



NOVEMBER 2020
**SUMMARY OF SPOT INSPECTIONS
2020**

**OUTSOURCING
OF INTERNAL CONTROL**

[amf-france.org](https://www.amf-france.org)

INTRODUCTION

As announced in the AMF's supervision priorities for 2020, the first series of SPOT inspections for the year on asset management companies ("AMCs") consisted in a review of the outsourcing of internal control to an outside firm. In view of the key role played by the internal control function in AMCs, and insofar as in any case these companies remain responsible for this function, it seemed relevant to analyse the conditions of such outsourcing and the quality of the services performed, through a SPOT inspection of a sample of seven companies using three different firms.

The verifications mainly covered the period 2017-2020 and examined:

- the internal control organisation of the AMCs (selection of the service provider, resources allocated, scope of outsourcing, governance, and links between second-level control and periodic control);
- the procedures and methodology for conducting controls and the control plan;
- practical implementation of the control process;
- reporting to senior management and the AMF;
- the system for evaluation and monitoring of the service provider by the AMC.

This review aims to shed light on the practices of the AMCs under review with regard to their outsourcing of internal control.

Scope of SPOT inspections and definitions:

- The SPOT inspections focused especially on the internal control system, which covers permanent control and periodic control. However, the review may sometimes examine compliance issues, in particular the implementation of adequate policies and procedures, due to the close link between the two parts of the compliance function¹ and the prerogatives granted to the service providers.
- Permanent control,² which checks, via second-level controls, the correct performance of the first-level controls,³ consists (excluding the risk control system) in: (1) monitoring and regularly assessing the appropriateness and effectiveness of the policies, procedures and measures implemented in the AMC, and the actions taken to correct any failure of the AMC and the persons concerned to fulfil their professional obligations;⁴ (2) monitoring and regularly assessing the appropriateness and effectiveness of the systems, internal control mechanisms and other arrangements, and take appropriate measures to address any deficiencies.⁵
- Periodic control, sometimes called third-level control, consists in: (i) establishing and maintaining a periodic control programme to examine and assess the adequacy and effectiveness of the systems, internal control mechanisms and arrangements of the asset management company, (ii) issuing recommendations based on the result of work carried out in accordance with (i), (iii) verifying compliance with those recommendations, and (iv) providing reports on periodic control issues.⁶ The periodic control function aims to ensure of the effectiveness of the compliance and internal audit system by conducting business audits and recommending corrective measures for any faults identified.⁷

¹ Cf. Articles 318-48 to 318-54 and 321-84 to 321-89 of the AMF General Regulation.

² Cf. Articles 318-50 and 321-85 of the AMF General Regulation.

³ Cf. Articles 318-51 and 321-86 of the AMF General Regulation.

⁴ Cf. Articles 61 (1) of Delegated Regulation No. 231/2013, 321-31 (I) of the AMF General Regulation and 22 (2) of Delegated Regulation No. 2017/565.

⁵ Cf. Articles 57 (6) of Delegated Regulation No. 231/2013, 321-27 of the AMF General Regulation and 21 (5) of Delegated Regulation No. 2017/565.

⁶ Cf. Articles 62 of Delegated Regulation No. 231/2013, 321-83 of the AMF General Regulation and 24 of Delegated Regulation No. 2017/565.

⁷ Cf. AMF Position-Recommendation 2014-06 (3.1).

- The term "outsourcing" used in this review refers both to outsourcing within the meaning of Articles 318-58 to 318-61 and 321-93 to 321-96 of the AMF General Regulation and Article 31 (1) of Delegated Regulation 2017/565,⁸ and to delegation within the meaning of Articles 318-62 and 321-97 of the AMF General Regulation and Article 75 of Delegated Regulation 231/2013.⁹

The AMF notes, via this series of SPOT inspections, that the internal control arrangements using the services of an external provider have levels of effectiveness that are disparate, or even in some cases insufficient. This underscores in particular the need, for any AMC wanting to use an organisation of this type, to pay special attention to selection and monitoring of the chosen service providers, and in particular the periodic re-assessment of the quality of the service provider's work. The AMF's policy regarding this will be clarified.

This document is neither a position nor a recommendation. The practices identified as either "good" or "poor" highlight approaches identified during the inspections that may facilitate, or complicate, compliance with regulations governing outsourcing of internal control.

⁸ Outsourcing to a third party of the performance of operational tasks or functions critical or important for the provision of a service or for performing activities.

⁹ Delegation of UCITS or AIF management / the fund manager's functions.

CONTENTS

| | |
|--|----|
| INTRODUCTION | 2 |
| 1. Summary of the main findings of the inspections | 5 |
| 2. Context and scope | 7 |
| 2.1. Presentation of the sample of AMCs inspected | 7 |
| 2.2. Applicable regulations | 8 |
| 3. Observations and analyses | 10 |
| 3.1. Internal control organisation of the AMCs | 10 |
| 3.2. Procedures and methodologies for conducting controls and the control plan | 17 |
| 3.3. Practical implementation of the control process | 19 |
| 3.4. Reporting to senior management and the AMF | 24 |
| 3.5. System for evaluation and monitoring of the service provider by the AMC..... | 26 |

1. SUMMARY OF THE MAIN FINDINGS OF THE INSPECTIONS

The outsourcing of internal control may cover different scopes depending on the AMC. Of the seven AMCs in the sample group, the inspections showed that the AMCs all outsource (i) the performance of second-level permanent control and periodic control, and (ii) the production of annual reports on compliance and internal control. Four AMCs also outsource, on a case-by-case basis, regulatory monitoring, the provision of training relating to anti-money laundering and combating the financing of terrorism (AML/CFT) and market abuse for employees and managers, the establishment of the AML/CFT system, drafting of their procedures, the preparation of internal control committees, the preparation of "FRA-RAC"¹⁰ reports and diverse assistance concerning the regulations with the supervisory authorities (in view of the creation of new financial products or the extension or updating of its authorisation).

In five cases, the allocation of outsourced human resources (between 20 and 30 days) for second-level permanent control and periodic control corresponds to or exceeds what is provided for in the programme of operations. For the other two AMCs, the number of days allocated in practice to periodic control does not correspond to what is mentioned either in the programme of operations or in the "FRA-RAC" report: the number of days allocated in practice to periodic control exclusively includes other subjects such as the writing of compliance and internal control reports, establishment of the "FRA-RAC" reports, conducting AML/CFT and market abuse training, and regulatory intelligence.

For the seven AMCs, the service agreements do not specify the experience and seniority of the consultants. In practice, in six cases, the consultants have significant experience in the field of third-party asset management. For one AMC, the profile of the consultant in charge of performing second-level permanent controls is very junior: at the time when she was hired by the service provider, she had only eight months' experience in activities related to asset management regulations. It should be noted, however, that this consultant was supervised by the chairman of the service provider company. The inspections noted the poor practice of having neither the CV of the consultants in charge of the internal control service nor any information regarding their possible "AMF certification".

As regards the technical resources, one service provider relies on a proprietary tool to define the second-level permanent control plan and the periodic control plan, to generate control sheets, and to supervise and validate the control work. The proprietary tool is also used to generate the remediation plans decided on (following identified anomalies) and the control reports intended for the AMC's managers. The documentary evidence of the controls is not stored, on the control date, in the proprietary tool but in a dedicated shared electronic records system on the AMC's network. The other two service providers rely on functionalities developed internally on the Office Pack.

In six out of seven cases, the AMC has an annual internal control committee during which (i) anomalies are reported to senior management and (ii) follow-up is performed on the recommendations made during the preceding committee meetings.

It appears that the seven AMCs have a procedure for selecting service providers; however, only five AMCs use this procedure to select the service provider in charge of internal control. The procedures of three AMCs are silent regarding the conditions of selection of service providers (invitation to tender or other). Only the procedures of three AMCs specify the criteria used to select service providers. They also mention the obligation for the AMC to formalise a complete service provider dossier including in particular (i) the documents relating to its identity ("K-bis"), (ii) the service provider's capacity (for example: profiles and average experience of the personnel, evidence

¹⁰ Annual fact sheets/annual inspection reports.

of membership of a professional association and of application of said association's charter, recommendations of other companies), and (iii) the signed agreement.

For the seven AMCs of the sample group, the distinction between permanent control and periodic control is not very clear, or even artificial. It was noted that the periodic control diligence did not concern the control work carried out in the framework of second-level control. In particular, the inspections highlighted the very poor practice consisting of not allocating strictly different human resources to permanent control and periodic control in a given firm in charge of outsourcing.

It is found that five AMCs do not have sufficiently precise and operational procedures covering the conduct of controls. Only the procedures of two AMCs include a control methodology and an operating procedure for the tool put in place by the service provider in charge of internal control.

The seven AMCs have risk maps including, both for the portfolios managed and for the AMC, liquidity risks, market risks, non-compliance risks, operational risks and AML/CFT risk. Only three AMCs include cybersecurity risk in their risk map.

