

# MFSA

MALTA FINANCIAL SERVICES AUTHORITY

5 September 2018

**Securities and Markets  
Supervision Unit**

Unit Tel: (+356) 21441155

Attn: The Directors and Compliance Officers of Fund Managers and Collective Investment Schemes

Dear Sir/ Madam,

**Re: Circular on the outcome of Compliance Inspections held at Fund Managers and Collective Investment Schemes**

## **Introduction**

The ever changing regulatory landscape is putting greater emphasis on the importance for authorised firms to have a robust governing body making informed decisions and providing effective oversight, whilst necessitating also that risk management and compliance are embedded into the core of licence holders' businesses.

As part of its ongoing supervisory process, the MFSA keeps aiming at increasing the compliance inspection efforts. Since 2013, the Securities & Markets Supervision Unit ("SMSU") has notably increased its compliance inspections, from 22 (in 2013) to 79 inspections (by end of 2017).

During 2017 to date, the Funds Onsite Inspections Team of SMSU has conducted a number of compliance inspections at Fund Managers, Collective Investment Schemes, Custodians and Fund Administrators.

Administrative measures and penalties imposed by the Authority in relation to authorised entities (including persons involved with authorised firms) in the Securities sector, were often noted as being due to shortcomings and regulatory breaches occurring as result of poor governance oversight and a deficient risk management and compliance culture.

In this regard, our inspection reviews have continued to *inter alia* focus on various aspects of governance, risk and compliance. For a number of fund managers and internally managed collective investment schemes (in particular, those which do not delegate portfolio management activities to third parties), a review of the investment process was also undertaken.

The purpose of this Circular update is to highlight a number of common weaknesses that have been identified by the Authority during the course of inspections, carried out at Fund Managers and Collective Investment Schemes (collectively referred to as 'LHs'). In addition, as part of our supervisory engagement with LHs, the Authority would also like to share good governance and compliance practices that were observed during these inspections.

**For the scope of this Circular, ‘Fund Managers’ include firms licensed as Alternative Investment Fund Managers and UCITS Management Companies, while ‘Collective Investment Schemes’ include internally and externally managed schemes, licensed as Alternative Investment Funds and UCITS schemes.**

Please note that any deficiencies mentioned in this Circular encountered during inspections, are not exhaustive. Furthermore, SMSU is still in the process of issuing certain post-visit reports in respect of recent inspections.

## **1. Governance**

### **1.1 Role and Involvement of Independent Directors on the Board**

A common finding identified during onsite inspections was related to the lack of active participation and engagement of a number of independent directors appointed on LHs’ Boards. From a review undertaken of the LHs’ Board meetings’ minutes, MFSA Officials noted an apparent limited degree of participation of a number of independent Board members during Board meetings where such members were supposedly raising, proposing or challenging any issues arising.

The Authority places an important onus on independent directors of LHs. It is important, that such directors ensure that in their role as external directors, they review the LH’s effectiveness, question the adequacy of the LH’s current organisational arrangements and put forward proposals for improving the overall operational efficiency and internal controls, as required, from time to time. Issues raised during Board meetings are to be recorded accordingly in the minutes.

Furthermore, where independent Board members are assigned certain monitoring tasks of particular functions (such as outsourced functions), it is critical that LHs ensure that such monitoring is being carried out effectively and adequately reported and recorded. In this regard, independent directors play an important role in overseeing any Committees established by the Board and in ensuring that the firm’s control functions are up to the required standards.

### **1.2 Board Proceedings, Board Packs and Minutes**

The importance of having comprehensive and well-structured Board packs and detailed Board minutes, is still being underestimated by a number of LHs. From a number of inspections carried out, it was noted that:

- It was not always clear when the agenda and the information pack are being circulated prior to the Board meetings. It is recommended that a copy of the email sent to circulate the agenda (and the information pack) prior to Board meetings is kept on file for audit trail purposes, evidencing the date of circulation and the names of the recipients. If such documentation is circulated via hard copy, a cover note duly signed by Company Secretary should be raised, indicating date of circulation of Board pack;
- Board Agendas and Information Packs are not always being circulated to Board members in a timely manner, leaving insufficient time for Board members to review the documentation included in the packs prior to Board meetings;

