



**ISLE OF MAN  
FINANCIAL SERVICES AUTHORITY**

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**Exempt and Exempt Type Schemes  
Governance, compliance and risk management  
(including AML/CFT)**

**Thematic Feedback**

***For the attention of Collective Investment  
Scheme Functionaries, and in particular  
Class 3 (11)/(12) Licenceholders***

**January 2021**

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## Glossary

**IMPORTANT NOTE - All references to legislation guidance or other information sources in this feedback are to the version that was in force at the date of issue.**

<b>AML/CFT</b>	Anti-Money Laundering / Countering the Financing of Terrorism
<b>Authority Officers</b>	persons employed by or contracted/seconded to the Authority
<b>Authority</b>	the Isle of Man Financial Services Authority
<b>Board</b>	the governing body of a licenceholder, scheme or other entity as relevant
<b>BRA</b>	Business Risk Assessment as per paragraph 5 of the Code
<b>CISA08</b>	the Collective Investment Schemes Act 2008
<b>Class 3 Licenceholders</b>	licenceholders with permissions on their Financial Services Licence to provide services to Collective Investment Schemes
<b>CMP</b>	Compliance Monitoring Programme
<b>Code</b>	Anti-Money Laundering and Countering the Financing of Terrorism Code
<b>CRA</b>	Client Risk Assessment as per paragraph 6 of the Code
<b>Exempt scheme</b>	an arrangement which meets the meaning of a “collective investment scheme” under section 1 of the Collective Investment Schemes Act 2008 (“CISA08”) and the “Exempt Schemes” requirements under Schedule 3 to the CISA08
<b>Exempt-type scheme</b>	is a term used to describe a scheme established outside the Isle of Man (“IOM”) that is subject to similar restrictions as the IOM Exempt scheme

<b>Exemptions Regulations</b>	Financial Services (Exemptions) Regulations 2011
<b>FSA08</b>	The Financial Services Act 2008
<b>Functionary</b>	includes manager, administrator, trustee, fiduciary custodian, custodian, registrar, asset manager, investment adviser, auditor and any other parties fulfilling significant functions for the scheme
<b>Fund Administrator</b>	as defined under Section 26 of CISA08. A person appointed by the governing body of a scheme who undertakes the functions of “administration” (insofar as they are relevant)
<b>Fund Manager</b>	as defined under Section 26 of CISA08. A person appointed by the governing body of a scheme who is responsible —  <i>(a) for ensuring that the scheme is managed in accordance with the documents constituting the scheme and its offering document;</i>  <i>(b) for the conduct of the administration of the scheme;</i>  <i>[the rest of the definition is not relevant to Exempt or Exempt-type Schemes]</i>
<b>Fund Services Team</b>	the Supervision team which supervises primarily Class 3 Licenceholders and the associated schemes
<b>Governance</b>	means, in relation to scheme, “ <i>a framework for the organisation and operation of funds that seeks to ensure that funds are organised and operated efficiently and exclusively in the interests of fund investors, and not in the interests of fund insiders</i> ” (source IOSCO)
<b>Governing Body</b>	means a person or body of persons responsible for the general supervision of the affairs of a fund (and is as defined under the CISA08)
<b>IOMWFSA</b>	the Isle of Man Wealth and Fund Services Association

<b>Licenceholder</b>	a regulated entity licensed under section 7 of FSA08
<b>Regulated Activities Order</b>	Regulated Activities Order 2011 (as amended)
<b>Relevant person</b>	means a person carrying on business in the regulate sector which is included in paragraphs 2(6)(a) to (t) of Schedule 4 to the Proceeds of Crime Act 2008
<b>Rule Book</b>	The Isle of Man Financial Services Rulebook 2016
<b>Scheme</b>	Collective Investment Scheme (as defined under the CISA08); the word “fund” is used interchangeably with “scheme”

## 1. Introduction

### 1.1 Thematic Feedback

We issue thematic feedback to explain the findings of review work undertaken across a sector or a sample of entities within a sector in relation to a specific topic. The feedback summarises what we found in terms of good conduct and conduct which requires improvement to meet the regulatory requirements.

