



Jersey Financial Services Commission

FUND SERVICES BUSINESS

ON-SITE EXAMINATION PROGRAMME 2012 SUMMARY FINDINGS

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1 Introduction

- 1.1 During 2012, the Jersey Financial Services Commission (the “**Commission**”) continued its programme of on-site examinations as part of its supervision of collective investment funds and fund services businesses.
- 1.2 The purpose of an on-site examination is to assess a business in terms of its performance against the legislative and regulatory framework, i.e. Laws, Orders, Recognized Fund Rules, Codes of Practice for Fund Services Business (the “**FSB Codes**”), and Codes of Practice for Certified Funds (the “**CIF Codes**”) as well as the Handbook for the Prevention and Detection of Money Laundering and the Financing of Terrorism for Financial Services Business Regulated under the Regulatory Laws (the “**Handbook**”).
- 1.3 The objective in publishing summary findings from a programme of on-site examinations is to share common findings in order that individual fund services businesses and collective investment funds may assess where they sit in terms of meeting the requirements of the legislative and regulatory framework.

2 Scope

- 2.1 The Commission undertook supervision on-site examinations during the year which were mostly broad in scope and designed to more closely examine fund services businesses and the regulated collective investment schemes they provide services to.
- 2.2 The fund services business supervision examinations comprised a review of corporate governance, systems and controls, including compliance with the FSB and CIF Codes and Sections 2-4 of the Handbook.

3 Process

- 3.1 Businesses were selected on the basis of their risk rating and their past examination history. Each business selected for an on-site examination was asked to complete a self-assessment questionnaire, covering a range of questions, depending on the type of examination. Responses to the questionnaire were analysed, areas of potential concern were identified, and this then set the agenda for the examination.
- 3.2 Generally, on-site examinations encompassed an assessment of parts of the businesses’ policies and procedures in relation to the specific areas being examined. Commission officers reviewed, on a sample basis, the records and files maintained by the fund services business and held discussions with management and staff involved in operational and compliance matters. The outcome of the assessment and discussions were then measured against the business’ procedures and the relevant legislative and regulatory framework.

4 Overview

4.1 A total of 48 on-site examinations were conducted during 2012, including 23 risk leaders, compared with a total of 34 examinations in 2011. The Commission aims to conduct approximately 50 Fund and Fund Services Business on-site examinations each year, prioritised according to the degree of risk and regulatory history of the business. This number is invariably influenced by the level of resource required to heighten supervision of any business where significant remediation is required. Therefore, the number of examinations conducted will usually fluctuate year on year.

4.2 Of the 48 on-site examinations conducted in 2012, the areas resulting in the greatest number of findings, included:

Corporate Governance:

- Board minutes failing to adequately record the deliberations of the board;
- Terms of reference for board committees;
- Frequency of board meetings; and
- Managing conflicts of interest.

Anti-money laundering:

- Business risk assessment and strategy; and
- Risk management systems and controls.

Internal systems and controls:

- Compliance monitoring;
- Policies and procedures; and
- Outsourcing and delegation.

The above points continue to be areas of interest for the Commission when conducting its on-site examinations and 'Conflicts of Interest' was again selected as one of the themes for 2013.

4.3 The action taken by the Commission as a result of the on-site examination programme was dependent on the materiality of the findings and is summarised below:

Action	2012 Number of FSB Risk Leaders	2012 Percentage
Formal monitoring of implementation of corrective action plan, via PEMS	20	87%
No formal monitoring	3	13%
Totals	23	100%

Formal monitoring via PEMS

4.4 The number of businesses where the Commission undertook formal monitoring of implementation of corrective action, via PEMS, in 2012 has increased by 2% to 87%. This reflects the Fund Supervision team’s approach to adopt PEMS to all findings, regardless of the risk rating applied.

No formal monitoring

4.5 Notwithstanding the adopted formal approach to the examination process and subsequent remediation, 13% of businesses did not require a formal report as there were no findings.

Conclusion

4.6 The levels of remediation required of those businesses subject to formal PEMS ranged from businesses required to implement only one or two medium risk recommendations over the short term, to businesses required to address a combination of a number of high, medium and low risk findings over a longer term.

5 Findings arising from on-site examinations

5.1 The summary findings detailed below have been drawn from all findings across the supervision examinations conducted in 2012.

Corporate Governance

Board minutes and failing to adequately record the deliberations of the board

5.2 Contrary to the terms of certain investment advisory agreements and fund prospectuses, a number of Investment Managers could not evidence that investment recommendations received from the Investment Advisor were being discussed by the Investment Manager’s board and approved by the Investment Manager on behalf of the fund it was acting for.

Terms of reference for board committees

- 5.3 The majority of findings in this area related to gaps and inconsistencies in the terms of reference for committees with delegated authority from the board.