- Board Minutes are not always sufficiently detailed leaving out important discussions on strategy issues being discussed at Board level;
- Board Packs are not always including all the necessary updates (such as, risk, compliance, investment committee, financial statements/ audited accounts, marketing and business development updates) and at times, even though such updates are included in the Board packs, they are not always being adequately discussed (as necessary);
- Draft Board minutes following a Board meeting sometimes take too much time until they are presented for Board approval by company secretaries. On certain instances, during interviews held with Board members, it was noted that minutes were only being provided at the following Board meeting. Board members should ensure that draft minutes are provided to them at the earliest following a Board meeting and ensure that these are reflective of any issues raised/ discussions held;
- Committees established by the LH are not always periodically reporting to the Board. Given that the Board is responsible for the oversight of each of its committees, it is critical that any Committees established by the LH (Valuation, Risk, Investment Committee, Internal Audit) report to the Board providing them with periodic updates (at a frequency as set out in the relevant Terms of References) which also need to be recorded in the Board minutes;
- A number of Board Members (particularly, external directors and Board members not involved in portfolio management or middle office operations of the LH) of Fund Managers and CISs are not always reviewing/ questioning certain technicalities being presented in Valuation Reports during Board meetings. Whilst Board members won't necessarily be undertaking the valuation task themselves, it is important that they have a clear understanding of the valuation process. The Board's responsibility does not stop at approving the Valuation Policy and Procedures document (including valuation methodology), but it also entails monitoring the implementation of the procedures and overseeing the valuation process, in particular, when there are asset classes in the funds' portfolios without a readily available market price.

In carrying such task, Board members should exercise judgement and consider what documentation of the valuation process they would like to have access to, and ensure that such documentation is providing them with adequate coverage for them to understand the methodology being used to value the assets.

In carrying out their valuation responsibilities, Board members need to be aware of the risks arising (such as valuation being obtained from a single source or counterparty, the reliability of data being provided for assets that are not exchange traded, use of models developed internally by the firm to undertake valuation etc.) and assess what questions to raise during Board meetings in this respect.

On a general note, LH's are urged to aim having their Boards ideally composed of a collective competence, with individuals having investment/risk, valuation, compliance/ legal background. Governance structures should be appropriately documented with clearly defined roles and responsibilities.

## 2. Compliance

Regardless of the size, nature and complexity of the LH, the LH's framework must be supported by a strong compliance culture that is promoted by the LH's Board. The role of a Compliance Officer keeps moving to a centre stage and the dynamic regulatory landscape is increasingly requiring closer involvement of Compliance Officers in the day-to-day operations and decisions of authorised firms.

The Compliance Function is expected to develop strong relationships and to have open lines of communication with the governing body and senior management of the authorised firm, such that any issues arising and any potential regulatory risks are properly identified, escalated and addressed in a timely manner.

In this respect, during inspections, MFSA Officials covered the adequacy of the LH's policies and procedures, the structure of the compliance function (such as the degree of independence and lines of reporting, including human and material resources dedicated to the compliance function), and particularly, assessing the overall effectiveness of the function, when this is being undertaken through a service level agreement (including secondments) with an external service provider.

### 2.1 Outsourcing of Compliance (including part-time compliance secondment arrangements)

Given the limited scale, nature and complexity of a number of locally registered LHs, it is a common practice for LHs to outsource the compliance function, or otherwise, to enter into part-time secondment arrangements. However, on certain instances, when the compliance function is being outsourced (or undertaken via a part-time secondment arrangement), MFSA Officials noted certain related deficiencies, such as:

- at times, there was an apparent limited liaison and ongoing communication between the LH and the engaged Compliance Officer, with the Compliance Officer not being kept informed and updated in a timely manner of any ongoing matters occurring within the LH;
- at times, the engaged Compliance Officer, who ought to be acting as a point of liaison with the MFSA, was not always copied in regulatory correspondence sent to the MFSA by the LH (or their legal advisors). In a number of cases, Compliance Officers were not even aware of such correspondence;
- at times, the engaged Compliance Officer was not being given complete access to the LHs records;

Outsourcing of the compliance function (including compliance secondment arrangements), should not stop at the signing of a service level agreement and the submission of periodic compliance reporting to the Board. LHs need to be mindful that such Compliance Officers may not always have enough information about the LH and at times, have to operate by relying on the information being provided from the LH. LHs should hence manage this limitation by ensuring adequate, timely communication and access to records. In addition, both the LH having in place such arrangement and the appointed Compliance Officer, have to ensure that sufficient time is being devoted for compliance to undertake the function effectively.

The Authority accordingly expects more ongoing communication between an outsourced/ seconded compliance official and the LH. Such LHs are to ensure that the Compliance Officer is involved (and

clearance sought from the Compliance Officer, as necessary) in any possible restructuring of the firm, business initiatives and ongoing marketing related issues. Furthermore, LHs are responsible to ensure that they give sufficient access for records to the Compliance Officer, in order for them to be able to undertake the compliance role effectively.

