

# The Luxembourg CSSF clarifies the oversight requirements of management companies on fund distributors

## CSSF Circular 18/698

23rd August 2018

*The Luxembourg CSSF has issued on 23<sup>rd</sup> August the CSSF Circular 18/698 that set all substance related to the provisions expected for governance and organizational structures of Luxembourg investment management companies.*

The requirements applicable to the oversight of key delegated functions, including marketing and distribution are of particular interest.

It is expected that the investment management company develop a **continuous risk-based approach** for the oversight of its distribution network.

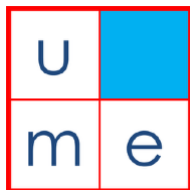
This approach needs to be based on

1. the types of distributors/intermediaries as well as information on the country of establishment of the intermediary and the AML / CFT legal and regulatory framework applicable therein, the authority and the supervisory regime which is applicable, the ownership and the

control structure of the intermediary;

2. obtaining sufficient information to fully understand the nature of the intermediary's activities and to assess, on the basis of information available to the public, its reputation and the quality of the supervision to which it is subject;
3. obtaining the documentation required on AML / CFT obligations when entering into an intermediary relationship ("Know Your Intermediary");
4. the distribution channels; for example, the use of unclear or complex distribution channels and cases where the intermediary is located in a country or territory with a higher risk, are high risk factors requiring implementation of enhanced monitoring of these intermediaries;
5. country risk.

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This approach needs to be materialized by a **procedure**. The procedure must determine the nature, extent and frequency of periodic due diligence to be performed taking into account a risk-based approach.

The management company must put in place a plan for carrying out periodic due diligence on its delegates for a multi-year period (in principle three years). This plan must be updated in light of the risk-based approach determined by the management company.

The monitoring of activities delegated to a third party, this includes marketing and distribution, cannot be delegated under any circumstances.

Thus, the management company must have a sufficient number of qualified staff in Luxembourg to adequately monitor the delegated activities, taking into account the risks arising from the delegation identified and the number of delegates. The procedure must identify which services or staff members of the management company are in charge of the continuous monitoring of the delegates.

The management company can consider, when setting up its control system, of the cross-functional or specific skills existing within the group to which it belongs. In this case, the management company must participate in the process of selecting and maintaining the delegation relationship. In particular, the management company must ensure access to documents obtained during initial due diligence and ongoing monitoring.

#### **Initial due diligence**

In carrying out the initial due diligence, the management company shall, among other things, identify and assess all risks arising from the delegation, including operational, financial, legal and reputational risks, with a view to properly managing them.

The initial due diligence must enable the management company to ensure that the enterprise to which functions will be delegated is qualified and capable of performing the functions in

question, depending on the nature of the delegated functions, in compliance with legal and regulatory and contractual requirements.

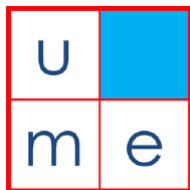
The initial due diligence must also enable the management company to ascertain the capacity of the intermediary to provide the information necessary for the exercise of its obligations for continuous monitoring.

During its initial due diligence, the management company must assess its ability to ensure continuous monitoring of the intermediary, taking into consideration the risks identified and the specificities of the intermediary.

The management company must, among other things, analyze the organizational structure of the intermediary. It must verify that the intermediary has taken the appropriate measures to comply in particular with the organizational requirements, conflicts of interest and rules of conduct.

In their assessment of the risks arising from the delegation, the management company must take into account any relevant criteria, in particular the elements contained in the following (non-exhaustive) list:

- the jurisdiction in which the intermediary is located;
- the nature of the regulation and / or the supervision by a supervisory authority;
- where applicable, the nature of the authorizations obtained by the intermediary;
- where applicable, the existence of sanctions imposed by a supervisory authority;
- the reputation of the intermediary;
- the ownership structure of the intermediary;
- the delegate's governance structure;
- the organizational structure of the intermediary;
- the organization of control functions within the intermediary (compliance, internal audit, risk management);
- the skills and capacities of the intermediary;



- its financial position via, for example, the review of the annual accounts and the opinion issued by the external auditor or equivalent;
- lack of suspicion of money laundering and terrorist financing;
- the quality of the intermediary's IT systems;
- the Business Continuity Plan and the Business Recovery Plan for the intermediary ("BCP / DRP");
- the measures put in place by the intermediary to guarantee data protection, especially when it is located outside Luxembourg;
- the risk of conflicts of interest between the management company and its intermediary and the management of these risks;
- review of complaints and claims received by the intermediary;
- the existence of sub-delegation by the intermediary and the measures of continuous monitoring by the intermediary of its own delegates;
- the intermediary's ability to provide reports and key performance indicators.

### **Continuous monitoring**

The continuous monitoring of the delegates must allow the management company:

- to ensure that the services provided by the intermediary are continuously in compliance, not only with legal and regulatory provisions but also contractual, and that they have a satisfactory level of quality;
- to assess in the long term the adequacy of the organizational structure and procedures of the intermediary relative to the delegated distribution activity and to determine whether the intermediary is qualified and capable of performing the functions in question;
- Regularly reassess the risks arising from each distribution delegation in order to manage them appropriately.

This continuous monitoring is based on both:

- the performance of periodic due diligence and;
- the implementation of a procedure for the continuous monitoring of activities delegated.

### *Due diligence*

Periodic due diligence includes a written critical analysis of the intermediary's activity and organization, while applying a risk-based approach. For this purpose, the management company re-evaluates the criteria analyzed during the initial due diligence and incorporates any other relevant criterion if necessary.

Each due diligence must be formalized in a written, dated and signed report, comprising, in addition to the aspects referred to initial due diligence, the following elements:

- follow-up observations observed during previous due diligence. The due diligence report then describes the action plans and the schedule chosen for their implementation. The report also describes escalation actions performed;
- the conclusions adopted and validated, dated and signed by any competent authority of the management company as regards the decision to maintain or terminate the delegation in question.

### *Continuous monitoring*

The requirement for continuous auditing requires that the management company establish a control mechanism that monitors the activity of the intermediaries and provides management bodies and its staff with access to data documenting the activities performed on behalf of and for the account of the management company and the UCIs that it manages.

In addition, the management company must define and implement a methodology for analyzing the results of the control system and set up its own alert systems, in order to control its delegates according to a risk-based approach. The analysis of this information must be documented in writing and made available to the CSSF upon request.



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## About ume

ume ([www.ume.solutions](http://www.ume.solutions)) is an award winning fintech company based in Luxembourg that provides a web platform to facilitate and optimise the due diligence process of fund distributors by mutualising the efforts of both fund distributors and management companies through sharing of due diligence questionnaire as well as supporting policies and documents.

ume provides a powerful business intelligence / data analytics approach to risk score each fund distributors based on the risk appetite of each management company. Additionally, ume provides the necessary automated reporting capabilities and maintains a complete record of the oversight of the distribution database that can be provided to supervisory authorities, if requested.

ume has received the 2017 award of best fintech start-up in Luxembourg.

To know more about ume or to request a demo, please contact: [contact@ume.solutions](mailto:contact@ume.solutions)



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