Delegation, Oversight & Due Diligence
Circular 18/698 & beyond
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“Authorized entities should [...] dedicate sufficient human and technical resources to the selection of potential delegates as well as ongoing delegation monitoring activities and that all individuals involved in this process have the required skills, knowledge as well as experience and time commitment for their respective tasks.”

The European Securities and Markets Authority (ESMA), 4 July 2017
General introduction

This white paper focuses on delegation, oversight and due diligence. The delegation of investment management functions by UCITS management companies and alternative investment fund managers has recently attracted increased scrutiny by EU regulators. This white paper aims to give an update on current industry standards with a particular focus on Circular 18/698 published by the Commission de Surveillance du Secteur Financier (CSSF) on 23 August 2018.

Let us start by providing some definitions before presenting the structure of the white paper in more detail. Delegation is the act of giving a particular job, duty or right to another party (legally, a separate entity) that will perform this task for the delegating entity. In the context of the financial industry, operating entities like promoters, asset managers, management companies or even investors may delegate some of their duties to third parties. These delegates will be responsible for performing these activities on a day-to-day basis, but the final responsibility will remain with the acting entity.
Oversight is the act of making sure that a particular task or duty delegated to another entity is performed diligently, honestly and fairly, in the best interests of the final beneficiaries, with due skill, care and diligence, and that the entity has all the resources and procedures in place to perform this task or duty.

Due diligence is a process that includes a quantitative and qualitative analysis of a fund manager, investment fund or administrator. It is generally performed by an institutional investor before considering any investment. During this phase, a detailed analysis of every aspect of the fund and the fund management company is carried out. It usually also includes one or more meetings with the management team. It is formally documented in a due diligence report prepared jointly during meetings with the management team and during on-site visits.

The objective of this white paper is to provide readers with some contextual insight into the concepts of delegation, oversight and due diligence, as well as further detail on the most important and challenging areas of the framework, with a focus on Circular 18/698.

This paper is divided into six sections. Section 1 starts with the history of due diligence over time, before detailing the types of due diligence that may be performed. Section 2 focuses on Circular 18/698, providing readers with an overview of the challenges that this circular represents in terms of delegation and oversight, followed by a description of the difference between delegating an activity and delegating the performance of an activity. Section 3 focuses on the delegated activities while section 4 on delegation policy and the corresponding procedures. Section 5 is dedicated to the due diligence process, including initial due diligence, periodic due diligence, the global delegation report and on-site visits. The final section is dedicated to the risk-based approach and the challenges it represents. We summarize the main findings of each section below.

“Oversight and due diligence have become central to the functioning of investment fund management companies. Standards are evolving rapidly, leading many players to invest time and energy in this area.”

Figure 1: Definitions

- **Delegation**: The act of giving a particular job, duty, right to another party (legally, a separate entity) that will run this job for the delegating entity.
- **Oversight**: The act of making sure that a particular job or duty that is delegated to another entity is performed diligently, honestly and fairly, in the best interests of the final beneficiaries.
- **Due diligence**: The formal documented complete analysis of a delegate.
Delegation & monitoring of delegates in five key points

Delegation & oversight policy

The basis of any delegation process is the delegation policy. This general policy must be detailed, prescriptive and supported by specific implementation procedures. It must be complete and regularly updated. The requirements in terms of formalization and documentation have become more important.

Initial due diligence framework

The second essential element to consider in the context of delegation and the monitoring of delegates is the initial due diligence framework. This framework relies on a questionnaire that is essential and must be comprehensive, precise and, above all, enable the delegating entity to understand the structure and the operating model of the delegate, and to identify potential sources of risk. It is important to remember that the due diligence questionnaire is not the objective of the process, but rather just a useful tool for the delegation process.

Figure 2: Five key elements to focus on in the context of Circular 18/698
Full delegation report
The full delegation report is the formal document on which delegation decisions are based. It includes, in addition to the completed due diligence questionnaire, the analysis of this questionnaire and the related documentation, but also the review of the policies, procedures and operating processes in place and controls carried out at the delegate's premises, as well as any interviews.

Ongoing monitoring
Ongoing monitoring is based on the periodic due diligence questionnaire and on the continuous monitoring process. The periodic questionnaire follows a similar logic to that of the initial questionnaire, however may be adapted to the risks identified for the delegate or the delegated function. The continuous monitoring process relies on the regular monitoring and operational reports provided by the delegate. This ongoing part of the process is demanding, because it must be flexible and suited to each delegate's specific situation, and above all to their level of risk.

The risk-based approach
The definition of the risk-based approach and the corresponding assessment grid are the last essential elements to be integrated into a global and coherent delegation and oversight process. The risk-based approach is a tool developed to assess the risks arising from delegation, aiming to assess the quality of the proposed delegate based on a collection of information that will be covered during the due diligence process. This approach should be consistent across delegate types and over time. Consistency and not oversimplifying the process are key.
History and insights into the due diligence process

The due diligence process has existed for decades in the asset management industry. Due diligence processes started with institutional investors looking to use the services of third party asset managers, followed by funds of hedge funds attracting interest from investors at the end of the 1990s and in the early 2000s. It has now become a standard part of the process regarding external providers and delegation.
The Due Diligence Process
The Alternative Investment Management Association (AIMA), one of the pioneers in the field, celebrated the 20th birthday of its due diligence questionnaire in 2018. There have been many iterations and versions of these due diligence questionnaires, reflecting changing standards.

We defined the due diligence process in the introduction to this white paper. While the definition may be seen as a little bit reductive today, it includes the main elements expected during the due diligence process. Let’s look at each of them individually. First and foremost, it is the process of analyzing a fund management company, an investment fund and/or an administrator (broadly referred to as a “counterparty”). This means that depending on the objective of the due diligence process, the focus and checks to be carried out will vary. In the context of delegating the management of a product (for example under a mandate given by an institutional investor or in the case of delegation of the management of a fund by a management company), the focus will be the delegated asset management company and not the product, as the product is owned either by the institutional investor or the management company. This means that aspects regarding the fee structure or liquidity terms are not covered by the diligence process in this context.

