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1 Key findings

The key findings of the thematic review are as follows:

- The Finnish depository market is highly concentrated (as at 30 November 2018):
 - o Depository services were provided by ten depositaries, two of which solely to alternative investment funds (AIF).
 - o Common funds' assets under management (AUM) amounted to €101.3 billion, 79% of which was held in custody by three depositaries.
 - o Alternative investment funds' AUM amounted to €19.3 billion, approximately 70% of which was held in custody by two depositaries.
 - o As a rule, depositaries provide their services only to a few of the main strategies under AIFM regulation (private equity, real estate, other, fund of funds and hedge)
- Personnel resources should be strengthened and automated supervision systems developed.
 - o The FIN-FSA was unable to verify the adequacy of personnel resources available for the activities; not all depositaries had people employed full time in depository supervisory duties.
 - o Some depositaries continue to perform supervisory duties involving large volumes of data to a significant degree manually. In particular, significant depositaries had acknowledged the need to develop efficient and automated systems to reconcile transactions.
- There remains some areas for development in the planning and implementation of the supervision by depositaries:
 - o Supervision plans: The supervision plans were not adequately based on the assessment of risks and did not in all respects indicate, for example, the planned supervisory actions and their implementation frequency.

- Supervision of subscriptions and redemptions: A significant proportion of depositaries failed to perform all duties related to subscriptions, such as the reconciliation of units. However, the majority of depositaries reviewed the processes of the management companies / alternative investment fund managers (AIFM) concerning the subscription and redemption of units on an annual basis.
- Supervision of valuation: A majority of the depositaries had adequate verification procedures, but the frequency of verifications performed by the depositaries varied greatly among the respondents.
- Monitoring of cash flows: A majority of the respondents monitored their cash flows appropriately and in line with the frequency required by regulation, i.e. daily.

2 Background of the thematic review

In January 2019, the FIN-FSA collected information from the depositaries of common funds and alternative investment funds (below “funds”) with a focus on the following themes:

- Nature and scope of depositary activities
- Organisation of depositary activities
- Planning of the supervision of the depositary
- Ongoing supervision by the depositary and its effectiveness in the following areas of supervision:
 - Supervision of subscriptions and redemptions
 - Valuation of the funds
 - Monitoring of the cash flows of the funds

The thematic review did not consider how depositaries keep custody of the funds’ assets or maintain records of assets that are not considered assets held in custody.

Key regulation applicable to depositaries¹ is largely based on EU regulation. The duties of a depositary are determined in detail in regulation. The safekeeping of common funds and alternative investment funds is largely subject to the same requirements.

The survey was sent to all depositaries operating or having plans to operate in Finland as a depositary for a common fund or an alternative investment fund. 12 operators responded to the survey, five of which were branches of a foreign EEA credit institution.

The depositaries were requested to submit information as at 30 November 2018, when two of them had not yet commenced operation. These two depositaries are intended to replace two currently active depositaries. In addition, one depositary has terminated its depositary activities in 2019.

In addition, FIN-FSA met the most significant depositary operators in April 2019 in order to discuss the responses provided to the thematic review.

¹The Mutual Funds Act (213/2019) and the UCITS Regulation (Commission Delegated Regulation (EU) 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries). The Act on Alternative Investment Managers 162/2014 and the AIFM Regulation (Commission Delegated Regulation No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision). Note! This document relies on terms based on the UCITS Regulation where there are differences between the various translations of the legal provisions.

3 Organisation of activities

3.1 Personnel resources

Key regulatory requirements

The starting point of regulation is that each fund has a depository, which must be located in the fund's home country.

The activities of the depository must be arranged in a reliable manner. The depository must take appropriate measures to ensure the management of risks pertaining to its activities, the effectiveness of its internal control as well as the continuation of its operation and regulatory compliance in all circumstances.²

A depository may not outsource its supervisory duties. A depository may only outsource the custody of financial instruments and other assets if the outsourcing meets all statutory requirements.³

A depository must seek to organise its activities so as to identify and prevent any conflicts of interests.⁴

FIN-FSA's findings

The FIN-FSA requested depositaries to provide descriptions and information on the organisation of the depository activities and its resourcing (personnel, systems) in order to review the organisation of the depositaries' activities against regulatory requirements. The responses demonstrated that depositaries allocate less than two man-years on average on their supervisory duties. In addition, some of the depositaries' supervisory activities are also conducted outside Finland.

According to the responses, three depositaries do not have any personnel engaged full-time in depository supervision, as supervision is conducted in addition to the personnel's other duties. In addition, as regards one depository, the FIN-FSA was unable to ascertain that the company employs any personnel working full-time in supervisory duties.

FIN-FSA's view

In the FIN-FSA's view, depositaries must have an adequate number of competent personnel in supervisory duties proportionate with the nature and scope of their activities.

The FIN-FSA considers that a depository relying on the supervisory efforts of less than two persons is very scarcely resourced with a view to the numerous and highly regulated duties of the depository. Where a depository has a significant market share, a considerable number of funds held in custody, or the underlying assets of the funds held in custody require special expertise, particular attention should be paid on the number and expertise of the personnel.