Further to the above, when the LH opts for the compliance outsourcing route, such LHs are responsible to ensure the implementation of effective oversight over the outsourced function, ideally by having a senior official within the LH to actively monitor/ oversee that the function. This approach should be similarly applied to any outsourced critical service.

## **2.2 Compliance Reporting**

As part of the Board pack reviews conducted during inspections, MFSA Officials reviewed compliance reports that are periodically presented to the Board. These were mostly found to be in line with the applicable Rules, outlining the required confirmations as set out in the applicable MFSA Investment Services Rules.

With regards to a number of LHs, MFSA Officials were pleased to note good compliance practice where compliance reports did not merely provide the required confirmations (as set out in the applicable Rules), but also provided certain valuable updates to the Board. These include the following:-

- update on the Compliance Monitoring Programme progress being conducted throughout the year;
- update on any local and international Regulatory developments (relevant to the LH's type of licence), including possible impact on the LH's business and operations;
- update on submission of regulatory returns - It was noted that, at times, a number of Board members of LHs would not even be aware that there might have been delays in the regulatory submissions to the MFSA (or overseas regulators, when the LH has such obligations) and providing them with an update on the submissions (in line with the Company's regulatory calendar of submissions) assists the Board in monitoring that regulatory filings are being made in a timely manner.

## **2.3 Compliance Monitoring Programme ("CMP")**

LHs have a key responsibility to monitor and test their compliance policies and procedures on an ongoing basis. Such monitoring and compliance tests help in assessing the effectiveness of the compliance policies and procedures.

During inspections, MFSA Officials reviewed the CMP and noted with concern that a number of LHs did not have in place an effective CMP, and for certain LHs these were found to be either outdated, or else incomplete and not covering all the LH's activities. At times, it could not be ascertained whether the CMP was being periodically presented for Board approval.

It was noted that a number of LHs are not conducting a proper risk mapping exercise and following a systematic process of identifying and prioritising compliance risk factors before drafting, or when updated the CMP. LHs are expected to utilise such risk assessment to identify areas of high, medium and low compliance risk and also identify gaps in the compliance programme and test the controls in

place to mitigate the identified risks. It is expected that such an exercise is carried out on a regular basis, and at least on an annual basis. Although certain LHs were identifying and classifying areas of risk, no evidence could be sighted during inspections of how these assessments had been made and how these are being reviewed on a periodic basis.

LHs in general are to dedicate more attention in developing the CMP and testing plan. The CMP should not merely be a tick the box exercise but an ongoing programme aimed at monitoring the various compliance aspects of the LH. LHs are expected to undertake a thorough assessment of their overall operations and procedures to ensure all aspects of the business are adequately monitored (including all services being provided as part of the LH's license) and included as part of the CMP. For each area to be tested, it is recommended that the Plan provides, *inter alia*:

- a description of the area to be tested;
- the relevant procedure explaining how such areas are tested;
- the frequency of such tests (depending on the level of risk ratings carried out in relation to the LH's specific operational structure and activities carried out);
- the findings and/ or recommendations;
- the period of when the testing was carried out.

Any findings identified and recommendations thereafter would be expected to be formally reported to the Board (for example, as part of the compliance report). Furthermore, the CMP should state the period during which the reviews/tests will take place and that once drafted, the programme is presented to the Board for consideration and approval, which should be in turn be ensuring effective compliance function monitoring and oversight.

A related CMP deficiency identified during inspections was that certain LHs maintained lack of documentary evidence of the testing carried out throughout the year. Such documented records are important to evidence that monitoring and testing occurred during the relevant period. It is also important that any periodic reviews of any policies and procedures are recorded, even where no updates are necessary.

Given the extent of shortcomings in relation to the CMP of various LHs, the Authority would like to outline, by way of general guidance, an indication of a number of areas tested that were included in well drafted CMPs of certain LHs, providing also some few examples of how the procedure may be tested:

***The LHs' attention is drawn that the information provided in the table hereunder is only being provided as an indication of what a CMP may include and which may be relevant to Fund Managers and internally managed schemes. Furthermore, it is important to note that any examples being provided of how the testing may be done, are NOT exhaustive or necessarily covering all aspects of the areas being tested. As specified above, it is the LH's responsibility to ensure that when a CMP is being drawn up, or else being revised, a proper assessment is undertaken to cover the LH's own operational setup and services provided (depending on the license) and made specific to the firm's requirements. Accordingly, adoption of these examples does not necessary mean that the CMP would meet MFSA requirements.***

*It is hence very important that the CMP is tailored to the type of licence in possession by the LH (for example, certain transparency requirements applying to AIFMs do not apply to UCITS Management Companies). The frequency and extent of checks undertaken throughout the year need to be determined by the LH and are strictly dependent on the operational setup and importantly, the scale, nature and complexity of the LH.*