We encourage regulated entities to consider all thematic feedback which is relevant to their activities and to critically assess whether there are areas in which they can improve their regulatory compliance in line with the thematic feedback.

Thematic feedback has the same status as regulatory guidance<sup>1</sup>.

### 1.2 Purpose of this Thematic Review

Functionaries to Exempt and Exempt-Type schemes can be traditional fund managers and administrators whose central business is providing services to schemes, and Trust and Corporate Service Providers whose central business is not providing services to schemes. These different types of regulated entity are licensed under the provisions of the FSA08 and are referred to as "Licenceholders".

The purpose of this document is to provide feedback about the Authority's approach and expectations with regard to the supervision of Licenceholders that provide services to Exempt and Exempt-type schemes. It also serves as a reference document to be considered by those providing such services, and those considering applying to provide such services.

### 1.3 Regulatory Objectives relevant to this Thematic Review

Two of the Authority's regulatory objectives are:

- the reduction of financial crime; and
- the maintenance of confidence in the Island's financial services ..... through effective regulation, thereby supporting the Island's economy and its development as an international financial centre.

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<sup>1</sup> The Isle of Man Financial Services Authority issues guidance for various purposes, including to illustrate good practice, to assist relevant persons in complying with legislation and to provide examples or illustrations. Guidance is, by its nature, not law, however it is persuasive. Where a person follows guidance this would tend to indicate compliance with the legislative provisions, and vice versa.

To meet these objectives we:

- regulate and supervise Licenceholders providing regulated services to Exempt and Exempt-type schemes (Class 3(11)/(12));
- regulate and supervise schemes within the meaning of CISA08; and
- maintain and develop the regulatory regime.

Licenceholders are required to implement adequate arrangements when providing services to Exempt and Exempt-type schemes, and to establish and maintain appropriate policies and procedures to comply with the applicable regulatory requirements.

#### **1.4 Elements of our Strategic Plan relevant to this Thematic Review**

Two of the Key Principles outlined in the [Strategic Plan 2018-2021](#), are particularly relevant to this review:

- We seek to understand the business of, and risks posed by, regulated entities: this allows us to prioritise our work, focus on what truly matters and take actions proportionate to the benefit received; and
- Regulated entities are responsible for managing the risks within their business. Our job is to design and advance a regulatory framework that promotes effective controls, good risk management and suitable disclosure; this is how we contribute to the soundness of our industry.

#### **1.5 The Thematic Review**

In 2018/19 the Authority undertook a programme of supervisory inspections to certain Licenceholders providing Class 3 (11)/ (12) services. During these inspections Authority Officers identified a number of common breaches / contraventions and issues which fall under the following areas:

- Lack of knowledge of the regulatory requirements including acting for Exempt and Exempt-type schemes without the necessary Class 3 licence permissions;
- Inability to demonstrate and evidence an appropriate level of knowledge of the schemes and services being provided to those schemes;
- Failures to review the operation of the schemes on an ongoing basis against the expected activities, including failure to review whether a scheme stayed within the legal parameters of the scheme and the regulatory requirements;

- Failures to consider and document the appropriateness of appointed functionaries and lack of appropriate functionary agreements;
- Failure to understand the application of the Code to schemes;
- Failure to risk assess and consider the appropriateness of each scheme under AML/CFT requirements;
- Failure to monitor AML/CFT compliance in relation to schemes;
- Failure to document the delegation of schemes' AML/CFT obligations;
- Governance failures and lack of knowledge of the Authority's Guidance on Governance of Schemes.

The Authority had also received a growing number of enquiries from Corporate Service Providers (Class 4 Licenceholders), requesting their licence permissions to be extended to include services to Exempt and Exempt-type schemes (the Class 3 (11)/(12) permissions).

The Authority also discovered, in a few cases, that Class 4 Licenceholders were acting for Exempt and Exempt-type schemes without the necessary Class 3 licence permissions.

Further information is contained in Sections 2 and 3 to this feedback.