The seven AMCs indeed have annual compliance and internal control plans ("PCCIs"): they are established either by the internal control service provider on the basis of the "FRA-RAC" annual report and the PCCI for financial year n-1, or by the AMC with the help of the service provider. Only the control plan of two AMCs formalises priorities on the basis of the non-compliance risk assessment: the control plan is established by a risk-based approach, with priority themes ((i) "FRA-RAC" reports or themes related to current events and to regulatory intelligence (reviews of SPOT inspections published by the AMF, amendment of the regulations in force), (ii) specific attention to the AMC's business (operational and/or organisational changes), and (iii) supervision priorities of the AMF for the year). On the other hand, the five other AMCs provide for a more systematic schedule for production of the control plan. Two AMCs have no periodic control plan, but controls identified as being "periodic" at the time of their performance are performed each year. The permanent control plans are generally complied with (more than 80% coverage for all the AMCs of the sample group).

In order to verify concretely the internal control outsourcing system, the inspections selected three control issues for each of the AMCs. All the AMCs of the sample group have suitably put in place second-level controls relating to these issues. The findings highlighted by the inspections are as follows:

- Regarding the procedural corpus, it appears that the procedures associated with the three issues inspected are not always sufficiently precise or operational. For five AMCs, at least one of the procedures analysed omits the due diligence to be implemented as part of first-level control. In five cases, the procedures do not refer to the relevant regulatory framework and/or do not mention the related second-level controls to be conducted ;
- Regarding the control sheets, it appears that they are suitably structured: they indicate the objectives of the control, the details of the work to be performed and the control conclusions including details of detected anomalies. For four of the AMCs, the control conclusions are accompanied by a colour code (green/orange/red) and the control sheets mention the regulatory references. For only two AMCs, a section dedicated to the follow-up of recommendations makes it possible to monitor, for each check point, progress on the associated remediation from one control to the next;
- Regarding the exhaustiveness of the controls, major check points are not implemented. For example, for AML/CFT, the following controls may have been omitted: control of the performance and quality of training, control of the tracing of Politically Exposed Persons (particularly as part of business relationship follow-up), control of the ultimate beneficial owner for clients that are legal entities, control of the client's presence on a blacklist, and control of abnormally large transactions;

- Regarding the quality and traceability of controls: (i) for four AMCs, the controls performed are formalised, documented and traced. Moreover, for these four AMCs, for which the controls are performed on a test basis, the composition and method of selection of the test samples are generally specified either in the control sheets or in the work files of the service provider; (ii) on the other hand, for three AMCs, the controls performed are seldom formalised, generally documented but seldom traced: the documentary evidence exists but it is difficult to establish the link between the findings on the control sheet and the conclusive documentary evidence substantiating the findings;
- Regarding periodic control: (i) the AMCs did not always perform periodic control on the selected issues; (ii) when periodic controls were carried out, the periodic control sheet in no case indicates the due diligence performed on the second-level controls. Lastly, the inspections noted shortcomings notably with regard to the formalisation of these periodic controls.

The organisation of the reporting statements to management is highly varied from one AMC to another:

- For three AMCs, the reports are too incomplete. They consist merely of a concatenation of the control plan for the past period (n-1), the conclusions of the controls for the year (n) and the objectives of the control plan for the following year (n+1). The report does not include information to assess the effectiveness of the control system and changes in the AMC's regulatory context;
- The reports of two other AMCs include all the control sheets produced during the past year, and the action taken or to be taken following the findings according to the identified risks for the AMC's business. They do not present an overall view of the level of compliance, even though the control sheets are detailed (main conclusions, procedures monitored, findings/risks identified and remediation measures implemented);
- The reports of the last two AMCs take the form of a PowerPoint file consolidating, by issue, all the observations expressed within the framework of controls performed in the past six months. By giving priority to a control by control approach, the reports do not give the managers a clear view of the service provider's half-yearly rate of progress in the performance of its control work, the overall level of risk sustained by the AMC and the effectiveness of the associated general control system, and changes in the AMC's regulatory context. However, such statistics are available in real time in the customer area of the proprietary tool. This tool allows the AMC managers notably to regularly monitor the state of progress of the control work across the scope of their business.

For the AMCs of the sample group as a whole, the "FRA-RAC" reports do not mention anomalies even though the control inspections noted shortcomings identified by the internal control function.

Three AMCs of the sample group do not monitor their service provider either as part of second-level permanent control or as part of periodic control. Although the other four AMCs monitor their service provider, the traceability of the due diligence performed is not always adequate.

2. CONTEXT AND SCOPE

2.1. PRESENTATION OF THE SAMPLE OF AMCS INSPECTED

The AMCs were selected in order to form a diversified sample group of outside service providers. The sample group accordingly consists of seven AMCs each of which has outsourced its permanent control system to an outside service provider. Five of the seven AMCs are entirely subject to the AIFM directive and one of them also provides a discretionary management service. The other two come under the UCITS directive, and one of them also provides a discretionary management service. Their clients are both retail and professional clients.

- AMCs 1, 2 and 3 have outsourced their internal control system to company A, consisting of less than five personnel at the time of the inspection. This company is not a member of a professional association:**
 - AMC 1 is an entrepreneurial private equity company which invests in early-stage businesses in all sectors of activity;
 - AMC 2 is an entrepreneurial private equity company specialised in European mid-market companies in all sectors;
 - AMC 3 is an entrepreneurial private equity company specialised in French mid-market companies. It gives priority to three sectors: B-to-B services, Retail & Consumer Goods, and Healthcare.
- AMCs 4 and 5 have outsourced their internal control system to company B, consisting of just over 20 personnel at the time of the inspection. This company is a member of a recently created professional association:**
 - AMC 4 is an entrepreneurial company specialised in equity investment management. It invests mainly in large- and mid-cap European companies ranking as leaders in their market, and in US companies which are either global leaders or leaders in their domestic market. It also manages investment management mandates and arbitrage mandates in unit-linked life insurance, and provides advisory services;
 - AMC 5 is a private equity company specialised in the financing of innovative unlisted French SMEs to transform them into mid-sized companies. The company is specialised in the following sectors: (i) IT/digital technology, (ii) health/nutrition, (iii) business services, and (iv) cutting-edge industries.
- AMCs 6 and 7 have outsourced their internal control system to company C, consisting of about thirty personnel at the time of the inspection, broken down by units. This company is also a member of the aforementioned professional association:**
 - AMC 6 is a company specialised in emerging-market equity investment management (mainly in Asia), using a stock picking approach;
 - AMC 7 is an entrepreneurial company specialised in equity and fixed-income investment management, and multi-management. It mainly manages arbitrage mandates within the framework of life insurance or funded pension scheme contracts under insurer-delegated management.

The investigations covered the period from 1 January 2017 to 22 October 2020.

2.2. APPLICABLE REGULATIONS

The work of the inspection task force was based on:

- Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012;
- Commission Delegated Regulation (EU) No. 2017/565 of 25 April 2016;
- The AMF General Regulation ("AMF GR");
- AMF Position No. 2012-17 (Requirements regarding the compliance function);
- AMF Position-Recommendation 2014-06 (Guide to the organisation of the risk management system of asset management companies);
- AMF Position-Recommendation 2012-19 (Guide to preparing the programme of operations for asset management companies and self-managed collective investments).

Main legal sources applicable:

| AIF | UCITS | Discretionary management |
|--|--|---|
| Internal control organisation and resources | | |
| - Article 316-3 of the AMF GR concerning the programme of operations for each of the | - Article 321-2 of the AMF GR concerning the programme of operations for each of the | - Article 21 (1a and d) of Delegated Regulation No. 2017/565) concerning the general organisation and the human |

