

# The new era of delegate oversight

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On 13 July 2017, the ESMA published an opinion on delegation by EU authorized entities to asset management companies located outside of their homeland, and more precisely in non-EU jurisdictions, in the context of Brexit. This opinion covers several aspects of the delegation process from policies and procedures around delegation to delegation oversight, governance, and substance, and some aspects of the investment process and risk management. Our focus here will be on the first two topics: policies and procedures relating to delegation and delegation oversight. While the opinion has been published in the context of Brexit, the underlying idea could most probably become an industry standard aiming at enhancing requirements around delegation and oversight. The ESMA describes this opinion as establishing the minimum standard required in the context of delegation and has repeatedly stated that existing regulations already stipulate that oversight must be organized. The difference is that the minimum requirements have been clearly defined and as the ESMA has

expressly specified that these rules apply to white-label entities (also known as third-party management companies) as well as entities that belong to a corporate group. The most interesting change is that the requirements are now clearly expressed in writing and in fact, are mostly repeated several times. It is also worth underscoring the fact that these requirements are seen as minimums. In other words, every authorized entity is expected to fulfil the delegation requirements detailed hereafter, but larger entities, and most probably newer ones, may be asked to go further.

### Delegation: policies and procedures

All authorized entities must draw up policies and procedures to select and monitor delegates. This means that specific policies and procedures have to be written, adopted, and applied in practice. These procedures should ensure that the delegation process is based on objective reasoning and carried out with the best interests of investors in mind. Objective reasoning is the first sensitive issue here, as the process is not without risk. The

second challenge is that monitoring should be carried out on an ongoing basis. The fact that this idea of continuity recurs a couple of times in the document confirms the importance of continuous monitoring of specific items.

A third key element to note in relation to the delegation process is that arrangements between the parties should take the form of written contractual documents precisely detailing the individual tasks and activities that are delegated to ensure that authorized entities have the right to inquire, inspect, have access or give instructions to their delegates. Again, we can infer that the key idea is that the authorized entity should play an active role. This section ends by stating that the delegating entity should be able to terminate the contract at short notice. Contingency planning policies and procedures should also be implemented. A direct corollary to these elements is that appropriate records should be kept of all due diligence and delegation monitoring activities and contractual arrangements. ➔





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#### **Delegation: oversight**

The elements presented in the previous section indicate that there are extensive requirements in relation to simply organizing oversight. However, expectations regarding oversight itself go even further.

The first requirement simply states that delegation arrangements must be subject to appropriate oversight. The opinion goes on to state that appropriate oversight must be underpinned by a due diligence on the delegate, among other factors (to be documented in writing).

Possible alternative delegates should be considered and the process around them documented. This documented due diligence should be performed on an ongoing basis, and should also be supported by regular on-site visits to delegates. These visits should be organized to monitor delegates and also to constructively challenge them where necessary. Authorized entities should play a key role in the process rather than being mere passive observers; this raises a number of issues including effective access to data on the delegated function.



### Delegation: corporate entity

There is nothing in the opinion to suggest that white-label or in-house delegation processes should be any different. To prevent readers from inferring this, the regulator even mentions rules specific to entities that are part of a corporate group on multiple occasions. These include the fact that conflict of interest policies and procedures should, where relevant, reflect the fact that potential conflicts are specified in the policies and procedures. In addition, but independently of that, the governing or management body of the authorized entity should have the ultimate decision-making power over the business conduct of the authorized entity even where the entity is part of a corporate group.

Two more potentially sensitive elements are firstly that where authorized entities intend to delegate functions to entities within the same corporate group, due diligence should be carried out by the authorized entity and the selection of a group entity should be based on objective reasoning. Secondly, no reporting lines to group functions or other individuals within the group should contradict the independence principle or impair the independence of internal control functions.

### Due diligence: a definition

Due diligence is defined as the process of carrying out quantitative and qualitative analysis on a delegate. Historically, it has been performed by institutional investors prior to an investment. During the due diligence process, every aspect of the fund and the fund management company is analyzed in detail. Due diligence also typically involves one or more meetings with the management team. The due diligence requirement comes from the world of hedge funds and it is driven by three main factors. Firstly, hedge funds were typically smaller structures with a limited infrastructures. Secondly, the nature of the strategies implemented by hedge funds meant that investors needed to work harder to fully understand the investment strategy and the risk associated with it.

Finally, several fraud cases have affected the industry and its reputation, leading potential investors to be more profound in their analyses.