On the other hand, before investing in a third-party fund, a multi-manager or more broadly speaking, any entity investing in third-party funds including, for example, family offices or discretionary private banking entities, must perform due diligence on the investment product in question. This process will first cover the asset management company in charge of managing the product and a set of questions will focus on the product under review. This is particularly true if the investment is being made for the benefit of third-party clients. The reason for this is that multi-managers have to know the product they are investing in on their client’s behalf. Depending on the fund structure and the jurisdiction, the expected level of due diligence to be performed will vary. The operational part of the process may or may not be covered, as it is not yet a regulatory requirement in every jurisdiction for every player. By operational due diligence, we mean an in-depth analysis of the operational aspects of the management company or investment product. This process focuses on unwanted risks. When investing with an asset manager or in an investment fund, investors are taking risks. These risks can be classified under two categories: risks that are consciously taken, and unwanted risks. Any investment that aims to offer returns will be exposed to investment risks. Such risks are consciously taken by the investors. To achieve an expected level of return, an investor will have to bear a certain amount of risk. On the other hand, there are the risks that are not directly linked to investments made or the investment strategy implemented, but which may result in losses. As an example, these include operational and IT-related issues, as well as unclear trading procedures. Unwanted risks should be minimized and, to do so, professional investors typically perform operational due diligence covering these unwanted operational risks. In the context of a non-regulated product, operational due diligence is a must, but even for regulated investment funds there is a tendency to perform these operational checks for every counterparty. In France for example, since 2009 the AFG (Association Française de la Gestion, French Asset Management Association) has recommended performing due diligence that covers a series of operational aspects in its regulation of conduct. In the United Kingdom, the FCA does not formally require operational due diligence to be performed on every single counterparty when funds are used. The regulatory body does practically check what is performed by regulated
entities during inspections and it has become clear over the last couple of years that the level of expectation regarding due diligence and oversight is continues to grow.

The last part of the definition states that the due diligence process typically relies on a series of meetings with the management team. This was originally key, as due diligence audits in the asset management world were performed on alternative investments and, more specifically, hedge funds. In the early 2000s, the typical hedge fund was run by a small asset management company created by intelligent portfolio managers and the product proposed was an offshore fund with very limited investor protection. In addition, the strategies implemented were new and complex relative to what was available previously. A series of meetings were therefore necessary, firstly to get familiar with the investment strategy and, secondly, to perform all of the necessary checks on the asset management company and the investment fund structure. As the financial community learns more and more, and as regulation gets increasingly protective, a single meeting may be sufficient.

**Expected level of Due Diligence**

The level of detail to be covered in a due diligence audit will depend on a number of factors, including the regulatory framework, industry standards and the market environment. Regarding the regulatory framework, it is continuously evolving, however the trend is clear: expectations regarding formalization and documentation of the delegation and oversight process are increasing. We have seen this in the banking sector, and the new Circular 18/698 sets new standards for UCITS & AIFMs. This includes any type of delegates, including but not limited to the asset management company. One may wonder what the expected level of due diligence to be performed on the delegate asset manager is. The management company is delegating the asset management of one of its investment funds to another entity. In this context, it has to fully understand how the investment strategy is implemented and check that the exposure to unwanted risk is limited. This means that full asset manager due diligence is expected. In addition, a regular update (typically on an annual basis) is necessary.
On 13 July 2017, the European Securities and Markets Authority’s (ESMA) published an opinion that gave more insight into where we are heading looking forward. This opinion was published in relation to Brexit, but it can and should be considered more broadly, as it aims to ensure a consistent supervisory approach to safeguarding investor protection, the orderly functioning of financial markets and financial stability. Regarding delegation, it states that delegating entities should implement effective policies and procedures in order to monitor the activities of their delegates on an ongoing basis, and carry out regular on-site inspections of their delegates (even when delegates are located outside the EU). On this basis, regular on-site inspections involving a practical check of what was covered in the due diligence questionnaire will become standard. In addition, the delegation and/or operational risk management policies and procedures of authorized entities should provide contingency planning with respect to delegates, and detail all necessary steps and measures in case of a change of delegates.

The second aspect to integrate when determining the level of due diligence to be performed are industry standards. As an example, complex alternative investment strategies will require a deeper analysis than traditional long-only strategies. In any case, it makes sense to document the work performed, as more and more players are doing. More complex strategies give rise to additional operational risks, meaning that operational due diligence seems to be a minimum requirement, and full due diligence is simply a wise thing to do, even if it will most likely become obligatory in the years to come.

The final key element that may affect the expected level of due diligence is the market environment. This is more specific to multi-managers, family offices or private banks taking investment decisions for their clients. Markets have been favorable for a couple of years, meaning that most investors have been making money in absolute terms. When markets get more volatile, investors will most likely start losing money. In this context, there is a non-negligible risk that some of them will start complaining and begin to ask questions about the process of selecting and overseeing third-party investment products.

**Types of due diligence – initial vs. ongoing vs. on-site**

There are two different ways to classify due diligence by type. Firstly, initial versus ongoing versus on-site and, secondly, operational versus product versus global due diligence. The initial due diligence process must be carried out prior to establishing a relationship with a counterparty, in order to evaluate the risk linked to these potential business dealings. This due diligence process assesses the risk at a certain point in time and before engaging in any business dealings with the counterparty. The ongoing due diligence process is run periodically during the duration of the business relationship. It is practically an update of the initial due diligence process, sometimes including a specific focus/deeper analysis of certain aspects. Its frequency will depend on two elements: the risk associated with the activity under consideration, and the risk of the entity to which the activity has been delegated. The on-site due diligence process complements the work done during initial and/or ongoing due diligence. It aims to confirm what has been determined during the written due diligence process and to formally and practically check specific elements (typically reports, policies and/or procedures) during on-site inspections.
In terms of objectives, initial due diligence aims to enable the entity performing the due diligence to firstly “know their counterparty”, and secondly to “assess their counterparty”. These objectives complement each other even if they remain clearly distinctive. “Know your counterparty” aims to cover the functioning of the company, key personnel, governance or policies and procedures in place. “Assess your counterparty” aims to rate the counterparty and determine whether this counterparty is suitable to work within the context of the delegated activity in question, and that the risks identified are acceptable and correctly managed. Ultimately, the overall objective is to be confident that what is expected from the counterparty will be achieved, and that the delegating entity has a clear and predefined way to assess the quality of the work carried out. Ongoing due diligence usually has two objectives. Firstly, to update the work previously completed, and to reassess the counterparty. It is also typically used to perform additional checks, including sensitive elements, and to cover, in more detail, certain aspects of the due diligence process previously performed. This usually covers challenging areas for the specific counterparty or important elements of the delegation process. Following the same logic, on-site due diligence combines the objective of exchanging/discussing sensible criteria and identified weaknesses with the counterparty, as well as performing checks on specific processes, policies or procedures.