AREA TESTED	PROCEDURE / TYPE OF TEST
<b>Permissible Activities</b> (not relevant to CISs)	Review that the LH does not have any client mandates and/or is not undertaking licensable activities, which are not part of its licence.
<b>LH Organigram</b>	Review that the LH has a fully updated organigram showing clear reporting lines.
<b>Governance</b>	Review that the Board is holding regular Board meetings, Board members are being provided with the required information and reports as part of the Board packs, Board packs are being provided in a timely manner, material issues covering the LH's operations are being discussed periodically as required.
<b>Staff Issues</b>	Review that requests for the approval of staff requiring regulatory approval were made and necessary Personal Questionnaire Forms and Competency Forms submitted and that any resignation notifications are also being duly submitted to the Authority and actioned by it.
<b>Training</b>	Review that staff engaged or employed with the LH are being provided with any required periodic compliance training as well other regulatory training on other areas relevant to the role performed by the individual. Ensuring that training logs are updated with the required supporting documentation of any training attended by staff.
<b>Complaints Handling</b>	Review that any complaints are being included in the relevant register and their resolution is followed up by the LH in line with the LH's procedure.
<b>Personal Account Dealing and Gifts and Entertainment Reporting</b>	Review that staff have provided written declarations, any Personal Account deals were carried out in line with the LH's Personal Account Dealing Policy. Checking that such policy is kept updated.
<b>Market Abuse and Financial Crime</b>	Checking for potential forms of market abuse for example, by selecting members of staff and monitoring certain emails, checking sample of trades against restricted lists, checking that Insider List maintained by the firm is up to date etc.
<b>Conflicts of Interest</b>	Review that the conflict of interest register is updated, reflecting both actual and potential conflicts (including those arising from the services being carried out by external counterparties). Ensuring that the conflicts of interest policy is updated. Ensuring that any Conflicts of Interests identified are mitigated/ disclosed/ reported in line with the relevant Policy.
<b>Breaches Register</b>	Review that breaches register (pertaining both to the LH and the LH's mandates) are being updated and if necessary, any required notifications to the relevant parties have been made following the breach escalation procedure, as stipulated in the Procedures.

<p><b>Monitoring of the LH's overseas branches</b></p>	<p>Review that any established branches are adequately manned, any required reporting by the branches (both to MFSA and other overseas regulators of where the branch is established, is periodically taking place, checking that activities being undertaken from the branches are in line with Passporting notification, or otherwise MFSA's approval (in case where no Passporting notification was required).</p>
<p><b>Passporting (including Private Placement Activities) and Marketing</b></p>	<p>Review that any Passporting activities (including Private Placement Activities) are being undertaken are in line with the passporting notifications submitted (or otherwise with the relevant national private placement regime).</p> <p>Review that the LH's website and any marketing material, promotions etc. are accurate and updated and that any marketing material requiring compliance approval, have been duly vetted.</p>
<p><b>BCP &amp; DRP and Data Security checks</b></p>	<p>Review that this is being periodically tested with test results being presented to the Board and that the BCP/DRP Policy and Procedures is updated.</p>
<p><b>Delegation</b></p>	<p>Review that agreements are in place, checking that any delegation arrangements are being undertaken in line with the agreements entered into with third parties, checking that any delegation arrangements are being undertaken in line with the applicable Rules and Regulations, checking whether any agreement updates are necessary.</p>
<p><b>Monitoring of critical service providers</b></p>	<p>Review that the list of critical service providers is updated, ensuring that the respective service level agreements are up to date, onsite and/or offsite monitoring of critical service providers is being undertaken periodically and reports being documented and presented to the Board.</p>
<p><b>Regulatory Derogations issued by MFSA</b></p>	<p>Review that any derogations granted by the MFSA have been documented and that any notification updates and/ or requests for extensions for such derogations (as applicable) have been made by the LH to the MFSA.</p>
<p><b>Capital Requirements and Professional Liability Risks</b></p>	<p>Review that the LH is in line with its capital requirements obligations, Review that any required changes in share capital (both increases and share transfers) were done in an orderly manner and in terms of the applicable rules and regulations.</p> <p>Where the LH is required to hold additional own funds, review that such funds are being held in a form, as required in terms of the AIFM and UCITS Directives.</p> <p>If a Professional Indemnity Insurance is in place, check that this is periodically being updated. If liability risks are otherwise being covered by means of having additional own funds, check that these are in an amount and form, as required in terms of the applicable Directive.</p>
<p><b>Remuneration</b></p>	<p>Review that Remuneration Policy is updated, remuneration related matters are adequately being discussed at Board level (or by the committee in charge of remuneration) any required performance appraisals are being carried out.</p>
<p><b>AML Compliance and KYC</b></p>	<p>Review that Anti Money Laundering ('AML') related checks (including initial and ongoing Know Your Client) are being carried out effectively and that client record files are complete.</p> <p>Ensure that AML/ CFT Procedure is updated.</p>