Frequency of board meetings

- 5.4 A small number of managed entities were unable to demonstrate that board meetings were taking place on a sufficiently frequent basis. For example, a small number of managed entities, whose business plans stated that quarterly board meetings would be held, were found to have allowed six months to elapse between board meetings. During this time, the Commission found that the managed entities were either making investment decisions in relation to the fund or in the early stages of the investment process.
- 5.5 Furthermore, the board minutes of these businesses did not evidence, in all cases, that transactional documentation had been tabled and discussed at board level.
- 5.6 Fund services business licence holders are required to comply with all the respective laws, orders and associated codes of practice and must be able to demonstrate the maintenance of an effective corporate governance system. The Commission would, therefore, expect frequent board meetings to be held during the early stages of the investment process and for the board meetings to table all relevant documentation pertaining to transactions undertaken. Thereafter, board meetings should be held at least quarterly or more frequently depending on the nature of the business and an entity's corporate governance structure.

Managing conflicts of interest

- 5.7 The Commission continued to focus on the management of conflicts as part of its on-site examination process.
- 5.8 The Commission found a number of instances where conflicts, perceived and actual, were not identified and documented as such. These included directors acting for both the Manager of a Managed Entity ("MoME") and the managed entities which it manages as well as fund services businesses adopting a group policy and failing to address additional conflicts specific to each entity for which they act.
- 5.9 Furthermore, where conflicts had been identified and recorded in a conflicts of interest register, there was no documentation on how the conflicts were to be managed. Where a business employs a spouse or relative of an existing employee, this should be recorded and managed in accordance with an appropriate conflicts procedure which takes account of the Commission's span of control requirements as set out in the relevant codes of practice.
- 5.10 In respect of procedures, the Commission noted that some businesses had not updated their procedures to address findings previously raised by the Commission.

- 5.11 The Commission will continue to include corporate governance and conflicts of interest in the scope of its on-site examinations on an on-going basis to ensure effective oversight and management in these two key areas.

Internal systems and controls

Business risk assessment and strategy

- 5.12 The Commission noted a limited number of findings in this area compared to that of previous years. However, the Commission found that due to the methodology of one entity's business risk assessment, only 48% of its clients had been risk rated. Other fund services businesses failed to recognise the importance of reviewing risk assessments to ensure they continue to reflect current business risks and that entering into a new venture, product or market would be reason to revisit the risk assessment. One risk assessment focussed on AML issues and did not address other risks present in the business.
- 5.13 Better business risk assessments demonstrated a link between the risks identified and their underlying customer base, made a further connection from the risks identified, to the strategy to combat the risks and then to its adopted policies and procedures.
- 5.14 The Commission noted that better business risk assessments also resulted where active participation on the part of senior management took place. It was therefore disappointing that the Commission continued to find one or two examples of business risk assessments not being tabled at board level for consideration and approval.

Risk management systems and controls

- 5.15 The Commission encountered issues in relation to risk management systems, ranging from inaccurate assessment of geographical risk, lack of details regarding customer background, and failure to risk rate investors from an AML/ CFT perspective.
- 5.16 One of the most serious findings was in relation to a service provider who was unable to fully meet the requirements of sections 3 and 4 of the Handbook for collecting and maintaining customer due diligence and customer profiling. In this case, the investor base of a fund serviced by the business was found to be 20% deficient in customer due diligence ("CDD") with the local service providers failing to establish a target date for obtaining the outstanding CDD.

Compliance Monitoring Programme ("CMP")

- 5.17 The Commission expects that, pursuant to the CIF and FSB Codes, businesses will have implemented a robust and effective compliance monitoring programme. With regard to those businesses examined in this area, the following analysis is made.

CMP - Content

- 5.18 A number of businesses omitted to either:
- implement a comprehensive compliance monitoring programme covering all their internal controls and relevant Sections of the Law, Orders and FSB Codes; or
 - demonstrate that the compliance monitoring programme, being restricted in scope, had been determined with an appropriate risk-based approach.
- 5.19 With regards to the latter, the Commission found that a number of regulated entities had:
- inappropriately restricted the scope of their compliance monitoring programme, for example to focus solely on AML matters excluding any testing of compliance with internal policies and procedures; and
 - failed to periodically review the compliance monitoring programme to ensure that factors, such as changes to its business strategy, areas of responsibility and regulatory requirements, are appropriately reflected.

CMP - Approval

- 5.20 Not all compliance monitoring plans had been tabled at the board for consideration and approval. Some businesses did not have a formal procedure in place by which outstanding matters on the compliance monitoring schedule are tabled at the board.
- 5.21 The Commission also saw examples where compliance checks were not signed off in accordance with an entity's written procedure.

CMP - Testing

- 5.22 Whilst a number of businesses were able to demonstrate the existence of a compliance monitoring report, some were not able to evidence the underlying testing to support all compliance reviews. Where testing did take place, the Commission was not of the view, in all cases, that testing was either risk-based or adequate.
- 5.23 For example, one dual-licensed entity was unable to demonstrate any specific fund services business monitoring and the board of one MoME confirmed that no compliance monitoring had been undertaken in respect of a Managed Entity for over a year despite the requirements of the MoME agreement.