**Types of Due Diligence – operational vs. global vs. product**

Another way to classify due diligence processes by type is on the basis of the content or focus of the due diligence. The operational due diligence process consists of a complete operational overview. It focuses on operational and cross-functional aspects, with specific attention to policies, procedures and processes. This operational due diligence can be seen as a more detailed subset of global due diligence.

Global due diligence aims to cover every aspect of the asset management business including corporate overview (e.g., organization or human resources), regulatory overview, operations (e.g., IT, execution and trading, if applicable, or outsourcing) and corporate governance (e.g., internal, compliance, risk management, internal audit or remuneration policy). In addition, there will be a specific section or set of sections directly linked to the activity under review, including for example investments (e.g., team, investment process or portfolio management) in the context of the portfolio.
management activity. The difference is whether these is a focus on specific operational aspects on the one hand, and the level of detail on the other.

Operational due diligence typically goes further in terms of the aspects analyzed. Product specific due diligence is based on the same structure as global due diligence, however it integrates particularities of the product. Regarding portfolio management, for example, the investment strategy, portfolio construction or trading will be covered in the three cases, but liquidity and fee terms of the product will only be analyzed during product due diligence. Such due diligence is performed by entities considering investing in specific products, rather than delegating the portfolio management activity to a counterparty.

When you deepen the analysis of the objectives of the due diligence processes, the three types of due diligence based on content have a considerable number of shared objectives. We can group them under six distinctive yet complementary (non-exhaustive) objectives. It starts with the financial stability of the company and its executive. A second important element is to look at the legal and regulatory environment, followed by an in-depth, detailed analysis of the governance in place. A fourth element to focus on includes the policies, procedures and processes in place, as well as the controls performed by the internal control functions (risk management, compliance and internal audit, if applicable). An analysis of the corporate governance structure comes next. Finally, the quality of the relationship between the counterparty and its third parties can be seen as the last common objective for any due diligence process.

Fundamentally, the goal is to identify sources of risk and, more importantly, sources of unwanted risk. The difference is that the operational analysis focuses only on this aspect.

**Conclusion – Historical and contextual insights into the due diligence process**

Due diligence has been performed for more than twenty years. There are various types of due diligence processes, however the ultimate objective remains the same: understand how a counterparty works and/or how a product has been built, and where the risks lie. Regulatory requirements and industry standards continue to evolve, and we can reasonably expect due diligence processes to continue to gain importance going forward, as the asset management industry continues to be increasingly integrated and regulated.
Circular 18/698, delegation and oversight

Circular 18/698 is an important publication for the Luxembourg investment fund industry. This section focuses on this Circular and its specific framework regarding delegation, oversight and due diligence.

Circular 18/698
On 23 August 2018, the CSSF published the CSSF Circular 18/698 (the circular) on the “authorization and organization of Luxembourg investment management companies; Specific provisions on the fight against money laundering and terrorist financing applicable to investment fund managers and entities carrying out the function of registrar agent.”

The circular applies to both UCITS management companies and alternative investment fund managers, as well as management companies subject to chapters 16 and 17 of the Law of 17 December 2010 relating to undertakings for collective investment. It sets out the fundamental governance and organizational structures expected in terms of substance from Luxembourg management companies.

“Circular 18/698 is not a revolution, but is a serious evolution in the regulatory environment of investment fund management companies.”
The circular sets out the existing practices applied by the CSSF as well as some specific new requirements in relation to governance, central administration and internal controls, the fight against money laundering and terrorist financing, delegated activities, and valuation. The CSSF Circular 18/698 applies with immediate effect and repeals CSSF Circular 12/546, as amended. The circular is not a revolution, but rather a formalized evolution of the Luxembourg regulatory framework, which also materializes the convergence between traditional and alternative asset classes that we have seen for several years.

A significant part of the circular is devoted to delegation activities and the monitoring of these activities. The focus of the rest of the white paper will be the impact of the circular on delegation and oversight. While this circular is specific to Luxembourg, it sets the level expected by the regulator of the largest fund market in Europe.

**Delegation**

Delegation has gained importance in the financial services industry, particularly in the world of investment funds. In this context, the regulatory framework and requirements of regulatory authorities have evolved and are increasingly specific. ESMA’s opinion, published in July 2017, has been a catalyst, confirming the new regulatory standards for delegation and supervision as expected by the independent European authority. In the same perspective, the CSSF published Circular 18/698, which precisely defines, among other things, the framework for delegation and supervision in Luxembourg. This CSSF circular and ESMA’s opinion both cover the delegation process as a whole, and aim to organise this function in order to formalise processes and answer questions such as: Why delegate an activity? How can this delegation be justified? What criteria should be used to select delegates? How can a coherent delegation process be set up? What elements are common to all delegate types and which specific ones should be covered? How is supervision organized? How often? In what form? How is the process formalized? We aim to respond to these types of considerations. The view described is based on both regulatory requirements and market practices. Our objective is to focus on the most important factors.

Let’s start by agreeing on what a delegate is. There is a difference if we are talking about traditional or alternative funds, but overall it is a third party carrying on a collective management activity (broadly defined) on behalf of the investment fund manager. This specifically includes portfolio management, administration or marketing for traditional funds, plus asset-related activities for alternative funds. However, this can also include the potential delegation of functions such as compliance, internal audit, IT system management or accounting, and even complaints handling.
The Circular defines key functions. These are the functions that form part of the activity of collective portfolio management (portfolio management, risk management, administration and marketing plus a series of specific areas for alternative investment funds), as well as Compliance, the internal audit function and the valuation function for alternative funds. There are specific requirements regarding the delegation of activities considered sensitive in the context of collective portfolio management.

