



Guernsey Financial  
Services Commission

# Investment Supervision & Policy Division - Governance, Risk and Compliance

## Fund Managers & Fund Administrators

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*Thematic Review – 2017*



## Foreword

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During late 2016 the Financial Crime Supervision and Policy Division and the Investment Supervision and Policy Division conducted a thematic review of fund managers' and fund administrators' governance, risk, and compliance frameworks. This topic was chosen because a key theme to emerge from supervision has been a weakness in the application of effective compliance monitoring arrangements. This review covered 34 investment licensees, predominantly rated low impact, under the Commission's supervisory framework PRISM. These firms manage/administer approximately £44.2 billion in funds representing 24,000 investor relationships.

Our objective in selecting this theme was:

*“To understand how fund managers and fund administrators had structured their governance, risk and compliance frameworks to mitigate governance and compliance risk in relation to collective investment schemes.”*

This review has culminated in the production of a report from each Division. This report comprises those matters specific to investment regulation but should be read in conjunction with that from the Financial Crime Supervision and Policy Division.

The subject matters considered were:

- Licensees' monitoring of collective investment schemes by way of key performance indicators and overall financial performance, for example net income;
- Licensees' assurance on valuations of collective investment schemes' assets; and
- Licensees' management and disclosure of conflicts of interest.

The Commission found a good governance, risk and compliance culture amongst the licensees sampled.

Notwithstanding the above, the following areas for improvement were identified:

### **Board Oversight of Compliance**

- Not all Boards had subjected their compliance monitoring programmes to timely review to ensure continuing relevance to the licensee's current business.
- Some Boards had not reviewed the scope and content of the compliance reports. Boards should ensure they obtain sufficient information in order to satisfy themselves that effective systems and controls have been implemented.

### **Collective Investment Schemes – take-on and review**

- One Board of a licensee was unable to articulate its risk appetite for the take on of new Schemes;
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- Although the majority of licensees monitor financial performance and key risk indicators, a few do not; and
- Some fund administrators were not seeking to independently validate prices supplied by the fund manager. Whilst validation, to the extent of 100 per cent assurance, can be difficult to achieve a failure to seek any form of validation would likely lead a fund administrator to fail to meet Schedule 4 to the POI Law, the Minimum Criteria for Licensing.

### **Collective Investment Schemes – Conflicts of Interest**

- All licensees had a conflicts of interest policy in place;
- However there was inadequate consideration of conflicts of interest in some cases where the fund administrator provided directors to sit on the Board of the Scheme.

We should like to take this opportunity to thank each licensee who responded to the thematic questionnaire, and in particular those ten who met with representatives of the Commission to discuss their policies, procedures and controls.

This report reflects the findings from the thematic review of predominantly low impact firms but nevertheless we hope its content will be useful to all firms licensed under the Protection of Investors (Bailiwick of Guernsey) Law, 1987.

Emma Bailey  
**Director of Investment Supervision and Policy Division**  
14 November 2017

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## Glossary of Terms

### Board

The Board of Directors or equivalent or the senior management, where it is not a body corporate

### BRA

Business Risk Assessment

### COB Rules

The Licensees (Conduct of Business) Rules 2016

### CMP

Compliance Monitoring Programme

### Fund Administrator

A firm designated by the Commission to be the designated manager of a scheme for the purposes of the POI Law

### Fund Manager

A firm which fulfils the management function to a scheme

### Licensee

A firm licensed under the POI Law

### NAV

Net Asset Value

### Principle 3

Principle 3 of The Licensees (Conduct of Business) Rules 2016

### Scheme

Collective Investment Scheme

### The Commission

The Guernsey Financial Services Commission

### The POI Law

The Protection of Investors (Bailiwick of Guernsey) Law, 1987, as amended

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## 1. Scope & Approach

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The thematic review consisted of two stages:

- First, a questionnaire was sent to 34 firms seeking responses to various questions on
  - compliance arrangements;
  - oversight by Boards; and
  - Board review of the policies, procedures and controls in respect of AML/CFT and scheme performance

together with basic background information on the firms sampled.

- Secondly, having evaluated the responses, the Commission conducted half day on-site visits to ten firms to gain a more detailed and practical understanding of their governance, risk and compliance and frameworks.

