CENTRAL BANK OF IRELAND ISSUES NEW GUIDANCE ON INVESTMENT BY DIGITAL ASSETS BY QIAIFS

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Asset Management and Investment Funds Alert

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On 4 April 2023, the Central Bank of Ireland (the Central Bank) published the 47th edition of its Alternative Investment Fund Managers Directive (AIFMD) Q&A document (the AIFMD Q&A), and in a significant development, the Central Bank has clarified the ability of Irish Qualifying Investor Alternative Investment Funds (QIAIFs) to invest in digital assets.

WHAT CONSTITUTES "DIGITAL ASSETS"?

The Central Bank considers digital assets to be assets that exist in digital form and attach ownership rights that depend primarily on cryptography and distributed ledger or similar technology, and the Central Bank has noted that the nature and characteristics of digital assets vary considerably. For the purpose of its updated AIFMD Q&A, the Central Bank considers digital assets to be ones that are based on intangible or nontraditional underlying assets.

RISKS ASSOCIATED WITH INVESTMENT IN DIGITAL ASSETS

In the context of digital assets, the Central Bank has noted that it considers that the most material risks associated with digital asset investment to include the following (nonexhaustive):

Liquidity risk

Credit risk

Market risk

Custody risk

Operational risk

Exchange risk

Risk of money laundering

Legal risk

Reputational risk

Cyber risk

When considering a proposed investment in digital assets, the Central Bank has stated that an alternative investment fund manager (AIFM) must understand (consistent with its obligations) the extent to which the risks mentioned above, as well as other relevant risks, are material to the investment. Furthermore, an AIFM must ensure it has appropriate risk management processes and procedures in place to manage any such risk and disclose such risks clearly in offering documents.

CRITERIA FOR INVESTMENT IN DIGITAL ASSETS

The AIFMD Q&A makes it clear that the Central Bank will permit a QIAIF to invest indirectly in digital assets subject to the criteria set out below being met. However, QIAIFs will not be permitted to invest directly until such time as it is demonstrated to the Central Bank that a depositary can meet its obligations under AIFMD to provide custody or safekeeping services to digital assets.

Where a QIAIF proposes to invest indirectly in digital assets, the Central Bank has stated that the following conditions will apply:

The AIFM must have an effective risk management policy to address all risks relevant to investment in digital assets. This must address, at a minimum, risk relating to liquidity, credit, market, custody, operational, exchange, money laundering, legal, reputational, and cyber.

The AIFM must carry out appropriate stress testing on the proposed investment in digital assets. The stress testing should be extreme yet plausible, reflecting asset price volatility of digital assets including the potential entire loss of value in the investment.

The AIFM must have an effective liquidity management policy in place that includes a sufficient suite of tools to enable the AIFM to manage liquidity events arising in the QIAIF.

The offering documentation of the QIAIF must contain clear disclosure in relation to the nature of the proposed investment in digital assets and must contain a clear articulation of the risks associated with that investment.

The QIAIF should assess the overall construction of its portfolio to ensure that there is an alignment between the redemption profile, the level of investment in digital assets, and the likelihood of illiquidity (both in normal and stressed conditions) in the types of digital assets invested in. In this regard:

Where a QIAIF proposes to invest up to 20% of its net asset value in digital assets, the QIAIF may be structured as having open-ended liquidity, provided that the portfolio as a whole is determined by the AIFM to be suitable for an investment fund providing open-ended liquidity.

Where a QIAIF proposes to invest up to 50% of its net asset value in digital assets, the QIAIF must have either limited liquidity or be close-ended.

INVESTMENT BY RETAIL FUNDS IN DIGITAL ASSETS

Owing to the risks associated with investments in digital assets, the Central Bank has made it clear that it is unlikely to approve a retail investor alternative investment fund proposing to have any exposure (either direct or indirect) to digital assets.

SUMMARY

The changes introduced by the Central Bank for QIAIFs are to be welcomed and are a positive development for the Irish funds industry. In keeping with the Central Bank's regulatory supervision of the funds industry in Ireland, it has been made clear that the Central Bank's approach in relation to investment in digital assets by investment funds will be kept under review and will continue to be informed by European regulatory discussions on the topic, with further changes possible as new information becomes available.

If you have any questions regarding any of the information contained in this document, please do not hesitate to contact any of the members listed below, who will be happy to assist.

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