**Figure 7: Functions that can be delegated**

**Organisation of the delegation**
Historically, the selection and monitoring or supervision of a delegate (or counterparty) often relied on completing a due diligence questionnaire and updating this questionnaire over time. This approach has evolved considerably in recent years and the organization and control of the delegation as described by ESMA and the CSSF follow a common logic based on three main priorities for any delegation and oversight process. Firstly, the definition and formalization of a specific framework for delegation. In other words, it begins with the definition of policies and procedures that encompass this activity. The second area of focus is the selection of the delegate and the initial due diligence process performed to select the delegate. This involves drafting a delegation questionnaire specific to the activity, which will be completed and then analyzed in order to assess the quality of the delegate. The third area of focus is on ongoing monitoring, which comprises two complementary elements. It covers, on the one hand, the periodic update of due diligence and, on the other hand, the implementation of a control system that allows for monitoring of the delegates’ activity on a continuous basis.
Delegation, Oversight & Due Diligence | Circular 18/698, delegation and oversight

**Delegation: policies and procedures**

Any entity that uses the services of a delegate for one of its activities must establish a formalised and detailed delegation and oversight policy, as well as the corresponding implementation procedures. This means that a specific policy and additional procedures for the selection, monitoring and supervision of delegates must be written, adopted and applied.

This delegation policy is based on a series of prescriptive elements that include details about the written due diligence process carried out by the delegating entity. This work is the responsibility of the Luxembourg entity. Any transversal or specific intra-group competences may be taken into...
account, however the Luxembourg entity retains full responsibility for the activity. Another key element in the implementation of a delegation policy is the formalization of the selection process and the replacement of a delegate. This process must be implemented and formalized in a written contract before the delegation begins. The formalization of a delegate’s replacement must also be considered and planned as part of the delegation and oversight policy.

This is followed by the practical organization of due diligence and continuous monitoring activities. The nature of the work carried out, its frequency or its scope should be formalized. A multi-year plan should be prepared to organize the continuous monitoring work, and should be based in the risk-based approach. The delegating entity should also integrate not only the risks incurred by each delegation, but also the number of delegates they use. This monitoring activity of the delegating entity cannot be delegated and the department or persons in charge of this activity must be identified, who will be responsible for formally signing off on the due diligence.

The agreement between the parties must take the form of written contract setting out the individual tasks and activities delegated, and should ensure that authorized entities have the right to control and inspect their delegates. This includes being granted the necessary access and right to give instructions to their delegates. This means that the delegating entity must be able to play an active role, or at least have all the necessary tools at its disposal to play such a role.

It is worth noting that the circular specifies that identical rules apply in the event of partial or total sub-delegation of an activity or function, and the monitoring of the policy and procedures for delegating sub-delegated
activities must be carried out. This last element has been an area of concern for many industry players. How far should a delegating entity go if its delegates partially or entirely sub-delegate the delegated activity? There is no single answer to this question; there are two ways to handle this. Firstly, a delegating entity should at least ensure that its delegates perform the same level of oversight on their sub-delegate. This needs to be checked during both the initial and periodic due diligence processes. The challenge is when the level of oversight performed by the delegate is not in line with the level required by local regulations. In this case, the expectation is probably to perform the oversight on the sub-delegates directly. The importance of the delegation function can be integrated into that context and more focus and energy should be paid to key functions.

Figure 11: The sub-delegation oversight process

Conclusion - Circular 18/698, delegation and oversight

Circular 18/698 is a serious evolution in the regulatory environment of investment fund management companies. The regulator’s requirements are intended to ensure that investment fund managers who delegate certain activities implement, formalize and document a process and that this process is complete, documented and regularly reviewed and updated. Changes in the regulatory framework governing delegation leads to greater need for formalization than any delegation by investment fund managers. This section focuses on the evolution of formal needs. We have defined the delegation activities, which outlines how to structure the delegation organization before focusing more specifically on the requirement to implement delegation policies and procedures.
Delegated activities

This section focuses on the specific organizational provisions relating to delegation and its organization as described in CSSF Circular 18/698, looking at the tasks, functions and activities that can be delegated. More broadly, we look at the framework defined by the circular. Among other things, we try to answer the following questions: what defines a delegation activity? Are there any differences between traditional and alternative funds? What are the possible changes compared to previous regulations?

Definition
The circular begins with a series of definitions and abbreviations. A delegate is defined as any third party performing on behalf of the IFM (investment fund manager) at least one function included in the activity of collective portfolio management (as defined in Appendix II of the 2010 Law), risk management or any function referred to in the appendix I if the AIFM law. For alternative investment funds, the external valuer should also be considered.

Some elements in this definition are clear from the outset while others require some additional analysis. A clear element that can be understood from the first reading is that a delegate is a third party. "Third party" means a separate legal entity, which implies that any third party entity carrying out an activity (as defined later in the definition) falls within the scope of delegation and the corresponding rules. This means that an activity performed by a third party entity will fall within the scope of the delegation, even if the entity is part of the same group as the delegating entity. This element will be formally clarified in the section on delegation, but this definition refers to it directly. The second clear element is that delegation takes place in the context of collective portfolio management activities (which we will be able to detail more precisely when analyzing the laws mentioned in the definition), risk management and, for alternative funds, valuation.

A second level analysis that looks at the appendices of the corresponding laws mentioned and the paragraph referenced in the definition indicates that the functions included in the activity of collective portfolio management for traditional funds include three main elements: portfolio management, administration which covers a series of activities including, among others, legal and accounting management services of the fund, client enquiries, valuation.
portfolio valuation, valuation of the stakes, income distribution, stakes issuance and buyback and, finally, marketing. Similar activities can be found for alternative funds groups regarding asset management functions, namely portfolio management and risk management. There are other common functions related to administration (with the same underlying elements as for traditional funds), marketing, and specific activities linked to alternative fund assets such as administrative real estate management, capital structure consulting, industrial strategy or fiduciary obligations. The framework defined by this definition has the advantage of clarifying the functions concerned overall, but more detail must be provided in the sections relating to delegation in order to specify the activities or functions concerned.

**Delegated activities vs. delegation of the execution of functions or tasks**

The definition of delegate provides the framework within which activities evolve. The delegation-specific sections of the circular clarify certain elements. The circular provides an interesting separation between the activities that can be delegated and the performance of the functions that can be delegated. It’s a fine line, but there is a difference between the two. On the one hand, there are the "traditional" activities of a management company, which are those included in the activities that can be delegated, and on the other hand, there are the functions for which the circular specifically requires, for each of them, that the IFM acquire its own corresponding function in Luxembourg. In these specific cases, the operational implementation of these activities may be delegated, but it is not the activity itself that is delegated.