The questionnaire was broken-down into the following sections:

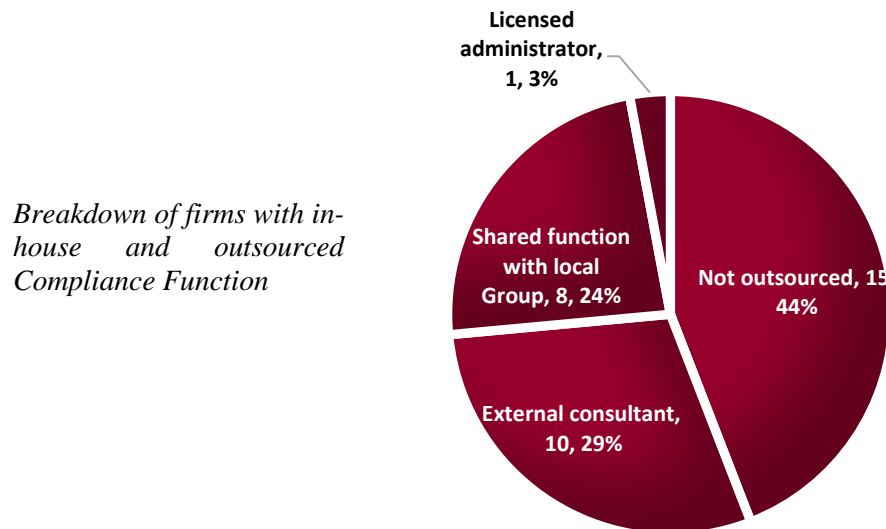
<b>Section</b>	<b>Component parts</b>
<b>Compliance, Business Risk and Audit</b>	<ul style="list-style-type: none"><li>• Board Oversight of Compliance</li><li>• Business Risk</li><li>• Financial Crime Compliance Monitoring and Testing</li><li>• Audit Function</li></ul>
<b>Collective Investment Schemes – Monitoring and Risk Reviews</b>	<ul style="list-style-type: none"><li>• Investment Performance and Valuations Monitoring of Schemes</li><li>• Conflicts of Interest</li><li>• Risk Assessment in relation to Schemes</li><li>• On-going Financial Crime Scheme Reviews</li></ul>

As stated in the foreword, this report covers matters in respect of the POI Law.

### 1.2.1. Licensed Businesses

The Commission selected mainly Low Impact licensees. Licensees categorised as medium low, medium high or high impact are the subject of structured engagement plans under the Commission's risk based system of supervision.

As can be seen by the following chart, just under half the licensees sampled had an established in-house compliance function, with the remaining firms outsourcing to group or a third party compliance consultant.



## 2. Compliance, Business Risk and Internal Audit

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### 2.1. Board Oversight of Compliance

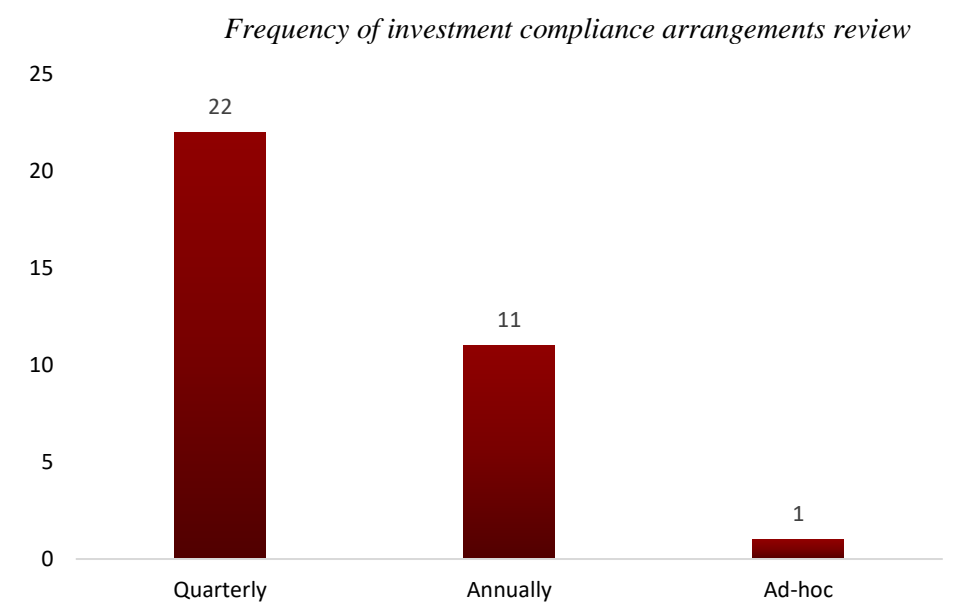
The Board of a licensee has ultimate responsibility for risk management and for ensuring that its business is conducted in compliance with the requirements of the POI Law and any other relevant legislation. This includes:

- determining the nature and extent of the risks the licensee is willing to take;
- providing appropriate resources commensurate to those risks;
- ensuring that there are effective systems in order to minimise the risk exposure of the firm; and
- ensuring that a good compliance culture is rooted within the organisation.