	<p>Where an internally managed scheme has outsourced the implementation of the measures and procedures applicable to it under the Prevention of Money Laundering and Funding of Terrorism Regulations ("PMLFTR") to its fund administrator, it needs to monitor that the procedures, checks and controls adopted and applied by the administrator are in line with the applicable regulation and AML duties are being carried out effectively.</p>
<b>Portfolio Management</b>	<p>As part of the portfolio management activity, a series of checks need to be carried out to test for: best execution, monitoring of trade surveillance (by choosing for instance, a sample of trades and ensuring that the relevant trade blotters are accurate and complete and dealing records are accurate and recorded accordingly, trades are only being executed by authorised staff and authorised counterparties, trades are being effected in line with the LH's trade allocation policy etc.), reviewing the list of approved counterparties, reviewing the company's trade allocation policy, operational error reporting etc.</p> <p>Review any required investment due diligence records are being accurately generated and properly recorded.</p> <p>Review compliance with the relevant investment objectives and restrictions applicable to managed accounts and funds under management.</p>
<b>Transparency Requirements</b>	<p>Review that disclosure in the offering documents and ensure that these are in line with the applicable regulatory framework and that information provided in such documents is accurate and up to date</p> <p>Checking that any required periodic reporting to investors (including relevant disclosure as required in terms of the applicable regulatory framework) is being made.</p>
<b>Valuation</b>	<p>Review that valuation records are being adequately maintained and that process was carried out in line with the relevant valuation policies and procedures.</p> <p>Ensuring that the valuation policies and procedures is kept updated <i>and</i> that it is in line with any valuation methodology being provided in the offering documents and constitutional documents of the funds under management.</p>
<b>Risk Management</b>	<p>Review that risk management policy and procedures is updated, checking whether any issues reported by the risk management function have been adequately escalated and reported through the applicable channels (in line with the Policy and Procedures document).</p>
<b>Record Keeping</b>	<p>Review that records are being maintained by the LH, including <i>inter alia</i> any relevant valuation reports, dealing records, client files etc. in line with applicable regulatory requirements and procedure adopted by the LH.</p>
<b>Regulatory Calendar of Submissions</b>	<p>Review that regulatory submissions were submitted in a timely manner or otherwise, the necessary notification for any exceptional required extensions have been made.</p>

With reference to third-party managed Collective Investment Schemes, the CMP is expected to cover all areas of business within the Scheme that may present compliance risks, such as:

- Onsite/ offsite monitoring on the scheme's service providers (including AML/CFT monitoring checks when the MLRO function has been delegated to the scheme's Fund Administrator);

- Review of the scheme’s Compliance Procedures Manual (including any individual policies held);
- Governance Checks – Checking that the Board is holding regular Board meetings, Board members are being provided with the required information and reports as part of the Board packs, Board packs are being provided in a timely manner, material issues covering the scheme’s operations are being discussed periodically as required;
- Regulatory Calendar of submissions of the scheme;
- Conflicts of Interest Register;
- Breaches Register;
- Investment Objective, Policies and Restrictions sample check (i.e. ensuring that scheme’s portfolio is in line with the relevant objective, policies and restrictions);
- Checks on dealing by officials of the scheme (as applicable); and
- Check that training Register of schemes’ officials is updated.

**2.4 Compliance Procedures Manual (including related individual Policies and Procedures documents)**

A common finding identified during the onsite inspections of both Fund Managers and CISs was related with the lack of detail, or inaccurate material, being included in LHs’ Compliance Procedures Manuals. The MFSA expects the LH’s staff to be more than merely familiar with the content of the Manual but to understand it and follow it in practice. Common observations and findings identified relating to the Compliance Procedures Manual include the following:

- Manuals were not always updated in a timely manner and on a periodic basis. A common failure in this respect is having LHs simply changing the date of the document, resulting in an inadequate review of the procedures and risk of leaving outdated references;
- Manuals were not always covering all licensable activities being provided by the LH and were not entirely reflective of the processes that the LH is following in practice when providing such services;
- In terms of the content of the Manual, MFSA Officials observed that cash controls is a section which is often overlooked in the LHs’ Manuals. It is recommended that such procedure details the LH’s policy for moving cash and securities, cash reconciliation processes and the signatories required for cash movements;
- A document revision history log was either not kept for all the policy and procedure documents or else the one provided was not sufficiently detailed. It is important that LHs ensure that such log is maintained for the procedures documents and other written policy documents kept by the LH. The document revision history log should ideally include the version number, a brief description of the reason for update, the date and the person amending the document, as applicable. As required in the applicable Rules and Regulations, Policies and Procedures should be periodically reviewed, at least on an annual basis, and as often as required. Such review also need to be recorded accordingly;
- Staff were not always given proper induction training with regards to the contents of the Compliance Procedures Manual(s). Besides such training, it is recommended that staff are requested to attest on a periodic basis that they have read, understood and complied with the Compliance Manual.

