THIRD PARTY MANCO DUE DILIGENCE

A few months ago, during an EGP meeting, one of our partners came up with the following question: “what would you be looking at if you were to run a due diligence on a third-party fund management company (ManCo)?”

As directors sitting on the boards of Luxembourg domiciled funds and/or ManCos we were both intrigued as to the context and eager to dig into the topic with our colleague.

We could all remember discussions about the initial selection of a ManCo, or as appropriate an AIFM, but to be honest not much about updating it afterwards within an ongoing oversight framework or perspective. It felt as if once the choice had been made the ManCo was a given as long as it maintained its license and the adequate level of servicing.

After a while discussing the matter amongst ourselves, we realised we were onto something of interest and decided to collect our thoughts into a paper for wider circulation and exchange.

The MANCO market has changed significantly and more change is underway…

As of the end of 2021, according to the latest PWC Luxembourg Observatory for Management Companies, there were 305 ManCo’s in Luxembourg overseeing more than € 5.3 trillion of AUM.

After a sharp increase from 199 in 2013 to a peak of 317 in 2019, the overall number of ManCos has slightly decreased over the last couple of years. On the other hand, AUM have had a whopping 70% growth since 2016 fuelled by the massive rise of AIF and the continued success of UCITS (74% of total AUM as of 2021).

The Top 20 ManCos overall had €3.2 trillion of AUM illustrating the usual concentration of business: 140 ManCos have less than € 1 billion AUM each while the 31 biggest had over € 50 billion AUM each.

Focusing on Third Party ManCos (i.e., those not belonging to a bank or asset managers bringing all/most of its business) the top 10 had a combined total of €0.6 trillion of AUM with the average AUM size in this segment having grown from € 7 billion in 2017 to € 17.5 billion in 2021.

The last couple of years have seen a renewed level of M&A activity taking place in the ManCo space driven mainly by PE/ VC firms working towards the consolidation of the industry: bringing geographies together, combining complementary services under one roof, raising the size of the businesses to foster further growth, etc.
Interestingly as well, the bigger long-established ManCos belonging to banks or asset managers have also increased or started a fund hosting activity and clearly AIFMD has been a catalyst in this respect.

Given the substance requirements imposed on ManCos and the growing business complexity induced by constantly evolving regulations, it is very likely that the forces at play currently will continue and more consolidation will take place in Luxembourg and across the European Union in the ManCo sector.

In Luxembourg ManCos are authorised and regulated by the CSSF

In the middle of Summer 2018, the CSSF has published a comprehensive document which all ManCos have to comply with whether they manage UCITS or AIFs: the circular 18/698.

This text provides a very detailed reference framework on what is required from ManCos both at inception and as going concerns. Among the many topics covered by this circular one can find: financial requirements, governance principles, human resources, risks control framework &policies, AML/CTF policies, delegation framework, portfolio management functions, external audit, etc. This is indeed very helpful for anyone considering using the services of a ManCo in Luxembourg.

Part 2 chapter 9 on the Program of activity is of particular interest to the CSSF for assessing the ManCo business plan at inception. Again, this is also of relevance when assessing a ManCo since such a choice is for the long haul in theory. Yet, this Program is done at inception/authorisation, but would need to be updated periodically over time to reflect how the ManCo is developing specially in today's context. The possibility to circulate the Program of activity to outsiders such as potential and existing clients (on a need-to-know/confidential basis) should also be considered to leverage its usefulness.

How to select a ManCo?

The ManCo being a key stakeholder in any fund structure, its selection is of critical importance. This is a decision which is ideally made for the long term. Continuity and stability are important to ensure a smooth and efficient working relationship between the ManCo, the fund Board, the fund Promoter and all the stakeholders supporting the fund in its day-to-day operations and responsibilities vis-à-vis investors.

The choice can of course always be reversed, but of course at a cost in terms of time, effort and money while avoiding disruption in the services given to investors. Not something to be considered light heartedly.

Obviously, one will only consider a fully authorised/licensed entity as a starting point and also one “compatible” with the project at stake in terms of experience and capacity to deliver the required/anticipated level of services.

There are both objective factual things to look for and more qualitative features such as the company culture and its capacity to engage proactively with the fund Board and Promoter. Increasingly as well the actual governance culture is to be considered: how are controls and policies developed and implemented, but also how is governance conducted to accompany the sound and sustainable development of the business in a constantly evolving regulatory environment?

