

## **Q&A Circular CSSF 12/552 on internal governance, central administration and risk control**

The CSSF has classified the questions on Circular CSSF 12/552 into themes broadly corresponding to the chapters and sub-chapters of the circular. Questions that span multiple themes have been ranged under their most prominent theme. In order to keep the number of categories of themes limited, we have classified a number of specific questions under the heading “Other”.

All references below refer to Circular CSSF 12/552 unless stated otherwise. “Board” means board of directors as defined in point 1.1) of Circular CSSF 12/552. LFS refers to the law of 5 April 1993 on the Financial Sector. “Institution” is a bank or an investment firm as defined in Article 1 of the LFS.

### **General**

**Q: Do institutions have to re-submit their amended internal governance organisation to the CSSF for approval following the entry into force of Circular CSSF 12/552?**

A: There is no need for an authorised institution to submit or resubmit its internal governance organisation to the CSSF for approval. It is understood that all legal reporting to the CSSF pursuant to Circular CSSF 12/552 (in particular points 20, 22, 57, 62, 64, 105, 129 and 210) has to be provided to the CSSF. The same holds for any exemption requests that require the explicit approval from the CSSF (points 53, 141, 157, 182 and 206).

### **Scope of Application (part I, chapter 2)**

**Q: Will Circular CSSF 04/155 and Circular IML 98/143 remain applicable to Chapter 15 management companies?**

A: Yes, Circular CSSF 04/155 and Circular IML 98/143 remain applicable to Chapter 15 management companies until further notice as per point 5.2.3 of Circular CSSF 12/546.

**Q: Does Circular CSSF 12/552 apply to those management companies that provide discretionary portfolio management?**

A: No, Circular CSSF 12/552 does not apply to those management companies.

### **Board (Sub-chapter 4.1)**

**Q: Do managers and employees of affiliate entities (parent companies, subsidiaries, branches) of the group that a Luxembourg institution is a part of, qualify as non-executive or independent directors on the board of the Luxembourg institution?**

A: Managers and employees of other group entities that are not branches or subsidiaries of the Luxembourg institution can be considered as non-executive for the purpose of Circular CSSF 12/552. However, the CSSF considers that they do not fulfil the criteria of independence defined in point 31 of the circular. Therefore they cannot be considered as independent directors on the board of Luxembourg institutions.

**Q: What should be the level of detail of documents pertaining to strategy and guiding principles required from the board pursuant to point 17?**

**Is the approval of the management's ICAAP report by the board sufficient or is the board required to issue separate governing principles and strategies as regards risks, own funds and liquidity?**

A: The board of each institution is responsible for determining the institution's needs for effectively and efficiently documenting its core principles and strategies, in accordance with the proportionality principle. Commercial and risk strategies as well as other core strategies such as those dealing with capital and liquidity are part of an institution's main governing documents and are to be set in writing. Having regard to efficiency and the delegation of day-to-day management to the authorised management, the board generally defines a parsimonious set of principles and strategies (point 17) that effectively maintain the day-to-day operations by the authorised management within the business case and the risk profile approved by the board. Authorised management transforms these broad principles and strategies into (detailed) policies and working procedures (point 54) that define and constrain day-to-day operations in a way that fully respects the board's principles and strategies.

The ICAAP report is the authorised management's report to the board with regard to the institution's risk situation, capital adequacy and liquidity. It is thus a regular feedback to the board on how the institution respects certain key principles and strategies set by the board. While the ICAAP will naturally refer to the strategies set by the board, the core principles and strategies defined by the board have to be documented separately from the report that is assessing the institution's compliance with them.

**Q: Which combined committees (audit - risk - compliance) are permitted according to Circular CSSF 12/552 and the principle of proportionality?**

A: The goal of Circular CSSF 12/552 is to ensure that each institution has properly functioning internal governance arrangements. There is no single arrangement that would fit all institutions' needs and institutions' boards must determine which committees are most effective and efficient to assist them in their specific environment. Circular CSSF 12/552 mentions a joint audit & compliance committee as a matter of example only. For some institutions, it may make sense to have e.g. a combined risk and compliance committee rather than an audit and compliance committee. In accordance with the principle of proportionality, smaller institutions may decide not to create such committees or to create combined committees in accordance with their internal analysis of the nature, scale and complexity of their business.