Management should ensure that all staff understand their responsibilities and that accountabilities are established and embedded in the organisation.

#### 2.1.1. Frequency of Board Review of Compliance Arrangements

The Board is required to ensure that a review of compliance arrangements is discussed at appropriate intervals. In this regard, reviews varied between quarterly, annually or, in some firms, catalysed by trigger events.





### **2.1.2. Responsibility for the Reporting of Non-Compliance**

It is important for a firm to have established appropriate reporting methods and channels in order for the Board to:

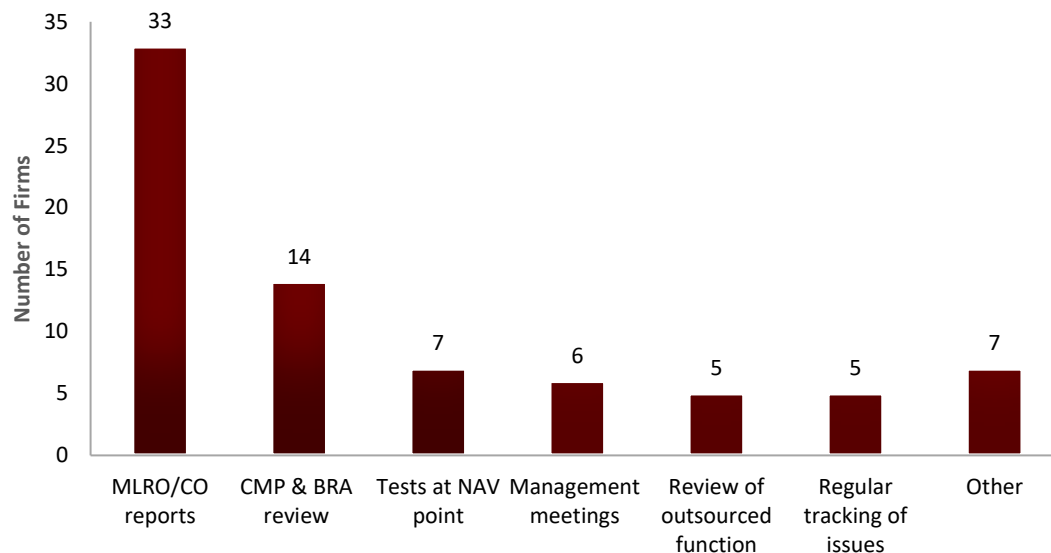
- be apprised of the risks faced by its business;
- ensure it has sufficient management information; and
- allow it to take necessary actions to remedy identified deficiencies.

The majority of firms delegated to the Compliance Officer the responsibility for reporting on matters of non-compliance or other deficiencies. Some firms stated that all staff, including directors, had responsibility for reporting.

### 2.1.3. Oversight by the Board

The Board must have controls in place to ensure that compliance tests are being conducted, and carried out, within the specified timeframes and ultimately that they are effective in mitigating compliance risk. The Board must also be satisfied that the firm has appropriate and sufficient compliance resource.

*Breakdown of control measures and oversight*



#### **CASE STUDY:**

An example of good practice observed during the thematic - one fund manager was intending to conduct thematic reviews to assess the risks and identify trends across its funds.



#### **AREA FOR IMPROVEMENT:**

One licensee's compliance reports did not provide sufficient detail with regard to the compliance monitoring tests carried out and their results. Without appropriate information the Board cannot take the necessary steps to address the issues identified.

In summary, firms use a wide variety of control measures and oversight. The Commission considers that Boards would benefit from reviewing the scope and content of their Compliance reports in light of these findings.

## 3. Collective Investment Schemes

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### 3.1. Take-on arrangements and ongoing review

#### 3.1.1. Scheme take-on arrangements

The Commission would expect a licensee to have a risk appetite which is clearly aligned with its business model and strategy. The Commission is not seeking to discourage licensees from taking on higher risk good quality business if this fits within their strategy and appetite, providing they have robust processes and controls to appropriately mitigate those risks.