The experience and technology to interface/interact with other service providers selected by the fund (TA, custody and administration, investment management) must also be taken into consideration with the growing volumes of data to be shared and transferred from one stakeholder to another in the fund eco-system.

Sustainability, impact and ESG efforts are to be looked at increasingly to assess their compatibility and consistency with what the fund/AIF itself is trying to achieve

Who should be involved in the selection process?

The fund Board has the ultimate oversight responsibility on the choice/decision to be made.

The fund Promoter is likely to be a key stakeholder in the initial selection process given that its reputation will be at stake if something were to go wrong with the project for a new fund. Legal advisers and consultants are also facilitating the process with their specific expertise when required. Sometimes as well when large organisations are concerned a central purchasing department may be involved to ensure group outsourcing policies are complied with.

Are more people involved a guarantee for a better outcome/decision? Not necessarily as we all know from experience. The overall selection process needs to be both organised and relevant given the objectives initially set forward.

By and large to date, there is no standardised way to run such a selection process and things get done pretty much case by case with consultants facilitating and organising the search very often.

Once a choice has been made, how is the actual ongoing oversight of the ManCo done? Within a risk-based approach there are periodic reviews of the fund stakeholders: administration and accounting, depository, TA and register, fund managers, distributors etc. and the ManCo is conducting all these periodic due diligences as well as the ongoing monitoring most of the time before they are presented for review and approval by the fund Board.

Oddly enough the ManCo itself seems most of the time to be left out of the periodic due diligence process for its own activities. Shouldn’t the fund Board take a look at that question given its oversight responsibility on outsourced activities and the central role played by the ManCo in the fund eco-system?

This is precisely the point our colleagues were trying to address when dealing with a Third-Party ManCo which was undergoing M&A activity. One Luxembourg licensed entity had been chosen by the fund a few years ago, and now the Board was dealing with a much broader international group both in terms of activities and geography. Not necessarily bad news for the fund of course but yet clearly something to be looked at carefully in order to assess its consequences and impact on the fund before eventually deciding on an adequate course of action.

What should the fund Board look at when conducting a due diligence update for a ManCo?

First, it would make sense that the fund Board designates a sub-group of its directors to work on the ManCo due diligence process with or without (as the case maybe) external help to ensure an effective and efficient process. The ownership by the fund Board is a key starting point.

A two-step approach would make sense with first a questionnaire sent out to the ManCo and second a formal meeting between the ManCo and the fund directors to go over outstanding or open items. Conclusions would then be drawn and recommendations proposed by the directors involved to be presented and validated by the full fund Board.

After due consideration we came up internally to EGP with a detailed list to initiate the process with any ManCo. We did try to be comprehensive, but we do recognize it cannot be definitive since this is something rather new, still work in progress and bound to evolve as the broader context changes. Please refer to the appendix where we present a high-level summary of the topics which could be looked at. We feel it a basis for further discussions and engagement to make it as relevant and applicable as possible for all involved.

As one would expect, this is a fair amount of work for both the fund Board and the ManCo. Couldn't there be a more effective way to run such a periodic due diligence process for all involved? Due diligence is nothing new in financial services and in areas where it has been around for a while the industry has worked towards developing standards or template questionnaires to ease the process to the benefit of all.

Given the nature of ManCo's activities one could imagine the production of a "standard" DD Pack updated once a year that they would use to pass information about their current status to both existing and potential new clients as well. Such a pack would be produced by the ManCo with possibly an external validation of all or part of it when appropriate. A certification process of some sort could take place to that effect on critical aspects of the ManCo's activities: risk control, etc.

Obviously, this is still pretty much work in progress and, at EGP, we would love to have your views and feedback about this challenging topic. Do feel free to reach out to us to progress the conversation and find out more on the approach we are developing!

September 2022

Appendix: MANCO Due Diligence high level check-list

- ✓ Identity for both group and Luxembourg entity
- ✓ Business activity: existing and forward looking
- ✓ Regulatory approvals
- ✓ External audit
- ✓ Internal controls, legal, compliance and risk management
- ✓ Internal audit
- ✓ IT/Technology
- ✓ AML/CTF
- ✓ Portfolio management function
- ✓ Service providers (custody, fund administration…) selection and ongoing monitoring
- ✓ Clients’ coverage & relationship management
- ✓ Miscellaneous