The activities that an investment fund manager may delegate can be grouped into five categories. First of all, there are the functions included in collective portfolio management activities, as included in the definition of the delegate, which include portfolio management, administration or marketing for traditional funds and asset management, administration, marketing and the specific activities related to the assets of alternative funds. Then, there is risk management, the evaluation function, complaint handling and discretionary management and ancillary services, each within the limits described in the corresponding sub-sections.

Activities for which operational implementation of the tasks can be delegated include the compliance function, the internal audit function, the
Delegation, Oversight & Due Diligence | Delegated activities

operation of the IT system and the accounting function. As a result, there is a clear new framework within activities such as compliance that can be delegated. The corresponding paragraphs refer to the sections that include the requirements for the internal implementation of the corresponding activities. This confirms the logic of the circular that the work performed must meet the requirements as defined in the circular, regardless whether the activity is internalized or outsourced.

“Delegated activities include the function included in collective portfolio management activities (portfolio management, administration and marketing), risk management, the valuation function, the complaints handling, the discretionary management function plus the activities for which the performance of the functions can be delegated (compliance, internal audit, IT operation and the accounting functions).”

Figure 13: Activities that can be delegated

There is a differentiation in terms of framework between delegated activities and those for which operational execution is delegated, but the difference ends here. There is no factor that differentiates the two types of delegation in terms of the delegate monitoring requirement. There is a differentiation in terms of notifying the CSSF, but for the rest, the framework is similar. For all delegated activities (or equivalent), a program of activities must be submitted to the regulator. This program should detail the proposed delegation of functions, the entities to which functions will be delegated and a range of other information such as the country of registration. In addition, the entire organizational framework surrounding this delegation must be described in order to enable the CSSF to verify that the conditions of the delegation have been met. The difference is that for certain delegated activities, such as portfolio management, risk management, central administration and valuation, the CSSF must be notified in advance of the intention to delegate.
Conclusion – Delegated activities

The circular covers delegation in detail. This section focuses on the definition of delegation, the difference in requirements between traditional and alternative funds, changes compared to previous regulations and, more specifically, the difference between delegation of functions and delegation of the performance of functions or activities. The circular has two effects. On the one hand, it formalizes or clarifies certain market practices by regulating them more precisely and assuring the regulator that all participants are at the same level in terms of governance, processes, procedures and substance. On the other hand, the requirement for formalism requires delegating entities to implement and implement more demanding processes.
Delegation policy & implementation procedures

This section focuses on the policy and procedures to be implemented in the context of delegation. Our goal is to provide an overview of the market requirements and best practices in this area. We do not aim to present all of the requirements or best market practices in detail, but rather to guide the reader by covering the main elements and by sharing our experience.

“The delegation and monitoring policy and related implementation procedures are key to the implementation of a delegation process. They set out a framework including how to document the work carried out, the elements to be covered and responsibilities.”
Delegation and monitoring policy
The circular details what should be covered in the “delegation procedure” in terms of delegate selection and the monitoring process, but also in terms of decision-making and the allocation of responsibilities. In practice, this delegation procedure can be likened to a “delegation and oversight policy” that aims to describe the working framework under which delegation takes place. This policy must be supported by implementation procedures that include, per delegate type, the practical details specific to the type of delegate considered. Such implementation procedures by delegate type do not necessarily have to be drawn up for each delegate type, however the delegated activities that require specific procedures must be identified, and the others may need to be grouped under a more general implementation procedure.

The objective of the delegation and monitoring policy is to set up a structured framework that formalizes the work performed and organizes the documentation of the process. This policy is intended to be general and not specific to any function or activity that can be delegated. It organizes the entire delegation and oversight of this delegation. Elements specific to any delegated activity will be included in the implementation procedures for the activity in question, where relevant.

The delegation policy must be based on at least four key areas: the selection and change of the delegate, the risk assessment approach, the due diligence process and finally the monitoring of the activity and decision-making process.

- **The selection and the change of the delegate**
  - Specifies the steps to be followed in the delegate selection process
  - Must be presented in a precise and structured way

- **The risk-based approach**
  - Can be seen as a reading grid based on a series of criteria identified and defined as relevant

- **The due diligence process**
  - Objective must be specified
  - Elements underlying its operational implementation are detailed
  - Families of characteristics to be covered are included in the policy and details are presented in the implementation procedures

- **The monitoring of the activity and the decision making process**
  - May never be delegated
  - Must identify which departments or staff members are responsible

Figure 15: The four key areas of the structure of a delegation

The process for selecting and changing delegates specifies the steps to be followed during the delegate selection process. The process must be presented in a precise and structured way. It typically begins with the creation of a short list of candidates, then defines the key steps and the number of candidates considered for each step of the process. In addition to the selection of delegates, the process must also specify the tasks to be carried out in the event of a change of delegate.

The risk-based approach can be seen as a reading or assessment grid based on a series of criteria identified and defined as relevant in determining the risk of the delegate under review. The criteria used must be varied and must include information such as jurisdiction, the regulated or supervised nature of the delegate, the existence of sanctions imposed by a supervisory
authority, the entity’s financial position and shareholding structure, the organizational structure and the governance structure. However, this is not the end of the story. Other information such as the quality of IT systems (including data protection), the business continuity plan or the delegate’s ability to provide sufficient and relevant reports and key performance indicators must also be integrated into the process. In practice, a reading grid must be created. In parallel with the risk-based approach, due diligence aims to gather information that can then be analysed. This reading grid ensures consistency throughout the delegate selection and monitoring process. The risk-based approach is a key element in the delegation process as it takes place at several levels, not only in the selection of the delegate, but also during his or her initial and ongoing assessment. For the last point, this is appropriate in terms of periodic due diligence, in the context of continuous operational monitoring and in the frequency and level of detail of monitoring reports.

Figure 16: Typical delegate selection process

The definition of the framework implemented in the due diligence process is the third key element of the delegation and oversight policy. The objective of the due diligence process must be specified and the elements underlying its operational implementation detailed. The policy aims to cover general elements, but implementation details will be presented in the implementation procedures. The key steps must be identified and the nature and extent of the due diligence determined. The methodology for assessing delegates on the basis of due diligence must also be specified and based on the above-mentioned risk-based approach. For periodic due diligence, the frequency and methodology for determining this frequency must be detailed. The delegation policy should also specify practical information such as the fact that due diligence must be drawn up in a written report, that it must be signed by the person in charge, or the process to be followed for historical delegates for whom such a process has not yet been completed.