| AIF | UCITS | Discretionary management |
|--|---|--|
| <p>services that the asset management company intends to provide;</p> <ul style="list-style-type: none"> - Articles 318-1 of the AMF GR, articles 22 (1) and 57 (1a) of Delegated Regulation No. 231/2013 concerning the general organisation and the human resources needed to carry out AMC's duties; - Articles 318-49 to 318-56 of the AMF GR concerning the organisation of the compliance, internal control and periodic control functions; - Articles 61 (2 and 3) and 62 of Delegated Regulation No. 231/2013 concerning the internal control function and the audit function; - Articles 318-5 and 318-20 of the AMF GR concerning the obligation for the chief compliance officer to have a professional licence; - Articles 318-58 to 318-61 of the AMF GR concerning the outsourcing of critical operational tasks or functions; - Articles 318-62 of the AMF GR, and 75 and 76 of Delegated Regulation No. 231/2013 concerning the delegated management of AIFs/investment manager functions; - Article 60 (2d) of Delegated Regulation No. 231/2013 concerning the responsibility of senior management regarding the permanence and effectiveness of the compliance function. | <p>services that the asset management company intends to provide;</p> <ul style="list-style-type: none"> - Article 321-23 of the AMF GR (I , II and V) concerning the general organisation and the human resources needed to carry out AMC's duties; - Articles 321-83 to 321-91 of the AMF GR concerning the organisation of the compliance, internal control and periodic control functions; - Articles 321-33 and 321-53 of the AMF GR concerning the obligation for the chief compliance officer to have a professional licence; - Articles 321-31 and 321-32 of the AMF GR concerning the compliance system; - Articles 321-93 to 321-96 concerning the outsourcing of critical operational tasks or functions; - Article 321-97 of the AMF GR concerning the delegated management of UCITS; - Article 321-35 (c) of the AMF GR concerning the responsibility of senior management regarding the permanence and effectiveness of the compliance function. | <p>resources needed to carry out AMC's duties;</p> <ul style="list-style-type: none"> - Articles 22 (2 and 3) and 24 of Delegated Regulation No. 2017/565 concerning the organisation of the compliance and internal control functions and the audit function; - Articles 30 and 31 of Delegated Regulation No. 2017/565 concerning the outsourcing of critical or important operational functions. |
| Procedures and methodology for conducting and implementing controls | | |
| <ul style="list-style-type: none"> - Article 61 (1) of Delegated Regulation No. 231/2013 concerning the system of procedures; - Articles 57 (1c) and 61 (2) of Delegated Regulation No. 231/2013 relating to internal control mechanisms and the permanent function of verification of compliance; - Article 318-51 of the AMF GR concerning second-level controls; - Article 318-57 of the AMF GR concerning the escalation procedure; - Article 60 (1 and 2d) of Delegated Regulation No. 231/2013 concerning the responsibility of senior management. | <ul style="list-style-type: none"> - Article 321-30 of the AMF GR concerning the system of procedures; - Articles 321-23 (IV) and 321-31 of the AMF GR relating to internal control mechanisms and the permanent function of verification of compliance; - Article 321-86 of the AMF GR concerning second-level controls; - Article 321-74 of the AMF GR concerning the retaining of information about monitoring; - Article 321-92 of the AMF GR concerning the escalation procedure; - Article 321-35 of the AMF GR concerning the responsibility of senior management. | <ul style="list-style-type: none"> - Article 22 (1) of Delegated Regulation No. 2017/565 concerning the system of procedures; - Articles 21 (1c) and 22 (2) of Delegated Regulation No. 2017/565 relating to internal control mechanisms and the permanent function of verification of compliance; - Article 25 (1) of Delegated Regulation No. 2017/565 concerning senior the responsibility of senior management. |
| Reporting to senior management and the AMF | | |
| <ul style="list-style-type: none"> - Article 57 (1d) of Delegated Regulation No. 231/2013 concerning an effective system for internal reporting and communication of information at all relevant levels; - Articles 60 (4) and 61 (3b) of Delegated Regulation No. 231/2013 concerning reports on compliance, internal audits and risk management; - Articles 318-61 (V) of the AMF GR and 79 (c) of Delegated Regulation No. 231/2013 concerning the information provided to the AMF relating to outsourced tasks or functions. | <ul style="list-style-type: none"> - Article 321-23 (VI) of the AMF GR concerning an effective system for reporting to senior management and communication of information at all relevant levels; - Article 321-36 of the AMF GR concerning reports on compliance, risk control and periodic control; - Article 321-96 (V) of the AMF GR concerning the information provided to the AMF relating to outsourced tasks or functions. | <ul style="list-style-type: none"> - Articles 21 (1e) of Delegated Regulation No. 2017/565 concerning an effective system for internal reporting and communication of information at all relevant levels; - Articles 22 (2c) and 25 (2) of Delegated Regulation No. 2017/565 concerning reports on compliance and risks; - Article 31 (5) of Delegated Regulation No. 2017/565 concerning the information provided to the AMF relating to outsourced functions. |
| Service provider evaluation system | | |

| AIF | UCITS | Discretionary management |
|--|--|--|
| <ul style="list-style-type: none"> - Articles 318-61 (II, 2°) of the AMF GR and 75 (e and f) of Delegated Regulation No. 231/2013 concerning evaluation and supervision of the service provider; - Article 57 (6) of Delegated Regulation No. 231/2013 concerning inspection and evaluation of the control system. | <ul style="list-style-type: none"> - Article 321-96 (II, 2°) of the AMF GR concerning evaluation of the service provider; - Article 321-27 of the AMF GR concerning inspection and evaluation of the control system. | <ul style="list-style-type: none"> - Article 31 (2b) of Delegated Regulation No. 2017/565 concerning evaluation of the service provider; - Article 21 (5) of Delegated Regulation No. 2017/565 concerning inspection and evaluation of the control system. |

3. OBSERVATIONS AND ANALYSES

3.1. INTERNAL CONTROL ORGANISATION OF THE AMCS

➤ Scope of the outsourcing of control

The outsourcing of control may cover different scopes depending on the AMC. All the AMCs delegate the performance of second-level permanent control and periodic control, and the production of annual reports on compliance and internal control. However, the following differences were identified by the inspections:

- Six AMCs outsource regulatory intelligence and the provision of training for employees and managers relating to anti-money laundering and combating the financing of terrorism (AML/CFT) and market abuse;
- Two AMCs occasionally outsourced setting up of the AML/CFT system;
- Five AMCs outsource the writing of their internal procedures;
- Two AMCs entrust other subjects to their internal control service provider for four days per year, namely the preparation of half-yearly committee meetings, preparation of the "FRA-RAC" reports and miscellaneous assistance in relations with the supervisory authorities regarding regulations.

The number of person-days (per year) devoted to the compliance and internal control function ranges between 24 and 100 days. The time devoted to outsourcing of permanent control (periodic control respectively) ranges between 15 (2 respectively) and 23 days (8 respectively).

➤ Selection of the service provider to which internal control is outsourced

The seven AMCs have a procedure for selection of service providers.

While, for AMCs 1, 3, 4, 6 and 7, the procedure clearly includes selection of the service provider in charge of internal control, the procedure for AMCs 2 and 5 does not mention this service provider, however critical.

Moreover, the procedures of AMCs 1, 3 and 4 are silent regarding the conditions of selection of service providers (invitation to tender or other).

On the other hand, the procedures of AMCs 6 and 7 specify the criteria used to select the service providers. They also mention the obligation for the AMC to formalise a complete service provider dossier including in particular the documents relating to its identity ("K-bis") and the service provider's capacity (for example: profiles and average experience of the personnel, evidence of membership of a professional association and of application of said association's charter, recommendations of other companies), and the signed agreement for provision of services.

In practice:

- AMC 1 does not select its service providers by an invitation to tender but based on peer recommendations;
- AMC 2 has not conducted an invitation to tender since 2010 to select the service provider in charge of internal control, even though it has selected another service provider in charge of internal control since then;

- AMC 3 did not provide the inspection task force with evidence capable of justifying the choice of its service provider. On the other hand, for its new service provider, selected in 2020, it performed the following due diligence to select it: identification of market participants corresponding to the requirements, selection of the short list, and choice of the service provider following discussions/conversations via email;
- AMCs 4 and 5 did not make invitations to tender to select their present internal control service provider. However, AMC 4 indicated that it selected its service provider based on criteria of reputation, size and experience and because it had performed work for a wealth manager that the AMC's managers knew. AMC 5 selected its service provider based on recommendations from market participants when updating its application for authorisation in which it had to draw up the control and compliance part including the handling of internal control by outsourcing;
- AMC 6 selected its service provider by comparing three offers of services based on several criteria: analysis of the personnel's levels of renown, expertise, organisation, resources and cost/seniority ratio;
- AMC 7 made no invitation to tender to select its present service provider. The AMC's former chief compliance officer selected its service provider following oral discussions conducted via the AFG and with the representatives of the potential service providers.

The missions found that the panel's AMCs had not examined the consistency between, on the one hand, the resources allocated by the selected providers to the outsourced tasks and functions, and, on the other hand, the global human resources of these providers and their volume of activity.

It should be noted that the professional association of which service providers B and C are members has an operating charter describing the commitments subscribed to by the members. These commitments concern, for example, (i) annual reports on the number of permanent and periodic control assignments performed, the utilisation rate per person or by level of experience; (ii) an attestation of at least 40 hours of training per year for each partner and consultant; (iii) an attestation of at least 20 person-days of regulatory intelligence for the teams of consultants; (iv) an independent annual review of the control assignments performed; and (v) the establishment of a conflict of interest management policy and a commitment not to accept assignments which might place the firm in a situation of conflict of interest in relations with its clients.

Regulatory reminders:

- AMCs shall establish and keep operational appropriate policies, procedures and measures to detect any risk of non-compliance with the professional obligations of the Monetary and Financial Code and the subsequent risks and to attenuate those risks (Article 61 (1) of Delegated Regulation No. 231/2013, Article 321-30 of the AMF GR and Article 22 (1) of Delegated Regulation No. 2017/565).
- If AMCs outsource the execution of operational tasks and functions that are critical or important for the provision of a service or the conduct of business, they shall take reasonable measures to prevent an undue exacerbation of operating risk. The outsourcing of critical or important operational tasks or functions should not be done in a way that materially impairs the quality of internal control (Articles 318-58 and 321-93 of the AMF GR).
- Outsourcing consists of any agreement, in any form, between an AMC and a service provider under which the service provider takes over a process, service or activity that would otherwise have been performed by the AMC itself (Articles 318-59 and 321-94 of the AMF GR, Article 31 (3) of Delegated Regulation No. 2017/565).
- An operational task or function shall be regarded as critical or important if a defect or failure in its performance would materially impair either the AMC's capacity for continuing compliance with the conditions and obligations of its authorisation or its professional obligations, or its financial

performance, or its business continuity (Articles 318-60 and 321-95 of the AMF GR, Article 30 (1) of Delegated Regulation No. 2017/565).

