Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2014

Feedback Statement on CP78: Consultation on carrying out depositary duties in accordance with Article 36 of the AIFMD

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Introduction

1. On 7 March 2014 the Central Bank of Ireland (the "Central Bank") published Consultation Paper CP78 *Consultation on carrying out depositary duties in accordance with Article 36 of the AIFMD* ("CP78"). The closing date for comments was 30 May 2014 and 5 responses were received.

2. CP78 refers to the possibility, under Article 36 of Directive 2011/61/EU ("AIFMD"), for Member States to allow an authorised EU alternative investment fund manager ("AIFM") to market units of non-EU alternative investment funds ("AIFs") it manages to professional investors in their territory. It notes that this marketing is subject to a number of restrictions including *inter alia* a requirement that the AIFM ensures that one or more entities are appointed to carry out the depositary duties set out in Article 21 of AIFMD.

3. CP78 asked what requirements should apply to manage conflicts of interest where an Irish authorised fund administrator proposes to provide fund administration services and perform the depositary duties set out in AIFMD Article 21(7), (monitoring of cash flows of the AIF) and AIFMD Article 21(9) (oversight of AIFM operations), for a non-EU AIF for which it carries out fund administration duties.

4. The view of the Central Bank as set out in CP78 is that such conflicts will arise and they may be substantial. In order to address that concern certain requirements are proposed to be contained in the AIF Rulebook within Chapter 5 – Fund Administrator Requirements.

5. A summary of the responses received to the consultation together with Central Bank comments are set out below.

6. This Feedback Statement is published to promote understanding of the policy formation process within the Central Bank. The Central Bank is grateful to all parties who responded to the Consultation Paper and wishes to thank them for their time and effort.

Feedback on CP78

Authorisation requirements related to activities referred to in Article 36 of AIFMD: Article 21(7) – monitoring of cash flows of the AIF.

7. Two respondents consider that as fund administrators have been permitted, pre-AIFMD, to carry out cash reconciliations for the investment funds they provide fund administration services to, there should not be a requirement to carry out cash monitoring related duties in a separate subsidiary should they provide this service to non-EU AIFs when appointed in accordance with Article 36 of AIFMD.

8. One respondent considers that only specialist depositary entities should be permitted to provide all of the depositary duties referred to in Article 36.

Central Bank: The Central Bank notes that EU law makes a distinction between tasks which the AIFM must carry out and tasks which are obligations of the depositary. Cash monitoring is a depositary function and therefore should not be carried out by a delegate of the AIFM. It is to be carried out by the depository acting directly for the AIF.

Under Irish law, the Central Bank has an obligation to set out terms under which an AIF is administered which receives an authorisation in Ireland. In relation to such AIFs, we do not believe it to be appropriate for depository tasks to be conducted by a delegate of the AIFM. There is too much opportunity for conflict of interest.

However, in this case, we are considering the question of AIFs that we do not authorise - non-EU AIFs. Furthermore, an entity which specialised only in providing cash monitoring and/or oversight duties to such non-EU AIFs and did not also provide fund administration services, would not require authorisation by us. It is currently legal to provide such services from Ireland without authorisation.

We do not accept that pre-AIFMD practices are a reliable guide to good practices. Nor do we accept that what is allowed for cash reconciliations is what should be allowed for all AIFMD Article 21(7) and AIFMD Article 21(9) services. Therefore we reject the argument that we should allow this practice because cash reconciliations were once done by administrators. While we agree with the sentiment of the respondent who argued that only specialist depositories should provide such services, we have to have regard to the fact that that is not the law and it is beyond our power to make it the law. We can only have regard to the high level of potential for conflicts being taken on by a regulated entity, the fund administrator, in providing such services. Our legitimate role is to set constraints on the organisation of the fund administrator so that it takes on only a prudent level of risk and has internal organisation structures and practices aligned with those risks.

Authorisation requirements related to activities referred to in Article 36 of AIFMD: Article 21(8) – safe-keeping of the AIF assets.

9. Four respondents referred to the Central Bank's AIFMD Q&A in relation to Article 36 and had concerns in relation to that guidance. In particular there is disagreement with the following statement:

If an Irish entity proposes to provide the safe-keeping duties set out in Article 21(8) it must have authorisation to provide "custodial operations involving the safe-keeping and administration of investment instruments" under the Investment Intermediaries Act 1995.

10. Two respondents noted that entities authorised under the Central Bank Act 1971, the European Communities (Licensing and Supervision of Credit Institutions) Regulations or the European Communities (Markets in Financial Instruments) Regulations 2007 may provide safe-keeping services.

