which circumstances and also when both Circulars are applicable.

Central Bank of Ireland (CP138) Cross Industry Guidance Paper on Outsourcing

Directive 2014/65/EU (MiFID II) and Commission Delegated Regulation (EU) 2017/565 supplementing MiFID II

- The outsourcing of investment services or activities or critical and important functions is capable of constituting a material change of the conditions for the authorisation of the investment firm, as referred to in Article 21(2) of Directive 2014/65/EU. If such outsourcing arrangements are to be put in place after the investment firm has obtained an authorisation according to Chapter I of Title II of Directive 2014/65/EU, those arrangements should be notified to the competent authority where required by Article 21(2) of that Directive.

European Union (Markets in Financial Instruments) Regulations 2017 – S.I. No. 375/2017

- An investment firm shall ensure that any outsourcing by the investment firm of important operational functions is not to be undertaken in such a way as to impair materially – (i) the quality of its internal control, and (ii) the ability of the Bank to monitor the investment firm's compliance with all of the investment firm's obligations

DUE DILIGENCE

The Investment Fund Managers (“IFM”) is authorised to delegate to third parties one or several functions and must set a strong oversight and governance to control their delegates. For clarity, a delegate has been appointed and has a contractual arrangement of any form between a regulated firm and an Outsourced Service Provider (“OSP”) by which that service provider performs a process, a service or an activity that would otherwise be undertaken by the regulated firm itself, even if the regulated firm has not performed that function itself in the past.

We can differentiate three processes about overseeing the delegates:

- Step1: Initial Due Diligence
 - Notify the Regulator in respect to the appointment of an OSP
 - Identify and assess all risks arising from the delegation (operational, financial, legal, reputational) model
 - Ensure the delegate is well qualified and capable to perform these functions in compliance with the legal, regulatory and contractual obligations
 - The obligation to sign a contract
 - The mandatory content of the contract

- Step2: Ongoing monitoring
 - Ensure the services provided by the delegate are continuously in compliance, not only with the legal and regulatory provisions but also with the contractual provisions
 - If applicable, ensure that Information and Communication Technology (“ICT”) delegates are accurately covered by the Management Company’s governance framework.
 - Ensure the quality of the services are satisfactory
 - Assess the adequacy of the organisational structure and review the procedures of the delegate
 - Continue to ensure the delegate is well qualified and capable to perform these functions
 - Reassess on a regular basis the risks arising from every delegation, including the review of a written report of the delegate’s business and organisation resulting from the periodic due diligence

- Step 3: Adopting internal processes allowing for proper monitoring of the outsourced activity
 - Establish a delegation framework procedure which covers all aspects of delegation (initial and ongoing due diligence), including the requirements applicable in case of sub-delegation
 - Define the nature, scope and frequency of the periodic due diligences, based on an approved risk based approach
 - Identify material delegates and their associated risks
 - Have the set up in place to ensure the continuity of operations in case of momentary issues or in case of withdrawal of the mandate

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DELEGATE DD / OVERSIGHT – POSITION STATEMENT/Q&A

It is expected that IFMs consider this document in conjunction with their own risk appetite and their operating model to establish whether changes to procedures and processes should be implemented.

Q1. What is a delegate?

A delegate has been appointed and has a contractual arrangement of any form between a regulated firm and an OSP by which that service provider performs a process, a service or an activity that would otherwise be undertaken by the regulated firm itself

Q2. Which entities are subject to due diligence requirements CF. 18/698, 22/806, CP138 – Central Bank of Ireland Cross Industry Guidance Paper on Outsourcing?

External delegates or intra Group delegates can be used to outsource activities which would require a substantial effort in terms of internal set up or where economies of scales are envisaged. All delegates and the full delegation chain are subject to an initial and ongoing due diligence program. The depth and the frequency of the ongoing due diligence program can however be built and adjusted following a well-documented risk-based approach.

Q3. What is the groups view on the collection of distributor due diligence for those sub distributors investing via a fund distribution platform, where they leverage the contractual arrangements (and it is confirmed additional due diligence services are provided by the platform) with the IFM?

The IFM and the distribution platform must have contractual arrangements in place, this will include due diligence measures which focus on the platform provider itself, their organisational structure, their due diligence process, and their ongoing controls implemented in relation to their platform participants/appointed sub-distributors and performing due diligence requirements equivalent to Luxembourg and EU regulations, on such sub-distributors. The IFM should satisfy itself as to the appropriateness of the distribution platforms oversight of sub-distributors.

Q4. What is the difference between intermediaries and distributors?

An intermediary may be the mechanism through which an end investor enters the fund. The intermediary will be the named investor and may be a Custodian, Distributor, Platform, Bank, Nominee etc.

A distributor is an entity which enters into an agreement with the IFM to distribute the fund shares in specific jurisdictions. A distributor may also be an intermediary investor. A distributor may receive remuneration for these activities.

Q5. What are the oversight requirements for Intermediaries?