Monitoring of the activity is another aspect that should be detailed in the delegation and monitoring policy. The policy must specify who is responsible for what. The monitoring of activities delegated to a third party cannot be delegated. The policy must identify which departments or staff members are responsible for the ongoing monitoring of delegates. In the same way, it will describe the step-by-step intervention measures and the decision-making procedures around delegation.
Implementation procedures

Implementation procedures complement the delegation and oversight policy. These detail the operational elements specific to the delegated activity in scope. There will usually be a couple of them. Firstly, a general implementation procedure including the common rules applicable to delegated activities for which there is no specific procedure. Secondly, a set of procedures specific to some activities, which will typically be key activities. For example, a portfolio management delegation procedure will provide details such as a description of the portfolio management process, the identification of the performers involved in the process, the functioning of a possible investment committee, and the control and decision-making procedures. These procedures are an integral part of the delegation process and their importance should not be overlooked. Their final objective is twofold: on the one hand, they structure the increasingly demanding delegation process and a structured process will be easier to set up. On the other hand, they will prove to the regulator that the investment fund manager in question is in compliance with legal obligations.

There are other specific elements that form part of the due diligence process that need to be specified in the delegation and monitoring policy. For instance, these include measures to ensure business continuity in the event of withdrawal of the mandate or data protection.

Conclusion – delegation policy & implementation procedures

The delegation and monitoring policy and related implementation procedures are key to the implementation of a delegation process. They set out a framework that covers how to document the work carried out, the elements to be covered and responsibilities. As mentioned previously, although the new circular is more of an “evolution” than a “revolution”, it is clear that the corresponding existing policies and procedures will need to be reviewed and updated.
The due diligence process

This section focuses on due diligence questionnaires. We will cover the initial and periodical due diligence questionnaire. We also touch on the importance of the risk approach to be integrated into the implementation of the due diligence questionnaire.
The “Due Diligence” process
The Due Diligence process has been in place for decades. Institutional investors have relied on this type of process for a very long time and during the 2000s, the hedge fund industry developed rapidly with an exponentially growing fund industry, which allowed these processes to evolve and become more exhaustive (or demanding, depending on your point of view). Although the process began in the world of asset management and investment product selection, the Circular 18/698 context is somewhat different. Here, we are dealing with entities that must carry out controls on counterparties and delegates. In this context, it is a question of covering two main aspects: on the one hand, understanding the functioning of the entity considered for delegation and ensuring that the potential delegate has the necessary people, processes, systems and structure to be able to carry out the activity. The second aspect is the identification of sources of risk. It complements the first aspect well, and is part of a similar framework. The particularity is that the objective is not only to determine the potential delegate with the (broadly defined) capacity to perform the task, but also to identify the sources of potential risks. Risks are defined here with a focus on operational risks. These are not, for example, the market risks taken by the portfolio manager, but rather the risks related to the fact that the strategy cannot be applied as expected, that the controls in place are not effective or that the company does not comply with certain local regulatory constraints.

The rest of this article is built around three key areas. We will begin by contextualizing the process within the framework of the circular, before focusing on the initial due diligence process and its particularities, followed by periodic due diligence.

Initial due diligence
- Gather general and specific information about the delegate
- Includes the analysis of the organisation and the implementation of the various policies

Ongoing monitoring
- Monitoring of the delegate
- Reports and KPI analysis

Periodic due diligence
- Each delegate should be reassessed on a regular basis
- The regularity will depend on the sensitivity of the activity, the level of risk associated with that activity and more specifically on the delegate

“...management company must identify and assess the risks arising from the delegation in order to determine whether they are in line with the risk management policy. These risks include operational, financial, legal and reputational risks.”

Figure 17: The key areas around which delegation & oversight are organized
The circular details what is expected by the regulator by specifying, for most cases, that the requirements represent a foundation, rather than an exhaustive list of requirements or expectations. This is also the case in the chapter on delegation and the oversight of delegates. In practice, it is specified that the management company must identify and assess the risks arising from the delegation in order to determine whether they are in line with the risk management policy. These risks include operational, financial, legal and reputational risks. These few lines indicate that the level of detail expected is very broad as it covers the full spectrum of potential risks.

**Initial due diligence**

The level of detail found in the circular goes much further. Information to be covered and documented during the process should include everything that can be considered as “general” (information on the company, its regulatory obligations or its governance). Such information will most likely be common to any type of delegate. Then, focus should be placed on what specifically concerns the delegated activity, its implementation and the corresponding controls. For example, this includes ensuring that the delegate has required the skills and capacities to carry out the activity, and that it will be able to provide the delegating entity with all the information required in order to set up ongoing monitoring, and to update the due diligence carried out prior to delegation. This includes the analysis of the delegate’s organization, as well as the implementation of various policies, such as a conflict management policy or best execution. This is not only about gathering information, but also about analyzing the information received in order to formally assess the delegate, on a structured and consistent basis. The items listed are only examples of what needs to be covered, as the adequacy between human and technical resources and the delegated activity must also be covered. The additional requirements that can be expected for the delegation of key activities are illustrated by this last element.
The full delegation report
The due diligence is a written questionnaire that covers the elements listed above (and most likely more). However, having a completed due diligence questionnaire is not enough. The full delegation report mentioned in the circular does not end here. It must include a series of additional elements. These include the analysis of this questionnaire, the analysis of the related documentation, as well as the review of the policies and procedures in place or the controls carried out at the delegate’s premises. In addition, the critical analysis described must be formalized and potentially followed by escalation measures. Finally, the whole process must be validated and signed by the persons or body with decision-making authority. The delegate’s monitoring plan must also be included in the same report and formalized.

“The full delegation report includes, in addition to the completed due diligence questionnaire, the analysis of this questionnaire and the related documentation, as well as the review of the policies, procedures and operating processes in place and the controls carried out at the delegate’s premises, plus any interviews.”