## 2.5 Appointment and Ongoing Monitoring of Outsourced Critical Functions

A recurring finding, which was also raised in a previous MFSA Circular, relates to the initial checks and ongoing due diligence performed by LHs on their key service providers. During a number of inspections, it was noted that certain LHs do not have in place a structure to undertake checks when engaging critical service providers and besides business considerations, they were merely relying on the fact that such parties would be licensed/ authorised by a competent authority.

Furthermore, monitoring on such service providers was not always being carried out periodically and adequately documented. It was noted that although certain LHs were conducting an element of monitoring, such monitoring was at times merely covering a limited aspect of the service provider's operations.

It is considered important for LHs to have in place a structured process that covers the appointment and monitoring of operations of key service providers. With reference to the delegation of certain functions on behalf of AIFMs and UCITS Management Companies, reference is also made to the applicable regulatory provisions in terms of both the AIFM (including Commission Delegation Regulation No 231/2013) and UCITS Directives, highlighting *inter alia*, the requirement for the licensed entity to be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question, that it was selected with due care, and that the entity should be in a position to monitor effectively at any time the delegated activity.

LHs must accordingly perform initial checks and ongoing due diligence of key service providers. The goal of performing initial checks prior to engaging such service providers is to identify any potential risks arising from their engagement and to gather information on expertise, internal processes and controls.

With regards to ongoing monitoring, as soon as the contract is signed, the LH should establish an internal monitoring plan, which should *inter alia* have defined targets and deliverables (as communicated and defined in the engagement contract). The procedure adopted by the LH should reflect the applicable frequency when monitoring assessment would be conducted, who would be responsible for such monitoring and how such reviews are documented (and eventually presented to the Board). The frequency of the review should be on any pre-identified risk based approach applied by the LH.

An indication of whether the LH conducts onsite reviews at all of its service providers, explaining the approach applied, should be provided. It is advisable that onsite visits (or, for example, video conference calls with the service provider) are conducted periodically. Any visits should include updates from the provider regarding its operations, process systems and controls. Such visits should give the opportunity to the LH to give any feedback and challenge responses (as required).

The monitoring programme itself should be reviewed periodically by the Compliance Officer in liaison with the Board to ensure that it captures the most relevant and significant risks which are relevant to the service being provided.

The Authority expects that the services provided to the LH are not compromised by the delegation arrangement in place and that effective oversight is being undertaken. LHs are accordingly required to

ensure that the above is embedded as part of their CMP and reflected in its internal procedures, providing ideally;

- a list of the respective delegates and counterparties;
- a general overview of the relevant checks undertaken by the LH prior to engaging counterparties and delegates; and
- the offsite and onsite due diligence (including an indication of frequency of visits and for which service providers such visits shall be carried out) that is carried out as part of the monitoring on the key delegates and counterparties providing services to the LH.

As detailed above, if a risk-based approach is undertaken by the LH as part of the monitoring process in order to determine approach/ frequency, it is recommended that such assessment is also documented accordingly.

### 3. Investment Process Procedures

During a number of inspections of Fund Managers and Internally Managed Schemes (which do not delegate the day-to-day portfolio management to third parties), MFSA Officials reviewed investment processes, looking into the investment process procedure and also investment restrictions monitoring.

It was noted that although a number of LHs had in place a general investment process procedure, on a number of instances, this was found either being insufficiently detailed and/ or not reflective of the process followed by the LH in practice.

The investment process procedure ought to provide details of the whole trading flow procedure followed by the LH, reflecting (a) **pre-trade procedure checks** (including (i) asset eligibility assessment procedure for the various instruments) and (ii) pre-trade procedure (including investment restriction checks), (b) the **placing of trades** and (c) also **post-trade procedure checks** (including any compliance, risk related checks undertaken by the control functions, as well operational related checks undertaken by the middle office).

The Authority would like to share in this respect, high level guidance to the industry of what such Investment Process Procedures may include.