The CSSF defines an intermediary as a situation “where the units or shares of an undertaking for collective investments [...] are subscribed through an intermediary acting on behalf of his customers [...] the professional shall put in place enhanced due diligence measures of this intermediary [...]”.

Intermediaries are always subject to enhanced due diligence from an AML and KYC perspective.

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Q6. What are the oversight requirements for distributors?

The purpose of Distributor Due Diligence is ensuring compliance of the distributor with applicable marketing laws and regulations, contractual stipulations as well as AML/CTF laws and regulations. It is generally a process of asking questions and receiving and assessing answers (use of distribution due diligence questionnaire). The aim is to ensure that the distributor is compliant when marketing the Fund both in terms of marketing and governance rules as well as in terms of AML/CTF compliance. It is therefore a second important concept, that is very different in purpose from AML KYD or AML KYC.

Note: no distinction between internal and external outsourcing.

Q7. What oversight is conducted for OSPs (mainly transfer agencies, fund accountants and custodians) in respect of IT matters?

A Due Diligence is one component, amongst others, of a global governance IFMs should apply to monitor the services delegated to their OSP. IFMs should perform a detailed Due Diligence on a risk-based approach according to the type of services provided. The frequency may vary (every 1-2-3 years) depending of their level of Risk & Control Self-Assessment. For significant suppliers, IFM perform an annual due diligence questionnaire / certification review/TPISA (third party information security assessment). The review is generally undertaken by Group Info Security Team with any key findings escalated to the oversight teams within the IFM who follow-up with the OSP and will ensure that any issues are addressed. Monitoring outside of the annual review is also conducted at periodic service review meetings to ensure that there have not been any IT incidents. **Based on risk rating or Service providers, the frequency and level of details expected may differ. For Critical Vendors, like TA, FA etc, Annual onsite Due Diligence is expected (it is a usually a full day of reviews with a set agenda).**

Q8. Due to the exclusion of Business Process outsourcing in 22/806, what are the approaches to Cloud oversight?

- Risk Assessment should be performed on all 3rd party applications before on-boarding them in order to confirm if it is a Cloud or non-Cloud Application (applicable to the circular) and follow regulatory approval requirements in order to on-board a Cloud Application.
- A Register should be maintained for all Cloud and Non-Cloud IT applications
- Quarterly KRI's provided by Managers IT & InfoSec teams.
- For those that are contracted directly, depending on the criticality, an initial Due Diligence will be undertaken as well as periodic penetration testing.
- For those contracted with suppliers, understanding of what their material Cloud Outsourcings are and review of their outsourcing policies and 3rd party risk management process. The RAG status of the cloud service should also be included in the service review meetings.

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Q9. What is Managers Oversight processes for Best Execution (“BE”) for external advisors?

- Perform Due Diligence on external managers to evidence that they have adequate BE policies and procedures in place and complies with CSSF 18/698 para 417,495 & 496 and [CBI 10/11/20 MiFID II - Best Execution thematic inspection](#) and ensure that the following are included; (i) how it is monitored and evaluated internally (ii) details of volumes of trades by counterparty and (iii) number of failed trades (iv) ensure all asset classes subject to best execution testing
- On an ongoing basis, the frequency of which is determined by a firms approach and risk appetite request confirmation of any changes to the policy, including any material changes to the process for allocating/aggregating trades on behalf of their clients, or for consistently achieving best execution on behalf clients. During the period did the firm comply at all times with the best execution & allocation policies with respect to: Price; Costs (implicit and explicit); Speed of execution; Likelihood of execution; Likelihood of settlement; Relative size of the order; Nature of, or any consideration relevant to, the order; Liquidity of instrument; Confidentiality provided by a counterparty and consistent quality of overall service from the counterparty. If NO to any of the above, additional information must be provided and investigated.
- Sample of trades tested on a periodic basis.
- Obtain BE Review to ensure effectiveness.

Q10. What governance the IFMs need to put in place to monitor OSPs (TA, FA, Custodians)?

- Regular Service Review meeting must be organised for each OSP to be able to monitor sensitive topics and issues, projects, legal/contractual documentations including Service Level Agreements/Operating Memorandum, activity indicators (KPIs) and the level of quality for these services (scorecards)
 - Frequency should be adapted in line with a firms risk appetite and monitoring programme
 - The OSP should be in charge of preparing the materials of these meetings and of the minutes and follow up

Q11. What are the IFMs oversight requirements for delegated management services?

Develop the general delegation framework in accordance with Sub-chapter 6.2 of 18/698 and CP138 – Central Bank of Ireland Cross Industry Guidance Paper on Outsourcing

- Review Investment Management Agreements for compliance with CSSF 18/698 requirements
- Add and implement SLAs
- Build out reporting and KPIs from the IFM
- Develop specific processes for due diligence of the IFMs in accordance with Sub-chapter 6.3.2.2 18/698
- Implement ongoing monitoring program including performance reviews; EMIR/SFTR KPIs; IFM certifications and RFIs
- Review and enhance, where required, portfolio management procedures of IFM and ensure IFMs are compliant.

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