

DELEGATION OF FUNCTIONS



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In the asset management industry, although the conditions under which the functions delegated do differ from state to state, the delegation of functions¹ is a common practice. However, in view of the breadth of the subject, this document limits itself to the question of the delegation of functions related to the management of CIS and makes no reference to questions relating to delegations of functions by a custodian or depositary.

The questionnaire on “Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators”² has enabled a detailed survey of the conditions under which delegations of functions in each country to be made. In view of the extent of the development of the delegation of functions, particularly at an international level, the objective of the present document is to extend the work undertaken by the IOSCO Technical Committee in the preparation of the “Principles for the Regulation of Collective Investment Schemes”.³

The delegation of functions results not only from economic constraints but also from the inherent desire to improve the service provided to the client. However, the regulator in the course of exercising his mission should take into consideration cases where the delegation of functions is likely to be incompatible with the principles of investor protection. In this respect, it would seem particularly desirable to define general principles concerning both the actual implementation of the delegation of functions and its supervision by the regulators concerned.

I. Some of the reasons explaining the development and evolution of the practice of delegation

Considering the current economic and technological trends in the asset management industry, it is not surprising that the delegation of functions is becoming more and more widespread. This evolution is due to a combination of economic factors.

The cost pressure is such that asset management companies are obliged to control or to reduce their overheads as much as possible. In this respect, the delegation of functions, in other words subcontracting the work out, can provide a useful means of meeting this objective. By pooling functions, asset management companies can benefit from economies of both scale and scope especially in functions such as general administration.

This explains why the delegation of administrative functions or the delegation of accounting functions of collective investment schemes CIS are common: it is in those fields that the economies of scale are the most important.

¹ For the purpose of this document, “delegation of functions” means that a third party has been engaged by the operator of a collective investment scheme to carry out certain tasks on its behalf.

² “Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators,” Report by the Technical Committee of the International Organization of Securities Commissions, May 2000, available at www.iosco.org.

³ “Report on Investment Management - Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum”, Report of the Technical Committee of the International Organisation of Securities Commissions, October 1994, available at www.iosco.org.

Moreover, the increasing sophistication of financial markets as well as the need to follow investment strategies on an international basis often require specialised know-how that a management company may lack on a stand-alone basis. The delegation of functions is a simple way to acquire sophisticated management expertise in those fields that companies do not possess themselves. Delegation is also an answer to and a driving force behind the increasing internationalisation of the investment management industry. Many regulators share the view that delegation is a common practice within equity funds, especially those invested outside the home country of the CIS operator.

If the delegation of functions appears to be a common and well-accepted practice for administrative functions, there remain several outstanding issues concerning the delegation of functions in the area of management activities.

It must not be forgotten that the delegation of functions is largely due to the evolution of the economic environment and often contributes to the improvement of the service provided to the investors. Moreover, it is a way to create flexible partnerships : e.g. a delegation can be signed or terminated rather easily and quickly put into effect to meet CIS operator's objectives. From the operator's point of view, it is more profitable than investing in other CIS (because of liquidity constraints, or prior notice requirements) or developing in-house skills (with the attendant risks, costs etc.).

II. However, the delegation of functions is not without danger : it could result in the general principles or collective asset management rules being circumvented against the interest of the investors.

IOSCO has published a set of "Principles of Securities Regulation"⁴. These principles have three core objectives:

- the protection of investors;
- ensuring that markets are fair, efficient and transparent;
- the reduction of systemic risk.

Within the framework of these principles, IOSCO has also specified principles concerning the regulation of CIS and CIS operators. These principles deal with the independence of the CIS operator from the custodian, standards of conduct, the minimum eligibility requirements for a CIS operator, the need to avoid possible conflict of interest between the investor and the CIS operator, and the obligation to give clear and timely information to potential and actual investors.

These principles have been put into effect within the various national regulatory frameworks through a range of requirements generally imposed by regulatory systems on CIS operators including, but not limited to, the following items : minimum net capital; sufficient human and technical resources; "fit and proper test", educational requirements and specific disclosure requirements.

While delegation of functions is one way to create a more flexible and responsive organisation and can therefore benefit investors, it should not reduce the protections available to investors, or be used by the CIS operator as a way of avoiding complying with the standards of conduct or minimum eligibility requirements imposed by the regulatory framework.

⁴ "Objectives and Principles of Securities Regulation", Report of IOSCO, September 1998, available at www.iosco.org.