While this definition is probably slightly reductive today, it still conveys the main elements that should be included in the due diligence process. First and foremost, due diligence is the process of analyzing a fund management company, investment fund, and/or administrator (broadly defined as “counterparties”). This means that the focus and checks to perform will vary depending on the specific objective of the due diligence process. In the context of delegating the management of a product (for example in the context of a mandate given by an institutional investor or in the event 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. Conversely, before investing in a third-party fund, a multi-manager or—more broadly—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 under consideration. This process will cover the asset management company first and foremost, but also include a set of questions on the product under review. This is crucial if the entities in question are investing on behalf of third-party clients. The reason for this is clear: multi-managers must have adequate knowledge of the products they are investing in on their clients’ behalf. Depending on the fund structure and the jurisdiction, the expected level of due diligence to be performed will vary. The investment part is typically analyzed by a professional third-party investor to enable the team to take an investment decision and justify their choices. 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. ➔



Operational due diligence involves 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 in two categories: risks that are consciously taken and those that are unwanted. Any investment that aims to offer returns will naturally entail a certain degree of investment risk. Such risks are (or at least should be) consciously taken by investors in order to maximize their chances of achieving an expected level of return. On the other hand, there are risks that may lead to losses that are not directly linked to the investments themselves or the investment strategy implemented. These include operational issues, IT-related issues, and unclear trading procedures. Unwanted risks should be minimized and, to that end, professional investors typically perform operational due diligence on these operational unwanted risks.

In the context of non-regulated products, operational due diligence is a requirement, but even for regulated investment funds, there is a tendency to perform operational checks for every counterparty. In France for example, the AFG (Association Française de la Gestion, French Asset Management Association) has recommended performing due diligence covering a series of operational aspects in its code of conduct since 2009. In the United Kingdom, while the FCA does not formally require operational due diligence to be performed on every single counterparty, the regulatory body does in practice check what due diligence is performed by regulated entities during visits, and it has become obvious over the last couple of years that expectations regarding due diligence and oversight are becoming increasingly rigorous.

The full due diligence process is typically required when the portfolio management of a product is fully delegated to a third-party asset manager.

The last part of the definition states that the due diligence process relies typically on a series of meetings with the management team. This was key in the past when due diligence procedures in the asset management world were performed on alternative investments and hedge funds in particular. In the early 2000s, the typical hedge fund was run by a small asset management company created by smart 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 had been available previously. This is why a series of meetings was necessary, firstly to gain an understanding of the investment strategy and secondly to perform all the checks necessary on the asset management company and the investment fund structure. As the financial community becomes increasingly educated and as regulations become increasingly protective, a single meeting may be seen as sufficient.

#### Full Asset Manager Due Diligence (AM-DD) versus Operational Due Diligence (OP-DD)

So far in this article, we have introduced the concepts of asset manager due diligence on the one hand and operational due diligence on the other hand, but we have not fully explained the differences between the two. Asset manager due diligence aims to cover every aspect of the asset management business including corporate overview (e.g., organization or human resources), regulatory overview, investments (e.g., team, investment process or portfolio management), operations (e.g., IT, execution, and trading or outsourcing) and corporate governance (e.g., internal, compliance, risk management, internal audit or remuneration policy). In contrast, operational due diligence can be seen as a subset of full asset manager due diligence. The focus is the unwanted risks linked to operational systems as well as regulation. It focuses on the corporate overview, regulatory aspects, operations, and corporate governance.

The full due diligence process is typically required when the portfolio management of a product is fully delegated to a third-party asset manager. This makes sense as the investment process, the investment resources and the operational aspects should be covered. Specific operational due diligence is typically performed to check that the operational risks are limited and that the risks inherent to the corresponding investment are limited to investment risks. This is best understood as one component of full asset manager due diligence.

#### Concluding remarks

Delegation has grown in prominence over the last decade and as a consequence, the regulator expectations regarding delegate oversight have also evolved. This was formalized last summer in an ESMA opinion. This publication sets the standards expected by the regulator and confirms how such a process can and potentially should be structured. We are no longer in a world of basic questionnaire-based approaches. This new era for the oversight of delegates should be organized and structured around policies and procedures that rely on a selection of elements including objective reasons to select the delegate, a written due diligence, on-site visits, detailed contractual arrangements, recordkeeping, data access, alternatives and replacements, and contingency planning. This evolution shouldn't be seen as an issue but more as an opportunity, presenting itself as the ideal moment for entities that are not yet aligned to these new standards to ensure all their bases are covered. ●

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## TO THE POINT



- In July 2017, the ESMA published an opinion that covers the delegation process. It covers third party and in-house management companies that are subject to the same requirements.
- Policies and procedures to select and monitor delegates based on objective reasons have to be written, implemented and applied on a continuous basis.
- Documented and on-site due diligences have to be performed and possible alternatives should be considered.
- Authorized entities need to be able to inquire, inspect, have access or give instructions to their delegates and be ready to potentially change delegate.