CMP - Independence

- 5.24 Where compliance monitoring is undertaken by the Compliance Function, the Commission expects an appropriate level of the testing to be independent. Although the Commission recognises the challenges faced by Compliance Officers of smaller fund services businesses with regards to maintaining independence, it is important for the non-independent tests (those where the Compliance Function is checking an element of its own performance) to be identified as such and the balance to be testing of internal controls where the Compliance Function is not involved. An exception to this would be

where there is appropriate segregation of individuals within the Compliance Function who undertake the compliance monitoring activities.

- 5.25 One regulated entity did not have an independent compliance monitoring programme and relied on the business team, rather than the compliance function, to conduct its own monitoring. Another failed to have a compliance monitoring plan in place for its fund services business.

CMP - Evidence

- 5.26 One business failed to retain documentary evidence to demonstrate that the compliance monitoring that had been undertaken and that the testing was appropriate.

CMP - Reporting

- 5.27 A number of businesses did not provide comprehensive reporting to the board, or delegated sub-committee, on compliance monitoring, including:

- reporting on exceptions identified;
- remedial action and progress;
- trends; and
- progress on the completion of the compliance monitoring programme.

Policies and procedures

- 5.28 The Commission evidenced gaps in procedures and found that business' policies and procedures handbooks were not always reviewed and updated regularly enough for them to remain effective and consistent with the requirements of the CIF and FSB Codes and various guidance notes issued by the Commission. In the latter part of the year, the Commission encountered some examples where handbooks had still not been updated to include reference to the CIF Codes which were introduced in April 2012. The Commission also found examples where a fund services business had procedures in place for its collective investment funds business but no separate or specific procedures relating to its fund services business.
- 5.29 The Commission found gaps in procedures in almost one third of examinations undertaken in 2012. Deficiencies included a lack of detail whereby the procedures had little or no explanation of responsibilities or how to perform the tasks set out in the procedures.
- 5.30 Specifically, gaps in procedures and common findings related to the investment management activity of certain fund services businesses, staff handbooks being based on UK employment legislation with no or little consideration for Jersey employment law, gaps around requirements and conditions pursuant to Control of Borrowing Order consents, AIM listing requirements (where relevant), the breaches and complaints register, sanctions, CPD and the filing of special resolutions and accounts with Companies Registry.

5.31 The Commission's expectation is that policies and procedures should be revisited periodically (for example, as part of the compliance monitoring plan) and on an ad-hoc, arising basis in order that the business ensures that its policies and procedures are adhered to, are kept up to date with regulatory requirements and are relevant to current business needs and practices.

Outsourcing and delegation

5.32 Outsourcing and delegation is explained in the Commission's Policy Statement and Guidance Notes on Outsourcing and Delegation by Jersey Certified Funds and Fund Services Business (the "**Outsourcing Policy**") and sets out the expectations in respect of meeting the core principles such as monitoring the performance of the service provider to which the service has been either outsourced or delegated.

5.33 Core Principle 5 of the Outsourcing Policy requires that a fund services business must inform the Commission in writing of its intention to outsource any material part of its regulated function prior to the commencement of the outsourcing arrangement.

5.34 Commission officers found examples of activities being outsourced where the Commission had not been notified prior to the commencement of the arrangement.

5.35 The Commission also encountered examples of sub-delegation by a delegate, for example delegation by a sub-custodian, where the service level agreement did not contain appropriate provisions to ensure the fund services business was able to fully comply with the Outsourcing Policy. Fund services businesses are reminded that before a delegate enters into a sub-delegation agreement, the fund services business must first approve the sub-delegate as if the sub-delegate were itself the delegate. Furthermore, sub-delegation must not undermine the ability of the fund services business or the Commission to monitor compliance with regulatory requirements.

5.36 The Commission also found that outsourcing and service level agreements with the service provider to which services were outsourced or delegated had not been formally reviewed and updated for up to seven years in one case and up to twelve years in another. Accordingly, some of the provisions were either no longer relevant or out of date.

5.37 Furthermore, where agreements had not been kept up to date, the Commission noted that there was no provision for an annual review of the outsourcing or service level agreement and that the scope of services to be provided was not always clearly documented.

6 Conclusion

6.1 The foregoing is not intended as formal regulatory guidance, nor should it be taken to cover all aspects of the subjects touched upon.

6.2 The Commission recognises the efforts of the majority of fund services businesses to improve and upgrade their systems and controls on a continuing basis.

- 6.3 By their very nature, the examination reports set out the findings where fund services businesses and collective investment funds have been unable to demonstrate full compliance with the relevant codes of practice, the Handbook and the applicable statutory legislation. This report is therefore a commentary of such findings with the objective of providing businesses with analysis and context for internal assessment.
- 6.4 Any comments on the content of this paper would be welcomed. The Commission would also be happy to address any concerns or questions that the reader may have on matters raised herein. Any such communications should be addressed to:

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