Although specialised committees are recommended for larger institutions in order to assist the board with its responsibilities and oversight, their creation is not an obligation. Pursuant to Article 53-1(2) second bullet of the LFS, the CSSF might request the setting up of specialized committees if, as a result of its supervisory review and evaluation process, it reaches the conclusion that the board alone is not in a position to effectively provide oversight of an institution.

**Q: Why do specialised, board-level committees for audit, risk or compliance not have any decision-making powers but are only able to issue recommendations to the board?**

A: Prevailing laws and regulations consider the ultimate responsibility for an institution, and thus corresponding decision-making powers, to lie with the board. The specialised committees' roles are to assist the board by providing critical assessments and independent and expert advice pertaining to specific areas of the organisation and its functioning. The ultimate decision reached from these inputs belongs to the board itself. The authorised management may be invited to attend meetings of these specialised committees, but may not be a voting member.

## **Authorised Management (sub-chapter 4.2)**

**Q: Circular CSSF 12/552 refers to the authorised management’s collective responsibility. In practice, authorised management is generally organised in a way that allocates specific responsibilities to individual members of the authorised management.**

A: The authorised management’s collective responsibility for managing the institution is set by Articles 7(2) and 19(2) LFS. These articles establish the “four eyes” principle that ensures an appropriate level of mutual control at the level of the authorised management. The collective responsibility does not prevent any direct responsibilities from being allocated according to the specific competencies of managers and by avoiding conflicts of interest. Such individual allocation does however not alter management’s collective responsibility under law.

**Q: Which broader management committees are referred to by point 53?**

A: Art. 7(2) of the LFS requires that the authorised management, to whom the daily management is delegated, must be in a position to effectively decide on the activities of the institution. Any committee broader than the authorised management (e.g. credit committee, assets & liabilities committee) can therefore only hold decision-making powers if the authorised management is a part of it and retains a veto right.

Ultimately, board-level powers and responsibility lie with the board. Management-level powers and responsibility lie with authorised management.

## **Internal Control Functions (sub-chapter 6.2)**

**Q: Do all Luxembourg branches of institutions originating from EU member states have to implement a compliance function locally at branch level and notify a chief compliance officer to the CSSF? Is it not sufficient in certain circumstances to only designate locally an anti-money laundering officer and a complaints officer?**

A: The CSSF considers that the internal control functions in general and the compliance function in particular, are key elements of a sound internal governance organisation, including at branches in Luxembourg of institutions originating in other EU member states. This function should thus be created locally at these branches, covering the domains where the CSSF retains supervisory powers as the competent supervisory authority of the host country, and integrated in the group compliance function, having due regard to the principle of proportionality.

Circular CSSF 12/552 provides the compliance function with specific rights and obligations that are not normally granted to an anti-money laundering or complaints officer.

An exemption from appointing a full-time chief compliance officer (CCO) can be granted by the CSSF, based on a prior internal analysis by the institution of the nature, scale and complexity of its business and having regard to the principle of proportionality. This analysis must be done in writing and, even though limited to the areas for which the CSSF retains responsibility under law, must be transmitted to the CSSF together with the institution’s application for exemption, to enable the CSSF to assess the well-founded nature of the institution’s request.

The CSSF does not grant branches a general exemption from implementing a compliance function locally. Within the scope of its competencies, the CSSF offers the possibility of creating locally a part-time function only or, in exceptional circumstances, of allocating the compliance function to the member of authorised management that assumes the responsibility for compliance and who will then become also the branch’s CCO.

Consequently, the CSSF expects that a minimum-configuration compliance function must always exist locally at Luxembourg branches and that a CCO has to be notified to the CSSF.

**Q: How should the proportionality principle (point 4) be applied in practice with respect to internal control functions (including to instances of smaller institutions as well as subsidiaries and branches that are part of a larger group)?**

A: Sub-chapter 6.2 of Circular CSSF 12/552, dealing with internal control functions, requires every institution to have three distinct internal control functions which are to be headed by three distinct function heads.

The general principle of proportionality stated in point 4 of the circular is to be seen as a scaling factor. An institution's internal control functions should be scaled up or down according to the nature, scale and complexity of an institution's business.

The proportionality principle does not offer a complete waiver from setting up internal control functions. Point 119 states, as a general principle that internal control functions must exist within each constituent entity of a group. The necessity of an internal control function can therefore not be questioned in principle. But its specific organisation, size and resources should be scaled in line with the nature, scale and complexity of the institution.