Figure 19: The full delegate report

Periodic due diligence
Initial due diligence aims to determine the possibility of delegating an activity to a delegate with the necessary resources and capacity to carry out the task or activity in question. In addition to this preliminary check, each delegate should be reassessed on a regular basis. The frequency will depend on the sensitivity of the activity, the level of risk associated with that activity and on the delegate itself. The report must be updated and the entire process must be carried out on a regular basis. The regulator expects a job to be performed at the same initial standard. The minimum requirements are the same whether the level of risk of the delegate or the delegated activity is high or low. The work to be completed between higher or lower risk delegates can be differentiated at two levels. Firstly, by performing more frequent updates on higher risk delegates or functions. Secondly, by focusing on a greater level of detail for some delegates or functions during periodic updates. This report must also include any observations and intervention measures to be implemented.
On-site visit
It is worth noting that if the on-site visit is not stated as being mandatory; it must be considered and performed if required. The circular was not precise on this point, but it appears that the distance from a delegate should not be seen an obstacle to performing a documented on-site visit and that any element relating to it should be included and detailed in the final formal report. Practically speaking, on-site visits should be considered in the context of the risk-based approach. In other words, the conditions calling for on-site visits should be described in the delegation and oversight policy, as should the risk-based approach. Systematic visits are probably not strictly necessary, but visits to higher risk delegates in the context of the delegation of key functions are a must. It should also be noted that the documented interviews also have their role to play and should be included in the final report.

"The on-site visit is not mentioned as mandatory in the Circular 18/698, but it must be considered and performed if required on the basis of the risk-based approach."

Conclusion – the due diligence process
The due diligence process has evolved in recent decades and the Circular 18/698 formalizes existing standards for many stakeholders. This process is no longer limited to sending a standard questionnaire to a potential delegate, but rather to formalizing a complete and detailed process based on a specific methodology implemented within the portfolio management company. This methodology must be formalized, and it must be remembered that it is based on three key areas: the due diligence questionnaire, the risk-based approach that structures the assessment, and the global delegation report that formalizes the entire process that has been implemented. The process is described and detailed in the delegation policy and is related to the implementation process.
The risk-based approach

The last section of this white paper on delegation, oversight and due diligence focuses on the risk-based approach as presented in Circular 18/698. Many questions have been raised on this point throughout the industry since the publication of the circular at the end of August. The risk-based approach is mentioned a couple of times in the circular, however it appears most prominently in Chapter 6 on specific organizational provisions, and more specifically the delegation framework.

The risk-based approach in the Circular 18/698
In the chapter on delegation, six direct references are made to the risk-based approach. These references cover the entire process of delegation, supervision and due diligence. It appears for the first time in the section on the establishment of a delegation procedure. In this context, the risk-based approach must be used in the process of determining the nature, scope and frequency of periodic due diligence to be carried out. In other words, the regulator expects that on the basis of a given level of risk of a delegate, the due diligence work performed will be adapted. This can be done at two levels. On the one hand, the activities defined as key represent a greater risk, which means that the analytical work and especially the level of detail is adapted. On the other hand, for delegates who have been identified as risky not because of the nature of the delegated activity, but in accordance with an analysis by the delegate performed previously, some points of analysis will need to be further explored. For example, it is conceivable that, for a delegate of a low risk non-key activity, a due diligence questionnaire would be sufficient, while for delegates defined as higher risk, an on-site visit would be required.
Regarding frequency, an update every 18 months could, for example, be considered for a low-risk delegate, compared to a standard annual frequency, or more often in the event of a higher level of risk. The overall number of delegates should also be considered in this context. The underlying logic is that an entity that uses many delegates is exposed to a greater overall risk of delegation, which must be integrated into greater delegate oversight. Global delegation risk means the accumulation of specific risks for each delegation; in other words, the risk generated by the activity. The link between the frequency of due diligence and the risk-based approach is mentioned a second time in the same subsection. At this level, a direct link is made between the multi-year due diligence plan and the risk-based approach.

The risk-based approach is defined in the initial due diligence subsection. We will come back to its definition later, but the fact that this approach was defined in the subsection on due diligence and more precisely as a tool for determining the assessment of risks arising from delegation indicates that the primary purpose of the risk-based approach is to define a grid for interpreting a delegate, on the basis of predefined risk criteria and according to a weighting system specific to the delegating entity. The latter element is not specified directly in the corresponding paragraphs, but it is obvious when we consider the circular more generally.

The direct link between the due diligence process and the risk-based approach is reflected in the paragraph on the global delegation report and in the subsection on periodic due diligence. The risk-based approach must also be used when analyzing the results of the control system for delegates. We are no longer talking about an initial or periodic due diligence analysis, but about considering the level of risk of a delegate (without forgetting to consider the global delegation, risk as mentioned above) as part of the periodic monitoring of the delegate's activity and the monitoring of key performance indicators. The circle is closed, given that the framework for using the risk-based approach in the delegation and monitoring of delegates covers the entire process.

The risk-based approach in theory

There is no clear definition of the risk-based approach in the circular. However, a paragraph refers directly to the fact that in their assessment of the risks arising from delegation, and in order to assess the quality of the delegate under consideration, the entity considering delegation must take into account any criteria it considers relevant. This includes a non-exhaustive set of elements that are directly included and that must be considered as a minimum basis for integration into the analysis and determination of a delegate's risk level.

These criteria can be grouped into four families: legal/regulatory aspects, elements relating to the structure and organization of the delegate, elements of the situation and/or policies and procedures in place and the delegate's ability to provide information to the delegating entity.

Legal/regulatory aspects include elements such as the jurisdiction in which the delegate is located, and the regulated and/or supervised nature of the delegate, if applicable. It also includes the nature of the authorizations obtained and the existence of any sanctions imposed by the supervisory authority. Information relating to the structure and the organization of the delegate include the shareholding structure, governance structure,
organizational structure, and organization of control functions within the delegate (risk, compliance, internal audit).

Figure 21: Non-Exhaustive list of criteria to take into account when building a risk-based approach

The situation and/or policies and procedures in place include elements like the delegate’s reputation, skills and capacities, its financial position, the absence of any suspicion of money laundering and terrorist financing, the quality of IT systems (including the measures set up by the delegate to ensure data protection), the business continuity plan and the plan for the recovery of the delegate’s operations, the risk of conflicts of interest between the delegating entity and the delegate, the handling of complaints and claims received by the delegate and the existence of sub-delegation and the monitoring measures in place. Finally, the delegate’s ability to provide information to the delegating entity focuses primarily on available reports and key performance indicators. The importance of the last element covering the ongoing relationship between the delegating entity and the delegate should not be overlooked.