A core concern for regulators is that a delegation does not defeat the purpose of these regulatory requirements. For example, a complete and systematic delegation of functions could lead to the CIS operator divesting itself of any role in the conduct of the CIS whatsoever, so that it becomes nothing more than an “empty box”. In this event, the regulations aimed at, for example, ensuring that the CIS operator has the competence and experience to manage the CIS efficiently could be circumvented.

In particular, the following issues are relevant to the delegation of functions by a CIS operator:

- **Accountability.** In many jurisdictions, the CIS operator remains legally accountable and liable to regulators and investors for the performance of all functions, including those that have been delegated. In this way the regulatory authorities and investors can have recourse against the CIS operator if any delegated functions are not performed adequately. This provides an incentive for the CIS operator to ensure that the delegated functions are performed effectively.

As a result, the CIS operator must retain minimum capacity and have adequate resources and processes for monitoring the delegatee’s performance of the delegated functions.

- **Conflicts of interest.** If the selection of the delegatee is made without precaution, a conflict of interest could arise between the interests of the delegatee and those of the investors ; links between delegates and CIS operators could make it essential for precautionary measures to be taken. For example, in many jurisdictions, the delegation of the financial management to the custodian, the depositary or trustee could be incompatible with the principle of the independence of the CIS operator.
- **Delegatee’s capability.** Apart from the problems due to a conflict of interest, the selection of a delegatee could prove to be incompatible with investors’ interests if the delegatee is unable to provide a proper and reasonable service, due either to the lack of human, technical and financial resources or lack of fitness and properness; the same remarks would apply where the delegatee’s regulatory framework activities do not respect partially or wholly the general principles regulating CIS activity; similar problems arise when the delegatee is neither subject to the authorisation /supervision of a regulator OR fails to apply for authorisation.
- **Definition of the terms of the delegation mandate.** The financial management of a CIS must respect the rules concerning risk division, asset classes definition, borrowing limitations etc; and it must respect the objectives announced and undertakings given to the investors. Delegation is a relationship between two parties one of whom (the delegator) has a fiduciary duty to act solely in the interest of the investors, and in the event of a default by a delegatee to take all the necessary measures to rectify the situation.

If the clauses in the contract of the delegation are insufficiently precise, investors’ interest could be adversely affected: e.g. by management failure to respect the objectives of the CIS; or inability to quickly terminate the contract of delegation in emergency situations. The same problem occurs when there is no yardstick to evaluate the quality of a service. Finally, if there is a chain of sub-delegations⁵, it could lead to a dilution of responsibilities and make it impossible to monitor and/or control financial management.

⁵ For the purpose of this document, « sub-delegations » means that a delegatee chooses to delegate to another delegatee, whether partially or entirely, the performance of the delegated function. If this process is repeated several times this will lead to a chain of sub-delegations.

- **Monitoring delegation.** To entrust to a third party the management of assets that were initially entrusted to the delegating company by investors underlines the importance and necessity of monitoring and controlling; the responsibility for which, in the case of direct management, lies with the CIS operator.

It is important to pay particular attention to the performance of the CIS managed by the delegatee and to the manner in which the delegatee fulfils its functions and respects the instructions given to it. At the same time, delegation of functions should not be considered to be a blank cheque, nor should the delegating company be devoid of either the necessary means to effectively supervise or the internal expertise enabling it to evaluate the quality of the financial management function provided. When there is a systematic use of total delegation of financial management, the delegator's ability to monitor the delegatee could be brought into question.

III. The increasing number of delegations might alter the conditions under which regulators are fulfilling their mission.

The general principles of IOSCO established a framework for the different regulatory regimes that exist in the various jurisdictions. These regimes state that a CIS must be registered or authorised.

In the latter case especially, the regulator will ask himself many questions when considering a delegation of functions. Although this is not intended to be an exhaustive list, the principle questions are as follows:

- To who (and what) is it intended to delegate?
- Does the delegatee have the necessary qualities to fulfil the mission given to it?
- Is the delegatee supervised by an authority? Which one?
- What rules of conduct are imposed upon it?
- In the event of civil litigation, to which jurisdiction is the contract of delegation subject?
- Are there any legal or regulatory dispositions which are in conflict with the rules governing the CIS in its home country?
- What happens in cases of difficulty (mismanagement, net asset value calculation mistakes, frauds etc.)?

If the delegatee is registered with the same regulator as the CIS or the CIS operator, the answers to these questions will be relatively easy.