- AMCs shall exercise due skill, care and diligence when entering into, managing or terminating an outsourcing contract for critical or important operational tasks or functions. In particular, AMCs must take the necessary steps to ensure that the following conditions are satisfied: the service provider must have the ability, capacity, and any authorisation required to perform the outsourced tasks or functions reliably and professionally. The service provider must cooperate with the AMF in connection with the outsourced tasks or functions (Articles 318-61 (II, 1° et 8°), 321-96 (II, 1°) of the AMF GR, Article 31 (2a) of Delegated Regulation No. 2017/565).

Good practices:

- Indicate in the procedure for selection of service providers the criteria used to make that selection (for example, professional accreditations of the service provider, conditions of termination of the contract, cooperation of the service provider with the AMF, resources employed and continuity of service, and knowledge of the applicable regulations).
- In the case of competitive tendering (or any type of selection process), document the selection of the service provider using a grid or summary document making it possible to compare the suitability of the replies by the service providers questioned, on all the relevant selection criteria according to the context (quality, reactivity, availability, price, number of full-time personnel assigned by the service provider, etc.), and which provides for a hierarchic ranking and/or weighting of these selection criteria, to prevent any discretionary assessment.

Poor practices:

- Not providing, in the selection procedure and in practice, for a process of periodic competitive tendering or re-examination of the choice of service provider in charge of internal control.
- Not ensuring that the service provider has resources consistent with its business volume and, in particular, that it has adequate human resources to meet its service commitments.

➤ **Consistency of the human resources with the programme of operations**

In five out of seven cases, the allocation of human resources for second-level permanent control and periodic control corresponds to or exceeds what is provided for in the programme of operations:

- For AMCs 1 and 3, the allocation of human resources for second-level permanent control and periodic control exceeds what is provided for in the programme of operations.
- For AMC 6, the overall allocation of human resources dedicated to control (both second-level permanent and periodic control) corresponds to what is provided for in the programme of operations. On the other hand, even though the agreement signed between the AMC and the service provider stipulates a breakdown of the number of days allocated between permanent control and periodic control, and in practice the AMC's system distinguishes between the two aspects, the programme of operations does not clearly mention such a distinction.
- For AMCs 4 and 5, the number of days allocated in practice to periodic control does not correspond to what is indicated either in the programme of operations or in the "FRA-RAC" report, because it includes other subjects such as the writing of compliance and internal control reports, establishment of the "FRA-RAC" reports, conducting AML/CFT and market abuse training, and regulatory intelligence.

Regarding the other two AMCs:

- For AMC 2, the programme of operations does not distinguish between the allocation of human resources devoted to permanent control and that devoted to periodic control;

- The programme of operations of AMC 7 has not been updated since 2005 even though the contractual relationship with the current internal control service provider dates from 2013.

Regulatory reminder:

- The programme of operations shall specify the conditions under which the AMC intends to provide the services in question and shall indicate the type of transactions proposed and the structure of the company's organisation (Articles 321-2 and 316-3 of the AMF GR).

Poor practices:

- When changing the internal control service provider, not updating the programme of operations accordingly.
- Not indicating in AMCs' programme of operations the breakdown of the number of days allocated between permanent control and periodic control even though the agreement signed between the AMC and the internal control service provider mentions such a distinction, and in practice the AMC's system distinguishes between the two aspects.
- Including in the number of days allocated to periodic control, declared in the programme of operations and in the "FRA-RAC" report, other subjects such as the writing of compliance and internal control reports, establishment of the "FRA-RAC" reports, conducting AML/CFT and market abuse training, and regulatory intelligence.

➤ **Experience of the consultants**

For the seven AMCs, the service agreements do not specify the experience and seniority of the consultants.

In four cases, however, the inspections were able to verify the fact that the consultants were experienced:

- For AMC 1, the profile of the consultant in charge of performing second-level permanent controls is very junior: at the time when she was hired by the service provider, she had only eight months' experience in activities related to asset management regulations;
- For AMCs 2, 3, 6 and 7, the consultants were experienced (having a diploma representing 5 years of higher education) relating to financial regulation and having job experience (AMF, law firm, AMC) appropriate for the functions performed (four years on average for line personnel, more than 15 years for partners);
- For AMCs 4 and 5, the service provider did not submit to the inspection task force the CVs of the consultants who performed the controls during the period under review, but after sending the control reports it forwarded information making it possible to get an idea of the consultants' career record and level of experience, which proved to be significant.

Moreover, for the three service providers, there is an administrative review of the second-level control work performed by the consultants. For one of the three service providers, this review is not traced.

Lastly, regarding obtainment of "AMF certification"¹¹ by the consultants in charge of second-level permanent control and periodic control:

- Only one consultant of service provider A had obtained AMF certification at the date of the inspection;
- Service provider B did not provide the inspection task force with information as to whether or not the consultants had obtained AMF certification, but submitted information on this subject afterward (see above);
- The consultants of service provider C have all obtained AMF certification.

¹¹ Examination to test knowledge with a certified organisation at the request of the AMF (cf. Articles 318-7, 318-9 and 321-37, 321-39 of the AMF GR).

Regulatory reminders:

- AMCs shall use, at all times, adequate and appropriate human and technical resources, that are necessary pour the proper management of funds. They shall employ sufficient personnel with the skills, knowledge and expertise necessary for discharging the responsibilities allocated to them. (Article 22 (1) of Delegated Regulation No. 231/2013, Articles 318-1 and 321-23 (I and V) of the AMF GR, and Article 21 (1d) of Delegated Regulation No. 2017/565).
- To enable the compliance function to discharge its responsibilities in an appropriate and independent manner, AMCs shall ensure that this function has the necessary authority, resources and expertise, and has access to all relevant information (Article 61 (3) of Delegated Regulation No. 231/2013, Article 321-32 (1°) of the AMF GR, and Article 22 (3) of Delegated Regulation No. 2017/565).

Good practices:

- Use experienced personnel having a diploma representing 5 years of higher education relating to financial regulation and having at least three years' job experience in the asset management sector.
- Organise an administrative review that can be traced in the service provider's firm for second-level control.
- Use consultants having AMF certification to deal with internal control service.

Poor practices:

- Not checking that the service agreement indicates the consultants' experience and seniority.
- Not having either the CVs of the consultants in charge of the internal control service or information as to whether or not they have AMF certification.

➤ **Technical resources**

While two service providers rely on the functionalities of the Office Pack, one of the three service providers has developed a proprietary tool:

- Service providers A and B stated to the inspection task force that they relied on the Microsoft - Office Pack office software suite. The service provider consults the conclusive evidence necessary for the control either on the spot, or through emails sent by the AMC. In the latter case, data transmission is not performed in a secure manner (risk of cyberattack on the AMC's data not taken into consideration);
- Service provider C uses a proprietary tool. The latter is used to define (based on the authorisation grid) the AMC's compliance and internal control plan (PCCI) and periodic control plan (PCP), to generate standardised control sheets by applicable regulatory subject and then to supervise and validate the performance (and traceability) of the control work. The proprietary tool is also used to generate the remediation plans decided on (following identified anomalies) and the control reports intended for the AMC's managers. Use of the proprietary tool is supplemented by use of the collaborative workplace Dropbox Business – in the service provider's firm – which makes it possible to store and share information securely among the AMC and the consultants working for it. The documentary evidence of the controls is not stored, on the control date, in the proprietary tool but in a dedicated shared electronic records system on the AMC's network.

Good practices:

- Use a tool for conducting permanent and periodic controls making it possible to define the AMC's control plans, generate standardised control sheets by applicable regulatory subject and supervise

and validate the performance (and traceability) of the control work, and to generate the remediation plans decided on and the control reports intended for the AMC's managers.

- Have a secure collaborative workplace hosted by the service provider, shared among the AMC and the consultants performing work as part of the control service, capable of storing and sharing the necessary information to perform and substantiate these controls.
- Store the documentary evidence of the controls in a dedicated electronic records system on the AMC's network shared with the internal control service provider.

➤ Governance

Only AMC 1 does not have a compliance and internal control committee. In the other six cases, the AMC has an annual or half-yearly compliance and internal control committee meeting (bringing together the AMC management and one or more representatives of the service provider), during which a report is presented: 1/ anomalies, recommendations and levels of criticality are reported to management, and 2/ follow-up is performed on the recommendations made during the preceding committee meetings.