For example, the compliance function can, in the case of a smaller institution, be scaled down to a dedicated part-time function. In very small institutions, it can be allocated to the member of the authorised management who is responsible for compliance. This authorised manager will then also assume the position of chief compliance officer. As further stated in point 141, any institution that does not wish to appoint a full time chief compliance officer will need to obtain the CSSF's prior authorisation. Analogous requirements exist with respect to risk control (point 129; only a motivated notification to the CSSF is required), whereas internal audit may be outsourced to an external expert (points 117 and 157; prior authorisation from the CSSF required).

The second paragraph of point 4 provides general information on how internal governance arrangements can be scaled down for "smaller" institutions pursuant to the proportionality principle. An institution that makes use of the exemptions cited above has to demonstrate that it has thoroughly analysed its organisation and business (including risk) in terms of nature, scale and complexity and has validly concluded that a full-time appointment is not proportionate to its organisation and business. After validation of this written analysis by the authorised management and the board, the institution requesting a dispensation must transmit it to the CSSF, together with a description of the organisation and its businesses and including all supporting evidence, so as to permit the CSSF to assess the well-foundedness of the analysis and its conclusions.

There is no pre-established format to transmit such an application to the CSSF, nor is there a comprehensive list of criteria to be fulfilled. The CSSF will evaluate applications on a case-by-case basis. It has to be noted however that the dispensation from creating full-time internal control functions is an exception created for the benefit of smaller and less complex institutions only. As a matter of principle, it does not exempt the institution from setting up the function altogether.

Once its evaluation will be complete, the CSSF will, as foreseen in Circular CSSF 12/552, confirm its acceptance or rejection of the request, including possible suggestions for amendment.

**Q: What are the CSSF's expectations to the internal control functions of a parent company as concerns the oversight of non-controlling participations, including those which, on a stand-alone basis, may not be subject to Circular CSSF 12/552?**

A: The CSSF's expectations in relation to the internal control of non-controlling participations are set out in point 3 of Circular CSSF 12/552. The CSSF expects that institutions and groups will strive to apply the requirements applicable to the institution also to non-controlling participations, subject to the proportionality principle and putting substance before form. The objective is to ensure effective and comprehensive risk control, wherever in the group risk is located.

For participations that have the status of a PFS other than an investment firm (as defined in Article 1 of the LFS), Circulars IML 95/120, IML 96/126, IML 98/143 and CSSF 05/178 continue to apply until further notice.

**Q: How should a local internal control function in an entity that is part of a larger (sub-) group headed by a Luxembourg based parent company be organised and who should assess its performance?**

A: An internal control function should be set up at the level of each subsidiary or branch and its resources should be commensurate to the nature, scale and complexity of the local entity's activities, in accordance with the principle of proportionality.

The implementation of local internal control functions does not represent a waiver to group control functions of their group control obligations. The local internal control function should be embedded in the group internal control structure, functionally in subsidiaries, and both functionally and hierarchically in branches (points 119 and 120). This should be done in an efficient way without diluting however the responsibilities applying at each level.

Considering these organisational arrangements, local internal control functions will likely be assessed by the group's internal control function. In the case of a subsidiary, they will also be assessed by the board of the subsidiary or its respective specialised committee. In the case of a branch, they will be assessed as part of the audit function overall or individually by the group's specialised committee. These assessments by the respective committee could in any case rely on the work done by the group control function.

**Q: What expectations in terms of direct interaction with internal control functions does the CSSF have and what advice does the CSSF give the heads of internal control functions concerning the use of their access right to the CSSF?**

A: The CSSF has always been open to direct contacts with all internal control functions. Point 109 of Circular CSSF 12/552 specifically grants the internal control functions a right of access to the specialised committees, the board or its chairman, the external auditor and also the CSSF. Where circumstances warrant it, the heads of the internal control functions should of course contact the CSSF directly and without delay.

Circular CSSF 12/552 contains minimum requirements in terms of communication and reporting for credit institutions and investment firms. It does not in any way restrict or limit interaction between the CSSF and the institutions' internal control functions.

**Q: What will be the CSSF's approach in case of a dismissal or internal transfer of the head of an internal control function?**

Any change (appointment, transfer, dismissal) relating to one of the heads of internal control has to be notified to the CSSF (point 105). This notification must include the detailed reasons motivating the change.

Upon receipt of such a notification, the CSSF may request additional information, invite the respective persons, the authorised management or the chairman of the board for an interview or take such other measures as it deems necessary in order to clarify the circumstances having led to the decision.