## 2. Overview

Functionaries (managers, administrators, trustees, fiduciary custodians or custodians) in the Isle of Man providing services to Exempt and Exempt-type schemes are required to be licensed to conduct class 3(11) regulated activity under the [Regulated Activities Order](#) unless the activity falls under an exemption. A Class 3(12) permission is required to provide administration services to a person who is undertaking Class 3(11) regulated activity but is exempt from licensing by virtue of paragraph 3.2 or 3.6 of the [Exemptions Regulations](#).

An existing Class 4 Licenceholder is able to extend its licence to cover Class 3 (11)/(12) activity. The core business of these firms is to provide services to companies but they are also able to provide services to Exempt and Exempt-type schemes.

The Exempt scheme structure was intended as a vehicle for accommodating private arrangements in which shares, or units, are only made available to a closely-connected group of investors. In practice the structures are also used for tax planning and many have only one or two participants.



## 2.1 Scope

In 2016 and 2017 a number of high profile Isle of Man schemes failed. This resulted in thousands of customers losing the money they had invested and the failures generated negative publicity, which has been detrimental to the reputation of the Isle of Man.

Although the failed schemes noted above were Qualifying, Specialist and Experienced Investor funds (not Exempt or Exempt-type schemes), the issues presented challenged the Authority to consider its supervisory approach to **all** types of schemes.

The Fund Services team, part of the Banking, Funds & Investments (Supervision) Division was tasked with changing the approach to how the Authority supervises (both on and off site) Licenceholders providing services to schemes.

A mapping exercise was completed comparing the actual activities of the individual functionaries against the Authority's expectations for each of the different scheme types, including Exempt and Exempt-type schemes. This focused on the responsibilities of functionaries to schemes (including their oversight role), and the corporate governance of schemes (including the role of the governing bodies).

Supervisory meetings and inspections were used to gather further information and identify deficiencies and gaps in the oversight and services being provided.

### 2.1.1. Assessment

During inspections to those Licenceholders already providing Class 3(11)/ (12) services, or when assessing the knowledge of prospective Class 3(11)/(12) Licenceholders, the Authority considers the following:

- 1) Whether the meaning of a scheme under Section 1 of CISA08 and the requirements under Schedule 3 of CISA08 are met. Those providing Administration/Management services to Exempt schemes must ensure that a **scheme meets these criteria at all times**, not just at establishment. Also, during the course of supervision, the Authority may consider if other structures/companies that the Licenceholder is providing services to, fall into this definition.
- 2) The Manager/Administrator responsibilities under CISA08, that are applicable to all types of scheme (e.g. Section 5 and Section 6).
- 3) Requirements under the Rule Book that apply to Class 3 Licenceholders providing services to Exempt schemes (unless modified).

- 4) Policies or procedures applicable for Class 3 activity, to ensure compliance with CISA08, the Rule Book, and the Code.
- 5) Compliance monitoring processes for the Class 3 activity, to ensure compliance with CISA08, the Rule Book, and the Code.
- 6) Code compliance: a scheme (within the meaning of section 1 of CISA08) is included as a 'business in the regulated sector' under Schedule 4 of the Proceeds of Crime Act 2008 and is therefore subject to the requirements of the Code (as a 'relevant person').
- 7) Guidance issued by the Authority for schemes – this is applicable to all types of scheme and therefore should be considered by those providing services to Exempt schemes and Exempt-type schemes.

### 3. Findings

Authority Officers found a number of themes emerging in relation to the provision of services to Exempt schemes, and the Exempt schemes themselves.

#### 3.1 The Financial Services Rule Book 2016 (“Rule Book”)

1) The **Rule Book** has some **Class 3 specific rules**. Compliance with these rules was incorporated in the scope of the updated inspection approach. (Rules 6.53, 6.54, 6.56, 6.60, 6.63, 6.72.)

Observations:-

- Rule 6.54 – Observance of scheme particulars.

There was a lack of evidence to show how Managers and Administrators ensure their processes (operations) reflect the requirements contained in the latest scheme particulars. Administration / management was not always being undertaken in line with the scheme particulars, including calculations of fees, and production of audited financial statements. There was also no mechanism in place to review operational processes when scheme particulars were updated.