Regarding the formalisation of this committee, the inspections noted the following practices:

- AMCs 2 and 3 draw up minutes of the committee meeting, but these are not sufficiently formalised to effectively report deficiencies;
- AMCs 4 and 5 do not draw up minutes of this committee meeting to take formal note of the changes made to the draft half-yearly compliance and internal control report by the service provider by agreement with the managers, and to trace its final validation. But the half-yearly report, drawn up by the service provider and discussed during the half-yearly committee meeting, presents the decisions taken as a result of the observations, and the proposed remedial measures (person in charge of remediating the expressed recommendation, period allocated where applicable). On the other hand, the half-yearly report does not mention or establish a link to information capable of justifying implementation of the corresponding remedial measures (e.g. procedures, etc.);
- For AMCs 6 and 7, the report consolidates, for each tested issue, all the observations expressed within the framework of controls performed in the past six months. This document is discussed with the AMC's managers during the half-yearly internal control committee meeting notably in order to take formal note of the remedial measures to be taken. Following the committee meeting, the document is updated by the provider of the agreed action plans (control by control) and returned by email to the AMC managers to perform the remedial measures. For AMC 6, the recommendation follow-up document indicates the time frame in half of the cases.

Regulatory reminder:

- AMCs shall establish, implement and maintain decision-making procedures and an organisational structure that specify reporting lines and allocate functions and responsibilities; they shall ensure that the relevant persons are informed of the procedures to be followed for the proper discharge of their responsibilities; and they shall establish, implement and maintain adequate internal control mechanisms, designed to ensure compliance with the AMC's decisions and procedures at all levels. AMCs shall take into account the nature, scale and complexity of their business, and the nature and range of the services provided and activities undertaken in the course of that business (Article 57 of Delegated Regulation No. 231/2013, Article 321-23 of the AMF GR and Article 21 of Delegated Regulation No. 2017/565).
- The managers shall be responsible for ensuring that the AMC has a permanent and effective compliance function, even when this function is performed by a third party (Article 321-35 c) of the AMF GR, Article 60 (2d) of Delegated Regulation No. 231/2013).

Good practice:

- Have a half-yearly internal control committee meeting during which 1/ anomalies regarding the monitored subjects are reported to management, and 2/ follow-up is performed on the recommendations made during the preceding committee meetings, specifying the time frame for remedial measures.

Poor practices:

- Not formalising the decisions of the internal control committee to take formal note of the remedial measures by agreement with the managers.
- Not indicating in the committee meeting minutes the conclusive evidence in order to clear the expressed recommendation.

➤ Links between permanent control and periodic control

For the seven AMCs of the sample group, the distinction between permanent control and periodic control is not very clear, or is even artificial. The inspections noted that the periodic control diligence did not consist of monitoring the work performed by the AMC within the framework of permanent second-level control:

- For AMCs 1, 2, 3, 4 and 5, the periodic controls are thematic spot checks;
- For AMCs 4 and 5, part of the days allocated to periodic control are devoted to tasks relating to the preparation of internal control committees or "FRA-RAC" reports; the inspections were unable to distinguish between the teams in charge of periodic control and those in charge of permanent control, because the control sheets do not show the names of those involved;
- For AMCs 6 and 7, the service provider considers as periodic control (i) its participation in the half-yearly control committee meetings of the two AMCs and (ii) the quality review performed by the manager in charge of each AMC on the consultants' work. The controls recorded in the periodic control plan newly created in 2019 are mere transfers of permanent controls recorded in the previous internal control plan.

Regarding independence between permanent control and periodic control:

- For AMCs 1, 2 and 3, it appears that periodic control is not independent of permanent control. Although the permanent and periodic controls are taken charge of by two different persons, the chairman of the service provider company, in charge of periodic control, checks the consultants' work within the framework of permanent controls;
- For AMCs 6 and 7, similarly, the senior manager on the assignment is directly in charge of periodic control; the permanent control work is performed by the junior and senior consultants involved in each AMC;
- For AMCs 4 and 5, as already mentioned, there is no document making it possible to distinguish between the human resources allocated to permanent control activities and those allocated to periodic control (neither the service agreement nor any other internal document).

Regulatory reminders:

- Where appropriate and proportionate in view of the nature, scale, complexity and range of their business, AMCs shall establish and maintain an effective internal control function which is separate and independent from their other functions and activities and which has the following responsibilities: establishing and maintaining an effective periodic control programme to examine and evaluate the adequacy and effectiveness of the systems, internal control mechanisms and arrangements of the AMC; issuing recommendations based on the result of the work carried out; verifying compliance with those recommendations; and providing reports on periodic control

issues (Article 62 of Delegated Regulation No. 231/2013, Article 321-83 of the AMF GR, and Article 24 of Delegated Regulation No. 2017/565).

- An AMC shall generally not combine the compliance function with the internal audit function. The combination of the compliance function with other control functions may be acceptable if this does not compromise the effectiveness and independence of the compliance function. Any such combination shall be reported and documented, including the reasons for the combination so that competent authorities are able to assess whether the combination of functions is appropriate having regard to the organisation of the AMCs (AMF Position 2012-17). As stated in AMF Position-Recommendation 2014-06, "*From an organisational perspective, the periodic control function should not be grouped together with the compliance and internal control functions insofar as the periodic control function is responsible for auditing the other two functions.*"

With respect to the above regulatory reminders, the AMF expected to observe a **good practice** consisting in allocating strictly different human resources to permanent control and periodic control respectively, where both services are provided by a given external provider. Instead, the inspections noted the following poor practices.

Poor practices:

- Not distinguishing between the human resources allocated to permanent control activities and those allocated to periodic control in the service agreement or in any other internal document.
- Producing a periodic control plan for year N by merely transferring controls recorded in the permanent control plan for year N-1.
- Not showing the name of the persons involved in the control sheets.
- Allocating periodic control resources to tasks relating to preparation of the compliance and internal control committees or the "FRA-RAC" report.

3.2. PROCEDURES AND METHODOLOGIES FOR CONDUCTING CONTROLS AND THE CONTROL PLAN

➤ **Procedures and methodology for conducting controls**

Two of the seven AMCs have relatively precise and operational procedures concerning the conduct of controls: the procedures of AMCs 6 and 7 include a control methodology and an operating procedure for the tool implemented by the service provider.

Regarding the other AMCs:

- AMC 4 has no procedures dedicated to the internal control system. Although the procedural corpus refers to the AMC's programme of operations, the latter does not describe the control methodology;
- The procedures of the other four AMCs (1, 2, 3 and 5) mention the three levels of control and the role of the service provider.

Regulatory reminder:

- AMCs shall establish and maintain appropriate operational policies, procedures and measures to detect any risk of non-compliance with the professional obligations of the Monetary and Financial Code and the subsequent risks and to attenuate those risks (Article 61 (1) of Delegated Regulation

No. 231/2013, Article 321-30 of the AMF GR and Article 22 (1) of Delegated Regulation No. 2017/565).

Poor practice:

- Not having a dedicated procedure relating to the methodology for conducting controls and the associated governance.

➤ **Consideration of the AMC's risks through risk mapping**

The seven AMCs have risk maps including, both for the portfolios managed and for the AMC, liquidity risks, market risks, non-compliance risks, operational risks and AML/CFT risk. Only three AMCs (AMCs 3, 6 and 7) include cybersecurity risk in their risk mapping. However, AMCs 6 and 7 do not describe cybersecurity risk adequately. For example, (i) the risk of an internal or external malicious attack on the AMC's information systems is not formally recorded there, and (ii) several IT risk management systems are absent from the risk mapping whereas they appear in the control plans and sheets (heat maps of sensitive data and critical applications, control of administration of the information system, the IT security systems and access to sensitive applications and installations).

AMCs 4 and 5 do not formalise a review of risk mapping at least once a year, even when such a review is submitted to them by the service provider.

Regulatory reminder:

- AMCs shall periodically map their risk of non-compliance. This mapping should enable them to set the targets, resources and work programme of the compliance function. The work programme and resources of the compliance function should be reviewed regularly to take into account any risk arising, for example, from the launch of a new business (AMF Position-Recommendation 2014-06).

Poor practices:

- Not mapping sufficiently precisely and adequately risks (e.g. cybersecurity) inherent in the AMC's business, omitting in particular any mention of the associated risk management systems.
- Not formalising a review at least once a year of the risk mapping when its updating is entrusted to the service provider.

➤ **Control plan creation and updating process**

The seven AMCs do have annual compliance and internal control plans ("PCCIs"): they are established either by the internal control service provider on the basis of the "FRA-RAC" annual report and the PCCI for financial year n-1, or by the AMC with the help of the service provider.

The control plan of two AMCs (AMCs 4 and 5) formalises the control priorities based on the non-compliance risk assessment. The control plan is established by a risk-based approach, with priority themes ("FRA-RAC" report) or themes related to current events and to regulatory intelligence (review of SPOT inspections, amendment of the regulations in force, specific attention to the AMC's business (operational and/or organisational changes), and supervision priorities of the AMF for the year). It may change during the year in consultation with the AMC by adding, moving forward or postponing a subject.