In other cases and mainly when cross-border delegation is allowed by the regulator, the difficulties become more numerous : information concerning the delegatee can often be difficult to obtain, legal risks can increase, rules of conduct (and practices) do not always coincide with those of the home country and the management of any problem can become more difficult.

The management of a CIS is generally conducted on a long-term basis, and it is the same for the delegation of functions.

The monitoring of the delegation of functions concerns not only the CIS operators but also the regulators.

- If the delegatee should lose the very qualities which justified delegating the management of the CIS to it, and moreover if it loses authorisation to manage, it would be useful for the CIS regulator to be informed of the position and, if necessary, take appropriate measures.
- If the delegation concerns two entities that fall within the jurisdiction of the same regulator, the regulator is able to insist that the appropriate rules and regulations are respected. If the delegation concerns two

entities in the same country but which do not fall within the jurisdiction of the same regulator, it may well be that the regulator's supervisory role should still be effective if there is proper co-operation between the different regulatory authorities. Similarly, if the delegation is cross border, this is only possible if international co-operation exists.

IV. Towards the definition of principles regarding delegations.

A secure framework for CIS operating delegation requires the definition of general principles notably to ensure the efficient protection of the investor. In particular, when the delegator and delegatee fall within the supervision of different regulators, especially when located in different countries, effective co-operation between the two regulators is essential.

Based on the general principles concerning delegation stated in the Principles for the Regulation of Collective Investment Schemes adopted by the IOSCO in October 1994⁶ and considering the recent evolution affecting delegation, the general principles such as those proposed hereunder could be enacted.

1. General principles.

1.1. The delegation of a function to a third party should be done in such a manner so as to not deprive the investor and/or the regulator of the means of identifying the company legally responsible for the delegated functions.

1.1.1 When the delegator and the delegatee are entities supervised by the same regulator and are subject to the same registration procedure, the regulatory framework within a particular country may provide that the delegated functions can either remain the delegator's responsibility, or be the delegatee's responsibility or become a joint responsibility. The accountability of the delegator and the delegatee to investors may be statutory/legal, contractual or a combination of both. If this situation applies then, whatever the choice made, the investor will enjoy the same degree of protection : the regulator is responsible for the registration of both the delegator and the delegatee; both the delegator and the delegatee are subject to precisely the same conditions of authorisation or registration and they must also comply with the same rules of organisation. Accordingly therefore the investor protection is not adversely affected by a transfer of responsibility.

1.1.2. However, when the delegator and the delegatee are not supervised and registered by the same regulator, the delegator cannot discharge itself of its obligations. In that event, a CIS operator is responsible for the actions or omissions, as though they were its own, of any party to whom it delegates any part of the provision of services of a CIS. Moreover, as a minimum the CIS operator should, if it is to perform its role effectively:

- retain adequate capacity (ie skills and knowledge) to be able to assess whether the delegated function is being performed adequately;
- have adequate resources and processes, including compliance plans, to be able to monitor the performance of the delegated function by the delegatee; and
- be able to terminate the delegation where appropriate.

⁶ Referred to in footnote 3 above.

Where these conditions apply, it is considered that the CIS operator is likely to avoid becoming an “empty box”.

1.2. The delegation of functions should not be attributed to a delegatee whose interests could conflict with those of the investors. When a depositary is obliged to ensure the effective surveillance of the management of the CIS, it would be difficult for it to monitor any of the functions which it may have been delegated by the CIS. That is why the delegation of the financial management by a CIS to the depositary should be prohibited unless appropriate Chinese walls are put in place. The delegation of functions concerning administrative and accounting tasks seem to be less problematic.

1.3. The delegation of functions should not afford the delegator with the means to divest itself of its obligations, especially those concerning operating means. The use of delegations must not lead to the situation where the CIS operates as an empty box or there is a transformation, whether gradual or otherwise, of a registered CIS operator into an “empty box”. The systematic and complete delegation of core functions of the CIS operator would conflict with and/or circumvent this principle. However, if the CIS retains a minimum capacity of financial management and it possesses resources to monitor the conditions under which the delegated functions are performed, the possibility that a CIS operator be authorised to delegate the management of CISs could be envisaged.

1.4. The initial delegating company should ensure that the delegatee should not in turn delegate the functions delegated unless the sub-delegatee has been approved by the initial delegating company. Successive delegations may heighten the risk that the delegating companies would not be able to monitor the CIS effectively. So the practice of sub-delegation should be considered carefully by delegating companies and regulators.

1.5. Whatever the nature of the delegation, the rules applying to the products, for which the CIS operator is responsible, continue to apply.