There were some responses suggesting that licensees would need to be fully apprised of the whole structure and rationale for the scheme prior to taking it on. It is worth noting that the Commission would see this as being a fundamental first step for a licensee seeking to act as fund manager or administrator.

Firms must understand the rationale for establishing schemes in Guernsey. Responses to the thematic questionnaire indicate that licensees are undertaking the following:

- not taking on the scheme until the rationale behind it is fully understood;
- always asking for a copy of the tax advice for the scheme; and
- working with legal advisors throughout the process of establishing a new fund.

A number of licensees also meet potential new promoters face to face.



#### **AREA FOR IMPROVEMENT:**

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The Board of one licensee was unable to outline its business model & strategy, and instead noted that it would consider any new scheme on its own merits. The same Board found it difficult to articulate the licensee's risk appetite. With this level of Board uncertainty, front-line members of staff would find it difficult to know what type of new business would be acceptable to the licensee. Some scope for flexibility in acceptance of new business lines is natural. Nevertheless the Board should have a clear idea of which areas and product sectors it wishes the firm to target and should filter this down the organisation accordingly.



#### **CASE STUDY:**

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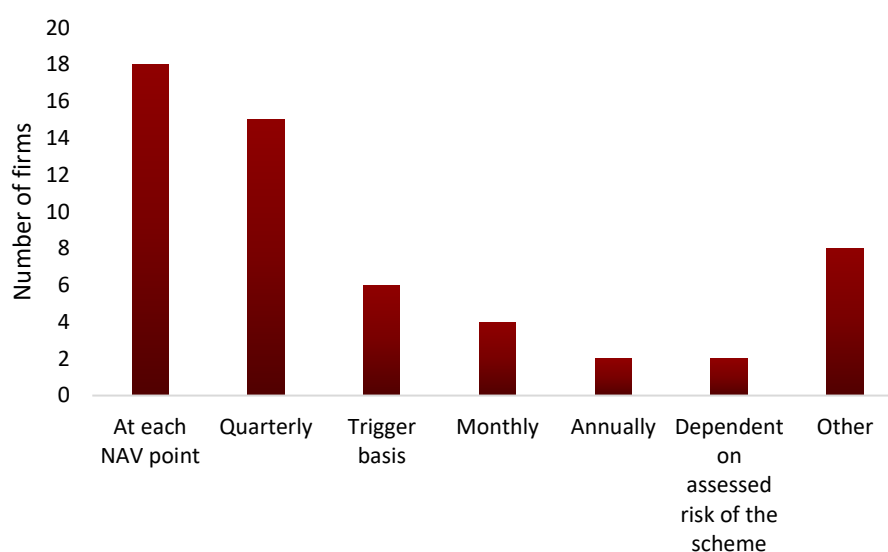
One licensee noted that it takes into consideration multiple risk factors when considering a new scheme and its risk appetite was to avoid schemes which fall into multiple high risk categories. Such an approach would appear to be pragmatic.

### 3.1.2. Frequency of Review of a Scheme's Performance

It is prudent for licensees to monitor the performance of schemes against similar products and markets, querying performance materially outside expectations. Performance of a scheme either significantly above or below its peers can be the first indicator that valuations may not be accurate and reasons should be investigated.

Most respondents indicated that they reviewed performance at each NAV point or on a quarterly basis. Only two of the respondent firms based their frequency of review on a risk based assessment, i.e. higher risk funds would be reviewed more frequently than lower risk funds.

*Analysis of review frequency of scheme performance*



Of the six licensees who only indicated “other” on the questionnaire, four did so because they did not conduct any performance monitoring, incorrectly believing it to be either not their responsibility or not necessary in light of the asset type of the schemes. The other two firms carried out no performance monitoring because the schemes they administer were in wind down at the time of completion of the questionnaire and therefore no longer subject to active management.



#### **POINT OF NOTE:**

The Commission would encourage all fund administrators to regularly review the performance of the schemes for which they are responsible in comparison with the market and the scheme's peers and to query over or under performance where there is no obvious explanation. The Commission would not wish to be prescriptive on the timeframe or nature of such checks as these would depend on the regularity of valuations as well as the perceived risks of the individual scheme.

### 3.1.3. Method and Challenge of Valuations

The fund administrator is usually the firm responsible for compiling the NAV of collective investment schemes in accordance with the scheme particulars. Certain asset types are more straightforward to value and independently verify however more esoteric or less liquid assets can be problematic. There will also be an inherent conflict of interest where that value is provided by a party connected to the scheme.