The other AMCs plan a schedule for performance of all the planned controls:

- For AMCs 1, 2 and 3, this schedule is included in the control plan;

- For AMCs 6 and 7, this schedule is implemented in the service provider's proprietary tool. The service provider's manager in charge of the AMC fills in a "customer data sheet" including the AMC's authorisation grid. The tool then automatically preselects the standard control sheets associated with the AMC's authorisation grid. Once the plan has been generated, it is presented by the manager of the service provider company to the AMC's managers for validation. At this stage the service provider's manager can alter the generated plan at the request of the AMC. The final plan is validated by the manager/chief compliance officer, then signed by the latter and by the partner of the service provider company. The plan is then placed in "validated" status by the aforementioned manager in the control tool. The standard control sheets are then automatically generated by the tool.

AMCs 1 and 3 have no periodic control plan, but periodic controls are performed each year. For example, in 2018 AMC 3 asked the service provider to perform a periodic control concerning risk management. It also wanted to monitor the internal methodology for calculation of the tax ratios applicable to the funds under management, and asked the service provider to perform a complete audit of the establishment of tax ratios as at 31 December 2019.

Regarding the validation and signature of the control plan by the managers:

- For three of the seven AMCs, the chief compliance officer manager validates the PCCI (not signed);
- For three AMCs, the chief compliance officer manager or one of the managers in charge within the meaning of Article L. 532-9 of the Monetary and Financial Code signs the PCCI;
- For one AMC, no document provides evidence of validation of the PCCI by the managers or the internal control committee, in the absence of minutes of this committee meeting and any other formal validation.

In general, the permanent control plans are largely complied with.

Good practices:

- Build the internal control plan by a risk-based approach, with priority themes ("FRA-RAC" report) or themes related to current events and to regulatory intelligence (review of SPOT inspections, amendment of the regulations in force, specific attention to the AMC's business (operational and/or organisational changes), and supervision priorities of the AMF for the year).
- Have the internal control plan validated and signed by the manager.

Poor practices:

- Not including priority indicators in the internal control plan.
- Not having a control plan for periodic controls even though there exists a periodic control function or if controls considered as periodic are performed.

3.3. PRACTICAL IMPLEMENTATION OF THE CONTROL PROCESS

➤ Presentation of selected controls

In order to verify concretely the internal control outsourcing system, the inspections selected three areas of control for each of the AMCs, related to their core business and/or AMF's supervision priorities.

| Issues / AMC | No. 1 | No. 2 | No. 3 | No. 4 | No. 5 | No. 6 | No. 7 |
|--|-------|-------|-------|-------|-------|-------|-------|
| Investment and disinvestment processes, valuation process | X | X | X | | X | X | |
| AML/CFT (for AMCs managing mandates and/or doing private equity) | X | X | X | X | X | X | X |
| Cybersecurity | X | X | X | X | X | X | X |
| MiFID II | | | | X | | | X |

➤ **Analysis of the procedures associated with the three themes monitored**

The procedures associated with the three themes monitored do not always appear sufficiently precise or operational.

For five AMCs, at least one of the procedures analysed omits the due diligence to be implemented as part of first-level control.

In a significant number of cases, the procedures associated with the three themes monitored do not mention the regulatory framework and/or do not include the related second-level controls:

- For AMCs 1, 2 and 3, the inspections noted that the procedures do not mention the regulatory framework and do not include the related second-level controls;
- AMC 4 has procedures including regulatory references. However, with the exception of that relating to investment constraints, the procedures do not include the related second-level controls;
- AMC 5 has procedures including regulatory references. However, the procedures do not include the related second-level controls;
- For AMC 6, (i) the procedure relating to the business continuity plan does not mention the permanent control system in place for the businesses that it regulates, and (ii) the procedure relating to the investment process does not include the regulatory references associated with the business that it covers;
- For AMC 7, a small majority of procedures (4 out of 7, or 57%) do not mention the permanent control system in place on the businesses that they regulate. On the other hand, all these procedures except one ("termination of mandates") include regulatory references associated with the business that they cover.

Moreover, the inspections noted the following shortcomings regarding the various control themes analysed.

AML/CFT:

The AMCs have procedures concerning the AML/CFT system for the funds' assets and liabilities. However, the inspections noted, for example, that:

- For AMCs 1, 2 and 3, the AML/CFT procedures (for assets and/or liabilities) do not indicate precisely all the documents to be gathered;
- For AMCs 2 and 3, the due diligence to be performed on anti-money laundering is not indicated; the procedure therefore does not indicate the enhanced or additional vigilance measures to be possibly applied;
- For AMC 3, the procedures do not mention AML/CFT due diligence within the framework of supervision of the stakes held by the managed funds.

Investment and divestment processes:

For AMC 1, the regulatory references of the investment, investment supervision and divestment procedure are not up-to-date.

Valuation:

For AMC 3, the valuation procedure is not operational because it does not describe either the various steps for estimating the fair value of assets, nor the valuation methodology applied (for example: methodology of EBITDA multiples depending on the nature, characteristics and circumstances of the investment, such as the company's investment development stage and sector of activity, and market conditions). Lastly, it makes no mention either of the principle of consistency of accounting methods or the cases of discounts/premiums applied.

Cybersecurity:

The AMCs have procedures concerning the following issues: "Business Continuity Plan", "Dysfunctions and incidents", "Archiving/preservation/protection/destruction of data".

The inspections noted the following shortcomings:

- The BCP procedure of AMC 2 does not mention whether BCP tests are performed. The inspection noted that this procedure refers to articles 313-55 and 313-56 of the AMF GR which are no longer applicable since 3 January 2018;
- The "Dysfunctions and incidents" procedure of AMC 3 does not plan to indicate to employees, managers or anyone on assignment the external escalation procedure;
- The BCP procedure of AMC 4 explicitly includes neither cybersecurity nor any tests to be performed.

MiFID II:

AMC 4 has no procedure for control and monitoring of falls of more than 10% in the value of the portfolios of clients under discretionary management. Based on analysis of the documents communicated, this point was not analysed and therefore not noted by the compliance function.

Poor practice:

- Failing to indicate in the procedures or in any document attached to them the applicable regulatory references inherent to the relevant item (regular changes in the regulations should not be a curb on such an omission).

➤ **Analysis of control sheet structuring**

The permanent second-level control sheets indicate the objectives of the control, the details of the work to be performed and the control conclusions including details of detected anomalies. For four AMCs, the control conclusions are associated with a colour code¹² (green/orange/red).

For three AMCs, the control sheets do not state that the controls aim to verify compliance with the procedures.

The interviews to be conducted are specified only in the control sheets of two AMCs (6 and 7). Moreover, for these two same AMCs, a section dedicated to the follow-up of recommendations makes it possible to monitor, for each check point, progress on the associated remedial measures from one control to the next.

Finally, the inspections found the following shortcomings:

- For AMCs 1, 2 and 3, the control sheets include no precise regulatory references and the list of documents to be reviewed is not clearly specified;
- For AMCs 4 and 5, the sheets contain neither a date nor signature of the service provider and the AMC which would provide evidence of its validation. Moreover, as indicated above, the inspections were unable to know the names of the consultants who performed the controls for want of traceability.

¹² For service provider B, the scale used is as follows: "detected breach of the regulations: action plan to be implemented in the short term"/red, "detected dysfunction or point for improvement: action plan to be implemented in the medium term"/orange, "business in compliance with the regulations"/green.
For service provider C, the scale is as follows: "regulatory breach"/red, "area for improvement"/orange, "regulatory compliance"/green.

Good practices:

- In the control sheets, in addition to information for identification of the control (internal reference, date of performance, frequency, consultants in charge), include the objectives of the control, the list of documents to be reviewed (procedures in particular) and interviews to be conducted, the regulatory references relating to the risks monitored, the details of work performed and the conclusions of the control (via a red/orange/green colour code) together with details of the anomalies detected.
- In the control sheets, provide for follow-up of the recommendations to make it possible to monitor, for each check point, progress on the associated remedial measures from one control to the next.

Poor practice:

- Not showing in the control sheets (i) the date of performance of the control, (ii) the person in charge of performing the control, and (iii) the signature of the service provider and the AMC (managers) as evidence of its validation.

➤ Exhaustiveness of the scope of control:

Regarding the selected themes, major check points were concealed by the AMCs of the sample group in the context of their permanent controls. For example, the following controls may have been omitted:

- For AML/CFT: control of the performance and quality of training, control of the tracing for Politically Exposed Persons (particularly as part of business relationship follow-up), control of the ultimate beneficial owner for clients that are legal entities, control of the client's presence on a blacklist, and control of abnormally large transactions;
- For valuation: control of the effectiveness of the role of the independent evaluator in the valuation process, and critical review of the valuation methodology used;
- For discretionary management/MiFID II: control of the conditions of investment in in-house funds by discretionary managed accounts, control of repayment to the discretionary portfolios of all trailing fees;
- For cybersecurity: control of the performance and quality of training, control of the managers' involvement in cybersecurity management, control of the existence of a map database of sensitive data and critical applications, control of the content of a map database of sensitive data and critical applications, control of IT security systems (updating of antivirus software, software licences, etc.), logical access control for sensitive applications, and physical access control for sensitive installations. In particular, AMC 1 performed no cyber control even though fraudsters and impostors had published false websites in the name of the AMC and have used scams to search for personal or confidential information.