Out of date scheme particulars was a common problem. A reason given for this deficiency was that governing bodies and functionaries were trying to keep fees down. In the absence of these updates it is near impossible for the functionaries to

evidence that they are complying with the most recent offering document, and demonstrate that the scheme is operating as per the offering document.

The use of “multiple addendums” was also in evidence with no form of control. This can become unwieldy, and result in incomplete or wrong information being given to new and existing investors when they are making investment decisions, or the scheme operating outside of the latest offering and constitutional documents.

- Rule 6.60 – Requirement for a written functionary agreement.

The agreements that were in place did not accurately reflect the services being provided or operational practice. In a number of cases there was no difference in agreements for services provided under Class 3, and the services provided under Class 4 business. There was also no detail with regards to any delegated activities for the Exempt scheme’s compliance with the Code.

- Rule 6.63 – Contract notes.

Contract notes meeting all the criteria of Rule 6.63 must be issued promptly to the participants in a scheme after a transaction. In some cases no contract notes had been issued and in other examples they did not meet all the criteria required by the rule.

The observations noted above are also indicators of weak corporate governance practices and in the Licenceholder’s approach to compliance with regulatory requirements, including the adequacy of management and controls put in place.

## 2) **Rule Book:** 8.3 Management Controls, 8.6 Risk Management, 8.23 Functions of Head of Compliance

Rule 8.3 requires that a Licenceholder must establish and maintain appropriate internal and operational controls, systems, policies and procedures relating to **all** aspects of its business.

Rule 8.6 requires that a Licenceholder maintain controls for monitoring compliance with its policies. Rule 8.6(5) requires a Licenceholder to monitor the risks identified in the BRA and tie through to the CMP. In addition rule 8.23 (1) requires Licenceholders to have robust and documented arrangements in place for compliance and that these arrangements be monitored.

**Observations:-**

Policies and procedures were found to be lacking for key areas of Class 3 business. Checklists, while an “aide memoire”, are not procedures. Highly qualified or experienced staff, while a necessary precondition for good compliance, are not a replacement for procedures and these two must operate hand in hand.

Licenceholders had, in some cases, not distinguished between their Class 4 and Class 3 business relationships; therefore they had not identified the additional regulatory and operational risks of providing services to Exempt schemes in their Business Risk Assessment (“BRA”). They had also not identified any risks that were associated to the specific activity of the Exempt scheme(s) themselves. There was no compliance monitoring undertaken, or planned compliance monitoring, specifically covering the Class 3 activity.

**3.2 CISA08**

1) Section 5 of CISA08 states:-

***“5 Matters with which managers and administrators must be satisfied***

*A person must not act as manager or administrator of a scheme unless the person has taken reasonable steps to be satisfied that —*

*(a) the following persons are suitable to act in relation to the scheme in the manner envisaged —*

*(i) any promoter, governing body, manager, administrator, trustee, fiduciary custodian, custodian or asset manager of the scheme; and*

*(ii) any person proposing to carry out any of the roles mentioned in subparagraph (i)”*

The Authority places reliance on the fact that the Manager/Administrator would not act for the scheme if they were not satisfied that the promoter, governing body, manager, administrator, trustee, custodian or asset manager were themselves suitable to act.

**Observations:-**

As well as the lack of knowledge and understanding of the CISA08, there was also a lack of evidence held by the Managers/Administrators to support any considerations or decisions that had been made with regards to the functionary appointments.

The Authority found in some cases that no public domain searches had been undertaken by the Licenceholders when considering appointments to the schemes. These checks may have identified adverse media that should have prompted further information being sought.

### 3.3 The Code

Exempt schemes established under the CISA08, and functionaries engaging in regulated activity within the meaning of the FSA08 (including those that are exempted) are sectors to which the Code applies, and as such are 'relevant persons', both have responsibilities under the Code which must be complied with.

*Exempt scheme - its customers are the underlying investors into the scheme.*

The scheme must comply with all provisions of the Code. Activities and reporting under the Code, such as CDD and ongoing monitoring, may be delegated to functionaries such as the Manager/Administrator. The ultimate responsibility for ensuring the scheme's compliance with the Code is that of the scheme (the governing body).