*Similarly as indicated in Para. 2.3 above, please note that the information provided below is not exhaustive and should be tailored and made specific to the LH, depending on the LH's internal operational setup and types of systems used (including the nature of funds managed):-*

#### Pre-Trade Checks

In terms of systems and the procedure document, it is recommended that:

- pre-trade procedures capture the trade development/ research stage, trade authorisation, execution, capture, matching, settlement and reconciliation;
- pre-trade procedures include cash positions check availability prior to investing and divesting;

- pre-trade restrictions (such as fund or client level restrictions, investment manager level restrictions etc.) are included in the portfolio management system and these should be periodically reviewed and updated;
- a system is also put in place for monitoring those pre-trade restrictions that cannot be hard-coded in the system;
- the LH allocates responsibility of who shall manage hard coded data in the system and determine who the system users and system administrators are (who can add/ remove data and investment restrictions);
- the procedure includes detail of the applicable process followed by the LH to check compliance with the pre-trade investment restrictions;
- in particular for UCITS Management Companies, the investment process procedure document includes checklist forms for each new asset being considered by the LH as a potential asset class to invest in together with a structured step by step procedure relating to the asset eligibility checking process (in respect of the different type of instruments; transferable securities, collective investment schemes, financial derivative instruments, money market instruments etc.);

Such checks would ensure that the asset is eligible before proceeding with the relevant trade. Any checklists are to be kept on record by the LH and would be expected to include reference to the relevant date when the checks have been undertaken and who is completing the relevant checks;

- the procedure document should cover details who will be involved in the pre-trade checks (Portfolio Manager, Compliance etc.) including whether and how results of any tests are being recorded;

#### Post-Trade Checks

In terms of systems and the procedure document, it is recommended that:

- the document includes detail on the relevant post-trade checking procedure that is implemented by the LH (followed by the Portfolio Manager in undertaking required monitoring and also by the Risk Manager and Compliance Officer (as applicable) in checking adherence with the respective investment restrictions and risk limits. The procedures should provide detail of who is responsible for monitoring compliance with the post trade controls and the system used to monitor and review the transactions;
- details should also be provided regarding the process followed by the LH when a breach is detected;
- the relevant procedure also covers post trade operational process/ middle office tasks and reconciliations - describing operational process used in relation to the trading activity and indicating controls and reconciliations performed by the LH as part of the trading activity (outlining process of how trades are reconciled, frequency that reconciliations are performed, persons responsible for carrying out such checks, escalation process and systems used).

### 3.1 Trade Errors

As part of the overall internal control investment procedures adopted by Fund Managers and Internally Managed Schemes (that do not delegate the portfolio management activity to third parties as in such case), MFSA Officials enquired about what controls are in place to mitigate any possible trade error risk. The Authority noted that a number of LHs did not have a relevant policy in place.

Besides having in place adequate internal system control checks to mitigate the risk of doing trading errors, the Authority considers that it is good compliance practice for Fund Managers and Internally Managed Schemes that as part of their trading practices, have in place a trade error log and policy, with the latter detailing how trading errors are dealt with by the LH. This could also be considered an integral part of the LH's management of conflicts of interests (when for example, deciding how to allocate possible gains or losses incurred due to trade errors).

Such a policy would be expected to typically include *inter alia* the following;

- what is considered by the LH to be a trade error (including materiality);
- how errors are reported internally and who within the LH is responsible to review trade errors and sign off any resultant actions or non-actions;
- in what circumstances would investors be made aware of the error;
- how the LH allocates the gains or losses incurred as a result of the error between the LH and investors; and
- what documentation and records are to be kept by the LH in case of trading errors.

### 3.2 Investment Committee (“IC”)

During inspections, MFSA Officials reviewed samples of IC Packs, including minutes. A common finding which transpired during a number of interviews held with IC members of LHs having a delegation of the Portfolio Management (‘PM’) activity in place, was that the appointed IC did not always have sufficient visibility on the appointed Investment Manager.

Further to our comments of Para. 2.5 of this Circular, it is critical that LHs which have a PM delegation arrangement in place, ensure that IC members are being given sufficient information by the delegate, such that they are in a position to make informed decisions, monitor and carrying out their role effectively.

Furthermore, at times, it was noted that there is lack of questioning/ oversight by the IC on the decisions being undertaken at the delegate PM level. A good practice that was noted by MFSA Officials during inspections of LHs having a PM delegation arrangement in place, was to have a monthly newsletter/ factsheet system distributed to the IC and to the Board (besides the periodic quarterly updates). This helps in ensuring that the IC (and the Board) are being kept updated on the tactical decisions taken at the PM level on a more frequent basis. (The frequency of updates provided would be dependent on the nature of investment strategy of the funds under management).