➤ Quality and traceability of controls performed:

For four AMCs, the controls performed are formalised, documented and traced. For AMCs 1, 2 and 3, however, controls are seldom formalised, generally documented but seldom traced: the documentary evidence exists but it is difficult to establish a link between the findings on the sheet and the documents; the control sheets do not mention precisely the documents analysed. Furthermore, the controls performed are always the same from one year to the next, the control sheets do not refer to or take into consideration regulatory changes; the controls consist of a mere documentary examination without verifying the practical conditions of application of the policies and procedures.

For four of the seven AMCs, the controls are performed on a test basis; the composition and method of selection of the test samples are generally specified either in the control sheets or in the work files of the internal control service provider; in one case, however, the process of selection of the sample of tested investment decisions is not explained.

The other three AMCs do not proceed by sampling, which could detract from the effectiveness of the control. Indeed, the inspections highlighted shortcomings in the due diligence performed by the service provider in the framework of second-level control. For example, for AMCs 1 and 2, the controls relating to AML/CFT consist in checking the existence of an Excel file identifying the AML/CFT due diligence conducted by the first-level control, but this Excel file does not make it possible to know precisely the due diligence actually performed and the documents actually analysed.

The inspections nevertheless noted the following positive findings:

- For AMC 3, the service provider adopts as a basis the good and poor practices identified in the review of cybersecurity SPOT inspections published in December 2019;
- For AMC 6, the inspections conducted gave an incentive, appropriately, for the establishment of a map database of the information system for the AMC.

The AMCs of the sample group did not always perform periodic control on the selected issues. When such a control exists, and for all the AMCs, the periodic control sheet does not mention the due diligence performed on the second-level controls. Moreover, the inspections noted shortcomings in the formalisation of these controls. For example:

- For AMC 2, the control notes that "*the investment and divestment process is satisfactory*" or that "*the valuation procedure is satisfactory*" without indicating the check points. The periodic control relating to valuation also suggested a "*review of the valuation process*" and a "*review of the (...) the AIFM note*" without indicating the identified shortcomings;
- For AMC 7, the rules for selection of test samples are neither explained in the control sheets nor consistent from one period to the next.

Good practices:

- Mention clearly, in the control sheets, the conditions of selection of the test sample and substantiate its representativeness.
- For performing controls, adopt as a basis the good and poor practices identified in the published reviews of SPOT inspections.

Poor practice:

- Not clearly referring, in the control sheets, to the documents analysed, which detracts from the satisfactory traceability of work and the conclusions of the control.

➤ Follow-up of the recommendations:

The follow-up of the recommendations is not always effective:

- For AMCs 1, 2 and 3, the lack of formalisation of the recommendations means that the managers cannot, where necessary, take appropriate remedial measures;
- For AMCs 6 and 7, the observations and associated recommendations expressed by the service provider for each check point tested are clearly formalised in the control sheets for the three issues tested. For AMC 6, however, it appears that no implementation timeline is provided for most of the recommendations still open on the control date, which hampers their management. For AMC 7, the action plans listed in the management table provided are incomplete (the person in charge and/or the estimated date of performance are missing) or behind schedule (by 3 to 12 months) in their implementation for the great majority of the recommendations still open on the date of the control (i.e. one-quarter of the total number of recommendations issued since January 2017);

- For AMCs 4 and 5, delays in implementation of the recommendations were also observed, by comparison with the timeline initially set.

Regulatory reminders:

- AMCs shall establish and maintain effective internal reporting communication of information at all relevant levels (Article 57 (1d) of Delegated Regulation No. 231/2013, Article 321-23 (VI) of the AMF GR, and Article 21 (1e) of Delegated Regulation No. 2017/565).
- First-level control shall be exercised by persons in operational functions. Permanent control shall be conducted through second-level controls to ensure proper execution of first-level controls (Articles 318-51 and 321-86 of the AMF GR, AMF Position-Recommendation 2014-06).
- AMCs shall establish and maintain effective and adequate internal control mechanisms, designed to ensure compliance with decisions and procedures at all levels of responsibility of the AMC (Article 57 (1c) of Delegated Regulation No. 231/2013, Article 321-23 (IV) of the AMF GR, Article 21 (1c) of Delegated Regulation No. 2017/565).
- Permanent controls should be documented. (If faults are identified or the observed situation fails to meet expectations, the compliance function should inform senior management of the facts and of the corrective measures that should be considered. The compliance and internal control officer monitors the implementation of the corrective measures he/she recommends and shall inform senior management of the appropriate measures taken in compliance reports. AMF Position-Recommendation 2014-06).
- Responsibility for ensuring that the AMC complies with its professional obligations is incumbent on its senior management and, where applicable, its supervisory body (Article 60 (1) of Delegated Regulation 231/2013, Article 321-35 of the AMF GR, Article 25 (1) of Delegated Regulation 2017/565).

Poor practice:

- Not providing for a timeline for remediation of identified anomalies, nor a person in charge of implementing the corresponding measures, which could make follow-up of the recommendations by senior management less effective.

3.4. REPORTING TO SENIOR MANAGEMENT AND THE AMF

➤ **Reporting to senior management:**

The organisation of the reporting statements to senior management is highly varied from one AMC to another:

- The reporting statements of AMCs 1, 2 and 3, produced annually, are not very well written and are incomplete. They consist of a concatenation of the control plan for the past year, the conclusions of the controls for the current year and the control plan for the following year. The report does not include the following information: a description of the implementation and effectiveness of the general control framework, a review of the main conclusions of the examination of policies and procedures, modifications and changes in the applicable regulatory requirements during the period covered by the report, and the measures which have been or should be taken to ensure compliance with the new requirements, other significant compliance problems occurring since the last report, and any alerts reported to the AMF. Moreover, the reports do not include statistics or analyses concerning changes in the results of the controls performed. The comments of AMC 1 concerning management's reaction to the shortcomings revealed by the controls are not very clear or are

inadequate. Moreover, concerning AMC 2, neither the management chairman nor the chief compliance officer signed their approval of the service provider's report;

- The half-yearly reports of AMCs 4 and 5 take the form of a PowerPoint file consolidating all the control sheets produced during the past year, and the action taken or to be taken following the findings according to the identified risks for the AMC's business. The assessments are presented in the form of a colour code (see above). They do not present an overall view of the level of compliance, even though the control sheets are detailed (main conclusions, procedures monitored, findings/risks identified and remediation measures implemented). There is no overall reporting statement reviewing the annual situation;
- The reports of AMCs 6 and 7 are also in the form of a PowerPoint file. They consolidate, for each tested issue, all the observations expressed within the framework of controls performed in the past six months. They include a summary table of the risks identified during the controls performed in the half-year, which enables the AMC's managers to obtain a consolidated view of the work performed. A general assessment of the controls performed is presented in the form of a colour code at the start of the report. It is determined according to the results of each of the controls performed over the period, scored according to the same code. A dedicated "follow-up of recommendations" section allows the AMC's management to specify the progress made in taking into consideration the recommendations expressed by the control service provider. On the other hand, by giving priority to a control by control approach, the reports of AMCs 6 and 7 do not give the managers a clear view of the service provider's half-yearly rate of progress in the performance of its control work, the overall level of risk sustained by the AMC and the effectiveness of the associated general control system,¹³ and changes in the AMC's regulatory context. The reports do not include detailed statistics regarding the coverage of the control plan or the quantity of anomalies detected. However, such statistics are available in real time in the customer area of the proprietary tool. This tool allows the AMC managers notably to regularly monitor the state of progress of the control work across the scope of their business.

Regulatory reminder:

- The senior management bodies of the AMC shall receive frequent compliance, risk control and periodic control written reports at least once a year specifying if appropriate measures have been taken in the event of deficiencies (Article 60 (4) of Delegated Regulation No. 231/2013, Article 321-36 of the AMF GR, Article 22 (2c) of Delegated Regulation No. 2017/565).

Good practices:

- Include in the internal control reports for senior management a summary table of the risks identified during the controls performed during the period.
- Present the observations of the internal control report in the same form as in the control sheets, assigning, for example, to each observation a colour code corresponding to a compliance or risk level.
- In the internal control reports for senior management provide for a section relating to the "follow-up of recommendations" allowing the AMC's management to monitor the progress made in taking into consideration the recommendations expressed by the control service provider.

Poor practices:

- Not including in the chief compliance officer's report sent to senior management the following information: a description of the implementation and effectiveness of the general control framework, a review of the main conclusions of the examination of policies and procedures, modifications and changes in the applicable regulatory requirements during the period covered by

¹³ No assessment of this risk level, consolidating the results obtained and placing them in perspective relative to the AMC's business and the control results for the prior six months, is set out formally.

the report, and the measures which have been or should be taken to ensure compliance with the new requirements, other significant compliance problems occurring since the last report, and correspondence with the AMF.