*Fund Manager/Administrator – its customer is the scheme.*

The functionary must comply with all provisions of the Code in relation to their own activities and in relation to the scheme as delegate, with regards to the scheme's compliance with the Code.

The scheme (governing body) must understand and document what services the functionary to the Exempt scheme is (and more importantly is not) providing in relation to the scheme and its obligations under the Code. This should be considered as part of the BRA of the scheme itself, and when the Fund Manager/Administrator prepares its CRA of the scheme. It should also be documented in the functionary agreement between the scheme and the Manager or Administrator. It is important that the scheme is able to demonstrate how it complies and remains compliant with **all** applicable areas of the Code.

#### Observations:-

1) In a number of cases agreements between the Exempt scheme and the functionaries did not adequately document the delegation of the AML/CFT activity and how this was to be undertaken.

2) Fund Managers/Administrators had not adequately risk assessed the Exempt schemes as their customers and identified that the schemes themselves are "relevant persons" for the purpose of the Code. This meant they had not considered, or not evidenced their considerations, how those schemes were able to fully comply with the Code. In some cases it had been assumed that all or part of the AML/CFT activities of the scheme had been

delegated to the Fund Manager or Administrator, but this did not form part of the CRA. In one case no delegation had been considered at all.

3) Risk assessing the investors in the scheme - the underlying customers of Exempt and Exempt-type schemes range from retail individuals to more sophisticated individual investors and also corporate and institutional investors. Investments are also made through intermediaries. Some investors may pose higher risk or be politically exposed. These customers must be risk assessed accordingly as per the Code.

Some CRAs of scheme investors had not been as comprehensive as they should be, nor had they been adequately documented to demonstrate the basis for the assessment. Common issues included: not including all the risk factors per the latest version of the Code; non-completion of boxes in risk assessments; limited or no rationale for risk ratings; and lack of segregation when completing and signing off (accepting the customer).

4) Ongoing monitoring - in some cases, after the initial investment had been made into the schemes, no ongoing monitoring was undertaken, and a trigger event had also not resulted in a review of the information and documents held for customer due diligence (para 13 of the Code, previously para 9).

Some Licenceholders were not regularly reviewing CRAs (as required by the Code para 6 (2), previously 7 (2)), and the decision as to why this approach had been taken was not documented and evidenced (e.g. if using triggers only).

*NB. It should be noted that using a screening provider regularly does not cover all the requirements of Para 13.*

5) With reference to beneficial ownership and “acting on behalf of”, there was a lack of evidence of the rationale where it was determined that a customer of the scheme (for example a regulated intermediary) was not acting on behalf of others, and how the beneficial ownership has been considered and concluded, as required under Para 12 of the Code.

6) In some cases, AML/CFT procedures/policies with regards to compliance with the Code were updated but the checklists underpinning them had not been (or vice versa). In general Authority Officers observed a lack of continuity between documents.

7) Use of out of date Code legislation and referencing within documents was also evident. Some Licenceholders had not updated policies and procedures in a timely manner when there were changes to the Code.

### 3.4 Corporate governance of schemes

When undertaking inspections to licensed functionaries, Authority Officers' reviews highlighted corporate governance issues of the schemes themselves. Whilst these issues are not necessarily the responsibility of the functionary, they still need to be addressed and may impact the services to be / being provided by the Licenceholder to the scheme, and need to be considered as part of risk assessments.

#### Observations:-

1) Although there are waivers often documented in the scheme particulars, the process surrounding this is often not formalised. This can lead to insufficient evidence being retained, or an audit trail to support decisions made, by the governing body. These waivers need to be built into policies and procedures of the Licenceholder.

2) Conflicts of interest are not always being identified at board meetings of the scheme and Managers/ Administrators do not have a log of conflicts in order to effectively manage /administer the scheme.

3) Minute books are not always being maintained. The governing body is responsible for keeping its corporate documents and there must be adequate arrangements made. Where a Company Secretary is appointed these arrangements are clearer, but in "2006 Act companies" (with no Company Secretary requirement) the administration and control should be formalised and the appropriate arrangements made. The Administrator/ Manager must be able to access the minutes and accompanying documents at the request of the Authority.