#### **4. Internal Audit Function**

MFSA Officials enquired about the internal audit function of LHs and whether any checks were being performed in relation to this function. A number of LHs advised that in view of the exemption from the requirement of having an internal audit function issued by the MFSA, no checks in this regard are being undertaken.

Notwithstanding the exemption granted by the Authority at the time of licensing, the Authority expects LHs to nonetheless adopt alternative mitigating arrangements for not having a fully-fledged independent internal audit function.

Should such task be outsourced to an external party, the function needs to be properly monitored by the LH. Furthermore, the Authority expects licence holders to adequately document any internal audit related checks and that such checks are discussed during Board meetings and minuted accordingly.

#### **5. Risk Management Function**

MFSA Officials reviewed the risk management function, including reporting structure, of LHs. The main issues noted were as follows:

- When the risk management function is being undertaken via a secondment or otherwise as an outsourced arrangement, the appointed Risk Manager is not always being provided with sufficient visibility to the LH's trading activity. At times, such Risk Managers would be merely receiving data, for example, at the end of a trading day. It is important that LH's ensure that the appointed Risk Manager has full visibility to the investment managers' trading activity, including the ability to monitor any intra-day trading activity, when required;
- From a review of the Board minutes undertaken during the inspections, questioning by the Board on the technical data being presented in the risk management reports, was found to be limited at times. For example, notwithstanding that the risk reports would be showing a persistent liquidity issue relating to a fund under management, no topical discussions were noted in the corresponding minutes;
- Operational Risk is not always being given the necessary coverage in the risk management reports being presented to the Board. Risk Managers should ensure that all aspects of the firm's operational risk (arising from possible failed trading operational controls, internal processes and systems not being robust enough, including BCP/ DRP and cybersecurity issues) are being covered as part of the risk management oversight undertaken. Boards, on the other hand, are responsible to ensure that as part of the periodic risk reporting, they are being provided with sufficient overview and confirmations about how this material risk is being monitored.

## 6. Conflicts of Interest (“COI”)

Conflicts of Interest was another area reviewed by MFSA during inspections. A number of shortcomings were noted in this respect, mainly:

- The COI Policy of a number of LHs is just a repetition of the applicable regulatory requirements, without however identifying the actual conflicts of the LH and entries in the registers were noted as not always being reflective of all the COI arising in relation for the LH;
- LHs are to ensure that all individual COIs are being accurately disclosed and included in the register (and reflective of any relevant ‘conflicts of interest’ disclosures included in the offering documents);
- For a number of LHs, COI was treated as a matter of merely disclosing involvements of Board members during the Board meetings and presenting lists. LHs’ attention is drawn to the fact that the area of conflicts of interest management is not just about individual involvements with third parties;
- The types of conflicts that may exist in LH’s business will vary based on its structure, the structure of its funds and the types of activities that are being conducted. A number of COI registers reviewed merely covered personal involvements and failed to address other types of conflicts. For example, any involvements that the LH’s officials may have with sub-managers/ advisors appointed by the LH in respect of certain funds managed by the LH, also need to be included accordingly in the register. Similarly, the allowance of effecting investments in funds that senior officials or the governing Board of the LH are involved with, preferential fee treatments and redemption rights, client cross transactions, etc. also need to be disclosed (in the policy and/ or register, as applicable);
- CMP tests relating to the COI management responsibility of the LH was often noted to being undertaken on an annual basis. It is important that, depending on the scale of operations of the LH, tests relating to conflicts monitoring are undertaken as often as necessary in order to ascertain, for example, that conflicts checks are being undertaken prior to the on Boarding of new clients and that any new actual or potential conflicts have been adequately logged in the register etc.

## 7. Anti-Money Laundering (“AML”)

Licence holders have a regulatory obligation to establish and maintain robust defences and frameworks that identify and mitigate money laundering risks. AML failures brought to the attention of SMSU are taken into account in our prudential supervisory work, in particular in the monitoring of internal controls of licence holders. This would accordingly trigger a regulatory follow up action by the MFSA.

## **Conclusion**

We trust that we have provided an overview of some good and poor practices in order to assist LHs in benchmarking their existing systems, or creating new ones. In light of our findings, observations and guidance provided, LHs should review their own governance, risk and compliance structures, including internal control procedures, undertake an assessment, and take the necessary action to address any deficiencies. LHs are also expected to assess and discuss how good governance and compliance practices that are mentioned in this Circular, can be best tailored and applied to the firm.

The Authority shall continue undertaking follow-up supervisory work in the future to assess whether the indicated shortcomings and guidance provided in this Circular, have led to an increase in the robustness of governance, risk and compliance setups and internal controls of LHs. Should the Authority note that the progress by LHs has not been sufficient, the Authority may then also consider appropriate regulatory action.

## **Contacts**

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