- Not providing, in the reports for senior management, statistics or analyses concerning the coverage rate of the control plan, anomalies identified and changes in the results of the controls performed.
- Not providing for the approval of the Senior Manager and chief compliance officer on the service provider's report, or at least minutes formalising that approval.

➤ Reporting to the AMF:

For the AMCs of the sample group as a whole, the "FRA-RAC" reports¹⁴ do not mention all the anomalies detected, even though the control inspections noted shortcomings identified by the internal control function:

- For AMCs 1 to 3, the "FRA-RAC" reports do not mention the shortcomings even though they were identified in reporting to senior management. For AMCs 4, 5, 6 and 7, the "FRA-RAC" reports mention only the most significant shortcomings (established cases of non-compliance);
- The "FRA-RAC" reports for AMCs 6 and 7 mention the performance of a periodic control. However, such due diligence does not appear among the periodic control information (plans and sheets) submitted by the AMC to the inspection task force in 2017 and 2018. Both AMCs stated to the inspection task force that they had treated the mere holding of the internal control committee meeting as periodic control for these two years;
- The "FRA-RAC" reports of AMCs 1, 2, 3 and 5 do not mention some of the prerogatives entrusted to the service provider (support for staff training, drafting of new policies and procedures).

Poor practice:

- Not mentioning in the "FRA-RAC" reports the major anomalies identified by the internal control function during the past period, even though the "FRA-RAC" report includes a field allowing them to be described concisely, on the pretext that they were rectified during the past period or that they are not sufficiently significant.

3.5. SYSTEM FOR EVALUATION AND MONITORING OF THE SERVICE PROVIDER BY THE AMC

➤ Procedures for evaluation and monitoring of the service provider

As mentioned above, the AMCs of the sample group all have a procedure for the selection of intermediaries and service providers. This procedure, drafted by the service provider in charge of internal control, includes the question of evaluation of service providers.

For AMCs 1 and 2, this procedure mentions that follow-up of intermediaries is performed whenever the work performed is "significant", without specifying an amount. For AMC 3, a threshold of €10,000 is set. While the procedure of AMC 4 indicates that operational functions perform follow-up in accordance with a formalised process of periodic evaluation, it does not specify whether this follow-up is performed from the first euro. **The procedure of AMC 5 mentions an annual evaluation of outsourced services without specifying clearly whether it includes an evaluation of the service provider in charge of internal control.** The procedure of AMC 6 does not cover the additional services agreed between the AMC and the service provider in charge of control relating to three services considered as non-"essential" by the AMC: ((i) the provision of internal training; (ii) updating of

¹⁴ Cf. Articles 318-37 and 321-75 of the AMF GR

procedures, policies and mapping; and (iii) assistance for the creation and follow-up of the corporate life of a French SICAV).

For three AMCs (Nos 2, 4 and 5), the procedure is silent regarding storage of the information. On the other hand, the procedure of AMCs 1 and 3 indicates that communications "*are kept in Outlook boxes and, in the case of attachments, systematically recorded in the folders concerned.*" The procedure of AMCs 6 and 7 specifies that the AMC keeps a paper dossier but also a scanned version of all the documents constituting the service provider's dossier on the AMC's network.

For three AMCs (1, 2 and 3), the procedure does not include a methodology for evaluation of the service provider's level of performance (quality and quantity control of the services provided). But in practice the evaluation process of the three AMCs is based on general criteria.

The evaluation process of AMC 4 consists in ensuring that the service provider informs the AMC of any incident or anomaly that could have an impact on the outsourced tasks or functions, and that the AMC has effective access to the data relating to the outsourced tasks or functions and the service provider's business premises. An appendix to the procedure specifies the various general and specific outsourcing evaluation criteria.

AMC 5 relies on a service provider monitoring database which allows classification of the entrusted service (essential service or not within the meaning of the regulations) and noting of any incidents with the service provider or regarding the service provided. This database is reviewed regularly and once a year the Management Committee performs an evaluation of the services classified as essential in light of the agreements and commitments signed, the quality of the services performed and, where applicable, the incidents detected. Apart from any incidents, the evaluation process does not rely on any other predefined criteria.

The evaluation process of AMCs 4, 6 and 7 is based both on general criteria valid for all service providers and on criteria, both quantitative and qualitative, specific to the outsourcing of internal control.

Good practices:

- Have an annual file filled in on an ongoing basis to formalise follow-up of the internal control service provider, in particular by evaluating its level of performance and making sure that it informs the AMC of any incident or anomaly that could have an impact on the outsourced tasks or functions, and that the AMC has effective access to the data relating to the outsourced tasks or functions.
- In the procedure, provide for monitoring of the internal control service provider on the basis of precisely defined criteria.

Poor practices:

- Not providing in the service provider selection procedure for preservation of information on the evaluation performed.
- Not providing in the service provider selection procedure for an appraisal methodology of the service provider's level of performance based on precise criteria (quality and quantity control of the services provided).

➤ Effective evaluation and monitoring of the service provider

Two of the seven AMCs of the sample group (2 and 5) do not monitor their service provider in charge of internal control. Although the other five AMCs perform monitoring, the traceability is not always sufficient:

- Each year, the chairman of AMC 1 evaluates the services of the AMC's service provider companies. He assigns a score on a scale from 0 (least satisfactory score) to 5 (best score) for six predefined criteria. The AMC's final

opinion on the service provider is a weighted average of each of these criteria. The criteria in question are as follows: (i) Quality of the service (coefficient: 7); (ii) Availability (coefficient: 5); (iii) Proactiveness (coefficient: 3); (iv) Cost of the service (coefficient: 3); (v) Financial soundness/reputation (coefficient: 2). The following organisational and security aspects were not monitored by the AMC: security in processing sensitive data, logical access control for sensitive applications, security level of technical installations (server room), and regular performance of BCP tests/backup restore tests;

- AMC 3 monitored the internal control service provider (proactiveness, availability of funds, technical competence, exhaustiveness of analysis, dependability, quality communications, trust, work habits, comfort, reputation and price). It also performs follow-up by rereading the service provider's control sheets and reports;
- AMC 4 uses about twenty criteria (divided into two groups: 13 "general/AMF criteria" and 8 "specific criteria"). The criteria concern updating of the PCCI, the existence of control sheets and compliance with deadlines relating to the PCCI but also to the holding of compliance and internal control committee meetings ("CCCI's"), and assistance relating to employee training and regulatory intelligence;
- AMCs 6 and 7 also use about twenty criteria (divided into two groups: 12 "general/AMF criteria" and 6 "specific criteria" of the outsourced activity). The AMF criteria mainly concern the professional accreditations of the service provider, the conditions of contract termination, continuity of service, cooperation of the service provider with the AMF, the AMC's access to outsourced data, the service provider's proactiveness and the permanence of its resources as well as its knowledge of the sector of activity and the applicable regulations. The criteria specific to the outsourced service concern the duties of the chief compliance officer service provider as defined in the service agreement. For AMC 7, the sheets provided do not identify the recurring negative observations made year after year.

None of the AMCs checks the existence of and compliance with ethical rules by its service providers/consultants (personal transactions, professional secrecy, conflicts of interest, etc.). However, AMC 1 monitors personal transactions on a declaration basis at least once a year.

Regulatory reminders:

- AMCs shall exercise due skill, care and diligence when entering into, managing or terminating an outsourcing contract for critical or important tasks or functions. They must in particular take the necessary steps to ensure that the following conditions are satisfied: the service provider must have the ability, capacity, and any authorisation required to perform the outsourced tasks or functions reliably and professionally; the service provider must carry out the outsourced services effectively. To this end, AMCs must establish methods for assessing the standard of performance of the service provider; AMCs must properly supervise the carrying out of the outsourced tasks or functions, and adequately manage the risks stemming from outsourcing, and must supervise those tasks and manage those risks (Articles 318-61 and 321-96 of the AMF GR, Article 31 (2) of Delegated Regulation No. 2017/565).
- AMCs shall monitor and, on a regular basis, evaluate the adequacy and effectiveness of the systems, internal control mechanisms and other arrangements, and shall take appropriate measures to address any deficiencies (Article 57 (6) of Delegated Regulation No. 231/2013, Article 321-27 of the AMF GR, Article 21 (5) of Delegated Regulation No. 2017/565).

Good practice:

- Formalise a reasoned evaluation based on the precise criteria provided for by the procedure to evaluate the service of the internal control service provider.

Poor practices:

- Not checking the existence of and compliance with ethical rules by its service providers/consultants (personal transactions, professional secrecy, conflicts of interest, etc.).
- Having evaluation sheets which are based purely on declarations and which are not corroborated by documents substantiating the verifications performed.
- Not providing in the evaluation sheets for comments on recurring negative observations.
- Not adopting, for evaluation of the service provider, criteria relating to the following organisational and security aspects: security in processing sensitive data, logical access control for sensitive applications, security level of technical installations (server room), and regular performance of BCP tests/backup restore tests.