4) Material decisions by the board are not always being adequately documented nor is supporting evidence being retained with the minutes.

5) It was noted that in some cases the boards of the Exempt schemes were not meeting on a sufficiently regular basis, appropriate to the size of the scheme and the connectivity of the participants.

6) Relevant guidance notes: "Corporate Governance of Schemes" and "2006 Act Companies as Schemes" guidance had not been evidenced as having been considered at all by the Class

3 Licenceholders, or the governing bodies of the schemes. Consequently, there was no evidence of any governing body self-assessments being undertaken against the Corporate Governance guidance note. This was despite the Corporate Governance of Schemes guidance note stating that “The Authority expects governing bodies of schemes to self-assess governance arrangements against the guidance on a regular basis and record the governing body’s approval of the assessment and governance arrangements”.

## 4. Good practice and areas of improvement

### 4.1 Scheme Particulars

Fund Managers/Administrators need to put in place procedures and controls to ensure that they are operating the scheme and undertaking their duties in line with the most recent published scheme particulars of the Exempt scheme.

Out of date information or areas of inaccuracy should be raised with the governing body of the scheme and addressed in a timely manner.

If addendums are used there must be controls put in place to ensure complete and accurate information is held and issued to investors on the scheme.

### 4.2 Functionary Agreements

Functionary Agreements should set out all the Class 3 services to be provided to the scheme. They should also, if applicable, cover any activity that the scheme has delegated to the Administrator/Manager in order to comply with the Code. The Authority expects this to be clearly defined, but that responsibility of compliance with the Code remains with the scheme’s governing body.

### 4.3 Policies, procedures and compliance

Class 3 Licenceholders should establish and maintain appropriate internal and operational controls, systems, policies and procedures relating to the services it is providing to the Exempt schemes. Licenceholders should also identify and manage operational and regulatory risks of providing services to Exempt schemes and also maintain appropriate procedures and controls for monitoring compliance with its regulatory obligations.



#### 4.4 CISA08 Suitability

To assess suitability of the functionaries/appointees, the Administrator/Manager should undertake standard due diligence (as required under the Code) and also look at experience, track record, regulatory status, review/ check for adverse media, and look at fees and any performance related incentives.

Evidence to support the assessment, findings and decision should be recorded. This should be done in advance of commencing services to the scheme or when there is a new functionary appointed. Licenceholders should also consider public domain searches and screening of the proposed appointees at establishment, and on an ongoing basis.

#### 4.5 AML/CFT

The CRAs undertaken on the underlying investors should take into account the wider factors contained in the BRA of the scheme.

*Risk assessing the scheme as a customer* - the functionary providing any services to a scheme should identify, as part of its CRA of the scheme, the provisions for compliance with the Code (by the scheme). If the functionary is not providing all the services to enable that Scheme to comply with the Code then they should be aware of who is undertaking those services and this should be documented. This should form part of the functionary's considerations for the CRA of the scheme.

There are no Code concessions available to Exempt or Exempt type schemes.

*Ongoing reviews and monitoring* - it is important that an appropriate framework for reviewing customer risk, and information, is in place. This is applicable for the Licenceholder with reference to the schemes that are its customers, and for the schemes and the underlying investors (the schemes' customers).

## 4.6 Corporate Governance

Class 3 Licenceholders and the schemes themselves should read the following guidance:

[Governance of Collective Investment Schemes](#) – *Guidance Note*:

The Authority expects governing bodies of schemes to self-assess governance arrangements against the guidance on a regular basis and record the governing body's approval of the assessment and governance arrangements. The Authority may ask to see such self-assessments as part of its normal supervisory processes. This process and evidence should also assist the Fund Manager/Administrator with its customer risk assessment of the scheme.

*The use of [Companies Incorporated under the Companies Act 2006](#) as collective investment schemes:*

The Authority considers that companies incorporated under the Companies Act 2006 are suitable for use as an Exempt scheme company, subject to the above guidance. The Authority has sought to ensure there is no material reduction in either investor protection or transparency in the information available to the public or the Authority by the use of these structures.