The CSSF's supervisory competence does not extend to employment law matters and its intervention, including the calling of exit interviews, will be limited to supervisory issues in general and the respect of Circular CSSF 12/552 in particular.

**Q: Do internal control functions have to report to the board or its respective specialised committees those audit, risk or compliance recommendations whose resolution by management is significantly overdue?**

A : Pursuant to point 116, internal control functions have to report regularly in writing and where necessary on an ad hoc basis to the authorised management or the specialised committees. These reports have to cover new findings and recommendations as well as the status of resolution of previously raised recommendations. Where an internal control function considers that recommendations are not being addressed by the authorised management, it should report directly to the board.

At least on a yearly basis, internal control functions must provide a written report to the board which must be approved by the board and the specialised committees (where applicable). This report, which is submitted to the authorised management for information only, must inform in particular about those internal control functions' recommendations whose resolution by management is significantly overdue.

**Q: The Basel Committee on Banking Supervision (BCBS) recommends that internal audit should be accountable to the board or its audit committee, acknowledging internal audit's role as third line of defence (principle 12 in the BCBS's "The internal audit function in banks"). Circular CSSF 12/552 defines dual reporting lines, to the board and to the authorised management.**

A: Circular CSSF 12/552 clearly highlights the role of internal audit as the third line of defence and emphasises its independence (point 104), fully reflecting the spirit of the BCBS paper.

Internal audit is a key instrument that should enable the authorised management as well as the board to fulfil their prudential responsibilities as codified in points 17 and 52 of Circular CSSF 12/552. This explains the dual reporting line of the internal audit towards the board and the authorised management. In order to fully guarantee its independence, the internal audit is ultimately accountable towards the board (point 105).

## **Other**

**Q: Can the chief compliance officer be the person in charge of the whistle-blowing process (point 90)?**

A: Persons within an institution's organisation who have the required level of authority and independence can be put in charge of the internal whistle-blowing process. The whistle-blowing procedure should also provide an alternative route for flagging problems that may relate to the person in charge of the whistle-blowing process itself. The CSSF considers that in particular the chief compliance officer and chief internal auditor fulfil the necessary criteria of authority and independence.

**Q: What is the meaning of « significant » under the new product approval process (sub-chapter 7.3)?**

A: Significance has to be evaluated in terms of risk, i.e. the nature and extent of risks associated with new clients, new instruments or other. This explains the prominent role allocated to the internal control functions and the fact that they can ask for a new product to be classified as significant and thus subject to the new product approval process.

**Q: With reference to point 193 of Circular CSSF 12/552, do institutions need to obtain their direct client's (the investment fund's) written consent or the consent of their client's clients (the fund's unitholders)?**

A: Pursuant to Article 41 (2a) of the amended Law of 5 April 1993 on the financial sector, in case an institution acting as central administration agent or depositary is outsourcing services implying a transfer of relevant information to a third party, the central administration agent or the depositary must ensure that its client, the Board of Directors ("BoD") of the SICAV or of the IFM for common funds, has accepted the outsourcing of the relevant outsourced services, the type of information transmitted in the context of the outsourcing and the country of establishment of the entities that provide the outsourced services.

The aforesaid requirements apply independently from the General Data Protection Regulation (EU) 2016/679, if applicable.

**Q: What are the CSSF's expectations with regard to "risk transfer pricing" (point 231)? Should this be owned by the risk control function?**

A: The CSSF's expectations are as defined in points 231-233. From the supervisory point of view, the main objective of sound risk transfer pricing is to ensure that the cost of risk is duly reflected in internal pricing so as to avoid that risk taking (profit seeking) is encouraged without due consideration of downside risks (eventual losses).

More generally, institutions should ask themselves what type of incentives, positive or negative, are generated through their internal pricing systems (including remuneration) and to what extent inappropriate or aggressive pricing (e.g. higher interest on deposits to attract such deposits) is prudent and sustainable.

It is the role of the risk control function to provide independent assessments as regards the proper alignment of risk transfer pricing with the underlying risks.

**Q: What is implied by the organisational segregation referred to under point 234?**

A: Point 234 recommends, subject to the principle of proportionality, the organisational segregation of an institution's advisory, discretionary and execution-only services offered to clients as the most effective means of ensuring the respect of the institution's contractual obligations towards the relevant groups of clients. Through the organisational segregation of these fundamentally different activities, the institution prevents conflicts of interest that might arise if different types of clients were handled by the same persons or within the same operational unit and facilitates the respect of its contractual and legal obligations towards the respective types of clients.