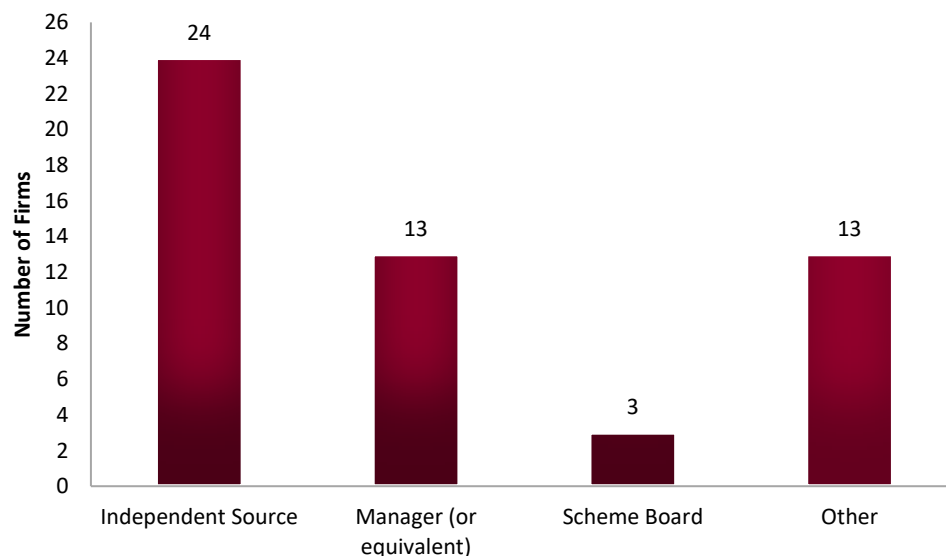
Asset valuations tend to be provided to administrators by the fund manager. Fund administrators must take steps to ensure they understand the methodology employed and have procedures in place to check valuations.



#### CASE STUDY:

One licensee in a private equity environment stated that it considered each investment individually and requested support for unlisted or inactively traded valuations. Further, in appropriate circumstances, it reviewed discounted cash flows and queried assumptions, particularly where a price had changed significantly. This licensee had often challenged the rationale behind an increase in price of an unlisted investment, resulting in a valuation adjustment. It is recognised that these specific controls may not apply in every circumstance but are a good example of additional controls employed by an administrator.

*Main sources of information when valuing the assets of schemes*



Firms who answered “other” were predominantly either not valuing the schemes (due to liquidation) or had a specialist source of pricing.

Thirteen fund administrators were reliant on fund managers for pricing information. Over half confirmed they had not challenged a valuation provided by a connected party in the last twelve months. The Commission is concerned that this lack of challenge could lead to a fundamental overpricing to the detriment of investors. The Commission would expect all fund administrators to take the necessary steps to verify information provided to them, especially where there might be a conflict of interest present or other key risk indicators.



#### **AREA FOR IMPROVEMENT:**

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One firm noted that there had been no reason to challenge the valuations provided by connected parties in the last 12 months as valuations had been discussed and accepted by the Boards of the schemes (or their general partners) which had a majority of independent non-executive directors. This does not suggest an appropriate level of assurance through evidence gathering or testing.

#### **3.1.4. Oversight of Key Risk Indicators**

The use of key risk indicators may be helpful in providing an early indication that a scheme might be in distress. The Commission enquired whether licensees were establishing key risk indicators - for example, tolerance tests – and, thereafter, recording, monitoring and escalating any potential concerns within the organisation.

A large number of respondents had tolerance tests in place to monitor NAV and asset price movements. A smaller number of firms monitored redemptions. Only six monitored market disruption. Of concern is that a small but significant portion of respondents had no tolerance tests in place at all.

The Commission is concerned that fund administrators are not identifying or monitoring key risks within the schemes they administer and therefore may not be able to identify that schemes could become distressed until it is too late.