11. Three respondents challenged the view that the entities which carry out safe-keeping of AIF assets which are not financial instruments under Article 21(8)(a) of AIFMD (and are therefore "other assets") should require authorisation to carry out that activity. They consider that the Central Bank is not taking due account of the distinction made in AIFMD between financial instruments held in custody and these "other assets". In support of their position they argued that the "safe-keeping" duties applicable to these assets are limited to ownership verification and record keeping and are duties which funds administrators carry out routinely in the context of this type of asset. The safe-keeping role for these assets therefore could in their view be carried out within an existing fund administration firm with additional controls and procedures implemented to mitigate any conflicts of interest.

Central Bank: The Central Bank agrees that firms can hold an authorisation under legislation other than the Investment Intermediaries Act, 1995, which has the effect of authorising them to carry out safe-keeping-type duties. The Central Bank further acknowledges that MiFID firms may be authorised to carry out safe-keeping as an ancillary activity. The response in the Q&A had focussed on fund administration firms. This is a useful correction and the text will now be rectified.

The Central Bank notes that Article 2(1)(h) of the Investment Intermediaries Act 1995 ("IIA"), includes the following as an investment business service which requires authorisation:

(*h) custodial operations involving the safekeeping and administration of investment instruments;*

Custodial operations are not limited to the financial instruments referred to in Article 21(8)(a) of AIFMD. The "other assets" referred to in Article 21(8)(b) of AIFMD will include assets included in the definition of "investment instruments", which term is also defined in Article 2(1) of the IIA. That some assets of an AIF may fall outside the definition of "investment instrument" in the IIA is not sufficient to allow for safe-keeping to be carried out without authorisation.

It is also important to emphasise here that the safe-keeping of "other assets" is not merely a book-keeping exercise and detailed rules in relation to the safe-keeping of these assets are prescribed in the AIFMD Level 2 Regulation. In particular, Article 90(2)(c*)* includes a provision that *"the depositary shall ensure that there are procedures in place so that registered assets cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions and the depositary shall have access without undue delay to documentary evidence of each transaction and position from the relevant third party.*

Authorisation requirements related to activities referred to in Article 36 of AIFMD: Article 21(9) – oversight duties.

12. Respondents agreed that oversight duties should be carried out in a separate legal entity. However only one supported the proposed approach, to allow a fund administrator carry out this depositary duty in a subsidiary.

13. The majority of respondents including two industry bodies considered that oversight should be carried out by an entity independent from the fund administrator and two respondents suggested that only depositaries who carry out oversight as a core business function should be permitted to perform this duty under Article 36. One industry body considered that a non-depositary should be capable of being authorised by the Central Bank to provide oversight to non-EU AIF under Article 36.

Central Bank: The Central Bank takes note of the strong views expressed in relation to this issue and welcomes the focus on the need to ensure separation of functions between fund administration and oversight duties in respect of non-EU AIF marketed to professional investors in the EU.

As set out in the AIFMD Q&A however, oversight is not an activity which falls to be authorised under Irish legislation. The issue presented to the Central Bank is the extent to which authorised entities can carry out that activity when appointed by an EU AIFM. It is a matter for the EU AIFM therefore, first and foremost, to be satisfied regarding any appointments made in accordance with Article 36.

The Central Bank could prohibit authorised fund administrators from carrying out oversight duties where they provide fund administration services to the same AIF. However, we have not been convinced by the arguments put that it is necessary to prohibit a subsidiary arrangement in order for firms to satisfy us in relation to their internal arrangements, as required by the Investment Intermediaries Act, 1995.

While we think the potential conflicts of interest are high, we recognise that well managed group structures can manage such conflicts if there is a determination to ensure that matters identified in the course of such oversight are not suppressed. It would in our view be a serious matter in relation to the fitness of the senior management to whom such a subsidiary reports, if such issues were not dealt with as well as they would be dealt with by a separate depositary. Furthermore, were we looking at this question from the perspective of avoiding risks with the potential to damage investors, we would not facilitate this practice. However, we must have regard to the fact that investors have chosen to invest in non-EU AIFs. Furthermore, having regard to the role the Investment Intermediaries Act, 1995 imposes on us, we believe that with a subsidiary arrangement in place to make the separate reporting lines and senior management responsibilities evident and unambiguous, that it is proportionate to allow this arrangement and this arrangement only for the conduct of Article 21(7) and 21(9) duties by the Irish fund administrator. In that light we will proceed to amend the AIF Rulebook as set out in CP 78. We intend to review the operation of this rule after a suitable period.

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