In total, the regulator lists 19 criteria representing the minimum requirements to consider when applying a risk-based approach to the assessment of delegates. The objective of this approach is to obtain, for each delegate, and on the basis of these elements, an objective evaluation that can be analyzed on an absolute and relative basis. The absolute assessment confirms whether or not a delegate represents a risk. The comparison of the overall assessment, and especially the assessment by section, will allow the delegating entity to compare the level of risk of the delegates and, above all, to identify the strengths and weaknesses of each delegate and where the identified sources of risk come from.
The risk-based approach in practice

In the previous section, we describe the elements to be considered, as a minimal requirement, when implementing a risk-based approach. In this section, we aim to be practical. The creation of a risk-based approach begins with the definition of the criteria under consideration. It is then necessary to determine on what basis the criteria will be assessed. This part of the process is key, as it is necessary to build a coherent process not only by type of delegate, but for all delegates, even if they cover different functions or activities. There are various kinds of information sources that can be used, ranging from policy or procedure to receipt of official documents, internal or external reports or documented interviews. The more formal the process, the more relevant it will be. The elements or documents thus defined must be identified in the due diligence questionnaire. These will include one or more questions that, alone or in combination, will make it possible to assess a specific element.

Once these elements have been identified, it will be necessary to determine a reading grid that will include these minimal requirements, but which may include additional elements. Overall, it is a question of building a reading grid that will link the due diligence questionnaire to the risk-based approach. This reading grid aims to assess the delegate. It is essential to build a clear, comprehensible and, above all, consistent grid making it possible to evaluate the delegates, and also to understand where the sources of risk, which may simply be weaknesses or areas for improvement, come from.
Mistakes to avoid
The implementation of the risk-based approach is most probably one of the most complex elements to build in the context of the oversight of delegates because it is built on a series of criteria and their definition and interactions can be difficult to assess. In addition, it must be built in parallel with the due diligence questionnaire. Finally, it must be consistent. Various challenges may arise in creating this approach. We will mention two of them: oversimplification and lack of consistency. The risk of oversimplification can occur at several levels. Firstly, in defining the elements considered in implementing the risk-based approach. The regulator cites a series of criteria that must be considered minimal, but more generally, all the relevant elements included in the due diligence questionnaire should be included in the reading grid. Secondly, the oversimplification risk is also present in the construction of the reading grid. The weight and contribution to the corresponding level of risk will depend on the level of sensitivity of the delegating entity to the various risks considered. This grid must be entity-specific and cannot simply be standardized and oversimplified. We expected that the delegating entity will determine its reading grid based on its understanding of risks. The risk of oversimplification ultimately lies in the assessment, which must not be limited to an overall assessment but must make it possible to identify the sources of risk and the points on which the delegate stands out, with its strengths and weaknesses.

Figure 23: Mistakes to avoid

The second mistake to avoid is inconsistency. The risk-based approach must be consistent across all types of delegates. It is not possible to justify different processes by type of delegate. There may be adjustments and there will be elements and risks specific to the various types of delegates, but the structure of the process, the logic in place, the audit basis or the logic behind the evaluation system must be consistent across all types of delegates.

Conclusion – Risk-based approach
The risk-based approach is a key element in the context of delegation and oversight. It has to be considered during the whole process and can be quite challenging to build. In this section, we analyze this risk-based approach in various ways. We start by its reference in the circular. From there we focus on how it can be built both in theory and in practice. Lastly, we highlight two challenges or mistakes that are typically faced during its completion: oversimplification and inconsistency.
Global Conclusion

In an increasingly globalized financial world, the delegation process has gained importance over the last two decades. Two main reasons behind this change are, firstly, the fact that investors use more and more external products or the services of third party portfolio managers. Secondly, fund management companies use more and more delegates to perform some of their activities. This concerns the portfolio management activity, but also includes, for example, administration or distribution. The delegation of activities does not mean the delegation of responsibilities; this means that the delegating entity needs to assess the capacities of their potential delegates and build a process around the oversight of these entities. In addition, delegation gives rise to new risks that must be integrated, as well as processes that need to be built in order to organize the oversight process. Such risks include operational, financial, legal and reputational risks that need to be measured. In this context, companies considering the full or partial delegation of certain activities need to build a delegation framework around these activities, to perform due diligence on these counterparties and organize the ongoing monitoring of their activities.

These risks have been identified as sufficiently important for the European Securities and Markets Authority (ESMA) to publish, in 2017, an opinion that gave more insight into what is expected in terms of delegation, oversight and due diligence. ESMA aimed to ensure a consistent supervisory approach to safeguard investor protection, the orderly functioning of financial markets and financial stability. At a local level, Luxembourg was one of the first to publish its local regulation on the topic, providing significant detail on the minimal requirements regarding delegation, oversight and due diligence. These elements are detailed in Circular 18/698, which is quite prescriptive on what is required in terms of delegation and oversight, and how it has to be carried out.

A circular like this one represents both a challenge and an opportunity. It is a challenge because delegation, monitoring and due diligence are among the most complex elements of Circular 18/698. In addition, the number of reports, policies and procedures to be produced, documented and implemented is high. It is an opportunity because it formalizes industry rules and best practices, which will enhance the level of protection for the final investors.

There are two additional elements worth mentioning to conclude this white paper. The first concerns the practical implementation of the requirements of Circular 18/698. Our analysis shows that, while it is true that the Circular is clear and precise on what is expected, it is probably a little less so on some of the practical aspects relating to the implementation of the corresponding tasks. Therein lies the challenge. It is about putting theory into practice, whether it concerns the delegation policy, the due diligence questionnaire, the reading grid, the risk-based approach or the delegate’s overall report. This is a real challenge currently facing the Luxembourg fund industry.

Finally, taking a more global view, looking forward and considering where we are in terms of requirements, and where we’ve come from, it is clear that expectations and requirements in terms of delegate oversight and due diligence processes are a moving target. The objectives and requirements regarding the delegation process are changing. In this context, entities delegating activities or functions need to be flexible in the way they work and reactive to changing market practices.”
diligence processes are a moving target. The delegation and oversight framework is continuously evolving, and one that relies on policies, procedures and the documentation of the work performed. There is a moving target in terms of objectives and requirements prior to and during the delegation of one or several activities. Entities delegating activities or functions need to be flexible in the way they work and reactive to changing market practices. As people in charge of organizing and overseeing delegation continue to gain experience in the field, standards will continue to evolve as they have done over the last couple of years. What is seen as the “best in class” today, will most likely be the standard market practice of tomorrow. This has been the case in the past, and will continue to be so in the future. This last element is essential, as it will continue to raise industry standards over time.
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