1.6. The delegatee should comply with the rules regulating its activity in the country where it is authorised.

1.7. The delegation should be contained in a written contract clearly specifying the functions delegated, the means to be implemented by the delegatee and the rules of conduct applicable. Furthermore, the contract should state the conditions under which it may be revoked.

1.8. Information regarding the delegation should be given to the investors so that they can make an informed decision in relation to the CIS. In particular, the client must be formally notified which company is responsible for the delegated function.

2. Basic rules to be respected by the CIS operator.

2.1. Before delegating a function, the CIS operator should make sure that the actual implementation of the delegation of functions will not conflict with the interests of investors.

2.2. Before delegating a function, the CIS operator should make sure that the regulatory framework of the delegatee’s home country provides protection for the investor equivalent to the one provided by the regulatory framework of the delegating company. In particular, when a delegatee is situated in a country where the delegated functions are regulated and such functions may only be performed by a registered entity, the CIS operator should make sure that the delegatee is duly registered.

If the function is delegated to a party which is not subject to the same level of regulatory supervision as the delegator, the investors should be informed, and the CIS operator should

have the competencies described above (for instance, retain adequate capacity and ability to monitor and to terminate the delegation).

- 2.3. Before delegating a function, the CIS operator should make sure that the delegatee can fulfil the function in a responsible, professional and suitable manner whilst ensuring at the same time the protection of the investor.
- 2.4. The CIS operator should be capable of monitoring the activity of the delegatee and evaluate the performance of the delegatee. This monitoring activity should not be delegated.
- 2.5. The CIS operator should provide all reasonable means to permit the delegatee to fulfil its obligations. The CIS operator should ensure that it has obtained all the necessary information from the delegatee to ensure compliance with the rules and requirements imposed on the collective investment scheme operation.
- 2.6. The CIS operator should be able at any given moment to regain the day-to-day control and management of the CIS from the delegatee. This could mean regaining the control of the core functions and/or delegating the functions to another suitability qualified delegatee.

3. Co-operation between regulators.

Today, the asset management industry is a truly world-wide activity. Although differences undoubtedly exist between the different national jurisdictions, there is a common agreement upon the essential objectives of the regulatory framework. In this respect, the development of a common understanding and the convergence of rules and standards facilitate the development of delegation of functions.

A network of international co-operation would enable Regulators to obtain necessary information concerning the conditions under which delegations of functions are undertaken. In particular, it would be helpful if Regulators were in a position to obtain details of both the legal framework within which delegates are operating and information on the delegates themselves. Such a co-operation between Regulators will facilitate not only the development of delegations of functions but also the protection of investors.

In this respect, whether on a case by case basis or more generally it would seem judicious to envisage the possibility of formal and informal arrangements between regulators to enable them to exchange material information concerning both cross-border delegations and the delegates themselves.

V. Conclusion

The delegation of functions is becoming a common practice because of economic constraints and the need to improve the service provided to the client. However, the development of delegations must not happen at the expense of investor protection.

Considering its mission, IOSCO cannot ignore the practice of delegation of functions. IOSCO members need to be vigilant to ensure that delegation of functions, especially at the international level, does not hinder the accomplishment of the mission of securities regulators and does not have dangerous consequences for the investor. It is the reason why it has appeared useful to define in this paper several principles shared by regulators.

In order to avoid diluting investor protection, the delegation of a function should respect some principles. The overarching principle is that the delegation of a function should not be done in a way that defeats the underlying purpose of the accepted principles for regulating CIS's and CIS operators. Thus, the delegation of a function must be done in such a manner so as to not deprive the investor and/or the regulator of the means

of identifying the company legally responsible for the delegated functions. The delegation of a function should not afford the delegator with the means to divest itself of its obligations, especially those concerning operating means, so that it becomes nothing more than an 'empty box'. The delegation of functions must not conflict with the interests of investors. Before delegating a function, the CIS operator should make sure that the regulatory framework of the delegatee's home country provides protection for the investor equivalent to the one provided by the regulatory framework of the delegating company. The CIS operator must retain adequate capacity and resources and put in place suitable processes to monitor the activity of the delegatee and evaluate the performance of the delegatee. In addition, the CIS operator must be able to terminate the delegation and make alternative arrangements for the performance of the delegated function where appropriate.

The development of cross-border delegations should lead to enhanced co-operation between regulators. In this respect, IOSCO, with its broad membership and having reached agreement on the key principles of securities regulation, has provided a sound basis for enhanced international co-operation between regulators.