#### **POINT OF NOTE:**

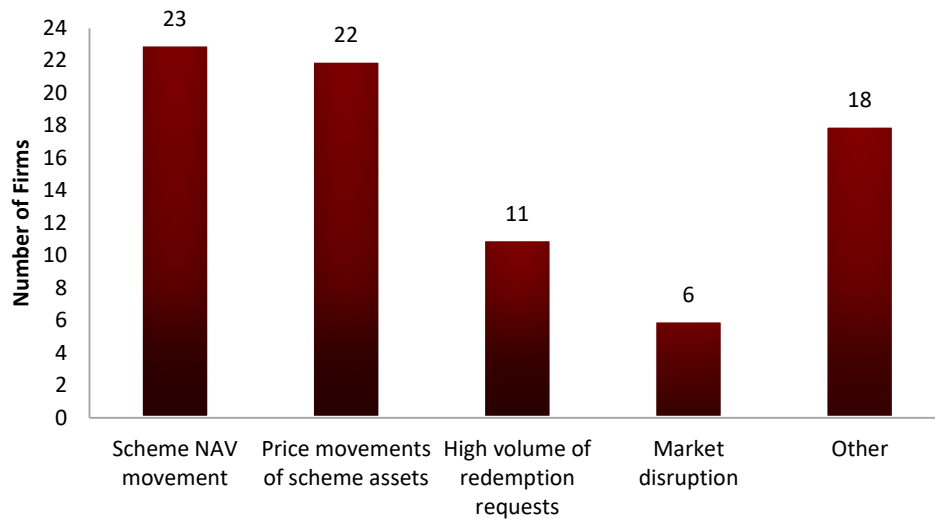
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The Commission was encouraged to note that some licensees extended tolerance tests beyond those suggested in the questionnaire – for example liquidity reviews, stale prices, foreign exchange rates and total expense ratios. All firms should consider whether these might be appropriate tolerance tests for them to consider.

In addition, the Commission would note that it is incumbent on licensees to consider the going concern implications of:

- negative NAVs;
- struggles with liquidity in dealing days; and
- challenges of rolling over debt/refinancing.

### *Analysis of tolerance tests undertaken by firms*



The Commission was encouraged to note that fund administrators and fund managers were recording key events (such as pricing suspension, gating of redemptions and operating in breach of principal documents) and that these were being escalated appropriately:

- 31 licensees confirmed that all such instances would be reported to the Board of the licensee; and
- 30 confirmed they would be reported to the Board of the scheme.

The Commission would take the opportunity to remind firms that all such instances should be taken seriously by firms and escalated to senior management where appropriate.



### **AREA FOR IMPROVEMENT:**

One licensee considered tolerance tests to be outside of their contractual responsibilities which is a concern to the Commission. The Commission considers adequate identification, monitoring and mitigation of risks posed by schemes to be a prudent and professional part of fund administration. The ability to evidence the mitigation of risks may be taken into consideration by the Commission in assessing whether a firm meets the minimum criteria for licensing.



### POINT OF NOTE:

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The Commission wishes to be kept informed of these key events, which for the avoidance of doubt include the following instances:

- Pricing suspension;
- Listing suspension;
- Late completion of annual audit;
- Suspension of subscriptions;
- Gating of redemptions;
- Operating in breach of principal documents;
- Performance out of line with sector or projections; and
- Management letter with significant findings.

As such, should any of the abovementioned instances occur, or any other key events which firms deem to be reportable, in relation to a scheme the licensee should duly notify the Commission through the submission of a Form 200 available within the Commission's Online Submissions Portal.

### 3.1.5. Conflicts of Interest

Principle 3 and Section 11, specifically Rule 11.1 of the COB Rules require all firms to manage conflicts of interest. There is an inherent conflict of interest when a person acts as a director of a scheme and is also an officer or employee of the fund administrator or fund manager. Investors should be made aware of all conflicts within the scheme structure - including where Board directors have more than one role.

The majority of licensees (85%) do provide directors to the Boards of the schemes they administer. Most licensees confirmed that they had a basic conflicts of interest policy and register in place and that declarations of conflicts were made at the start of each Board meeting.

Other licensees went further and considered how the quality of pricing and decision making could be impaired by conflicts.

The Commission noted a trend that a number of fund administrators are looking to move away from providing directors to the Boards of schemes.

None of the responding licensees indicated that investors, or potential investors, should be made aware of the conflicts described above. The Commission is concerned that conflicts in this context are not being considered adequately from an investor perspective. Licensees are encouraged to consider this point further. In addition the Commission has recently consulted on changes to the Registered Collective Investment Schemes Rules 2015 and The Prospectus Rules 2008 where disclosure of these conflicts will become mandatory.



### CASE STUDY:

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One licensee stated that the Chairman would always be an independent non-executive director. Another licensee stated that risk committee approval was required before each appointment of one of its officers to the Board of a scheme.