² Chapter 21, section 8(1) of the Mutual Funds Act and chapter 15, section 1 of the Act on Alternative Investment Fund Managers.

³ Chapter 21, section 5 of the Mutual Funds Act and chapter 15, section 5 of the Act on Alternative Investment Fund Managers. Requirements for the outsourcing of custody in chapter 21, section 5 of the Mutual Funds Act:

1) there is an objective justification for the outsourcing;

2) outsourcing is not carried out in order to evade the requirements provided in this Act;

3) the depository carefully selects the service provider, to which it intends to outsource a function;

4) the depository supervises the service provider, to which it has outsourced the safekeeping function, and reviews its operation on a regular basis.

⁴ Chapter 21, section 8 of the Mutual Funds Act and chapter 14, section 2 of the Act on Alternative Investment Fund Managers.

The reliable organisation of the activities of a depositary requires that the depositary employs personnel performing the supervisory duties belonging to the depositary as their principal task. In order to ensure operational continuity under all circumstances, the companies must also have effective deputy arrangements in place. The expertise requirements and any potential conflicts of interests with other duties must also be taken into account regarding the deputies.

A credit institution's branch is not an independent legal person, and therefore the transfer of supervisory duties to the credit institution's home country cannot be technically considered outsourcing; hence it is not directly subject to the restrictions imposed by regulation on outsourcing. However, regulation does require that the depositary of a Finnish investment fund is located in Finland.⁵ Therefore, credit institutions' branches must also consider that the branch must have adequate supervisory resources to independently conduct depositary activities in Finland. If depositary activities are conducted to a significant extent from the home country of the credit institution, it can no longer be considered that the depositary activities are conducted in Finland.

3.2 Independence of the depositary

Key regulatory requirements

In order to avoid conflicts of interests and ensure proportionate supervision, a depositary must be independent of the management companies whose investment funds it keeps custody of.

No person may at the same time be both a member of the management body of the management company and a member of the management body of the depositary. No person may at the same time be both a member of the management body of the management company and an employee of the depositary, nor a member of the management body of the depositary and an employee of management company.⁶

Where a group link exists between the management company and the depositary, at least one third of the members or two persons, (whichever is lower), on the management body shall be independent of the group. If the management company or depositary has another body than its board of directors or another management body in charge of the supervisory functions, the independence criteria apply to such body.⁷

Regulation concerning alternative investment fund managers does not impose equally detailed independence requirements to depositaries keeping custody of alternative investment funds.

FIN-FSA's findings on the independence of depositaries

The FIN-FSA requested companies keeping custody of common funds to report how they fulfil the requirement of independence concerning depositaries provided in Articles 21 and 24 of the UCITS Regulation. Six respondents keeping common funds in custody had a group link to a management company whose funds they keep in custody.

⁵ See chapter 20, section 1 of the Mutual Funds Act and chapter 14, section 1 of the Act on Alternative Investment Fund Managers.

⁶ See Article 21 of the UCITS Regulation.

⁷ See Article 24 of the UCITS Regulation.

The majority of the responses stated that the same people are not serving as members of the board of directors of both the depositary and the management company.

With the exception of one depositary, depositaries belonging to a group also fulfilled the requirement concerning an adequate number of board members independent of the group, even though not all respondents had reviewed independence in the extent required by regulation concerning investment funds.

FIN-FSA's view

The FIN-FSA considers the provisions concerning independence crucial from the perspective of the independent supervisory role of the depositary. Going forward, attention must be paid on this in the context of the risk assessment before entering into a depositary relationship. The FIN-FSA points depositaries' attention to the assessment of the degree of independence in circumstances where the depositary keeps custody of funds of a management company belonging to the same group, and it requires actions to be taken to fulfil the regulatory requirements.

4 Duties of depositaries

The depositaries were requested to describe briefly in their responses how they perform the duties provided in the articles of the UCITS Regulation⁸ and the AIFM Regulation⁹. Some of the depositaries supplemented the description by attached material, such as a process description.

4.1 Planning of supervision

Key regulatory requirements

Article 3(1) of the UCITS Regulation and Article 92(1) of the AIFM Regulation require that, at the time of entering into customer relationship, the depositary shall assess the risks associated with the nature, scale and complexity of the investment policy of the UCITS' and with the organisation of the management company.

As regards AIFs, the management company shall assess the risks associated with the nature, scale and complexity of the AIF's strategy and the AIFM's organisation.

Supervision procedures shall be devised according to these assessments and updated regularly.

FIN-FSA's findings

The FIN-FSA requested depositaries to describe the planning of the supervisory activities by the depositary and to submit the most recent supervision plan to the FIN-FSA.

⁸ Commission Delegated Regulation (EU) 2016/438 of 17 December 2015 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries

⁹ Commission Delegated Regulation No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

With the exception of one depositary, all depositaries submitted to the FIN-FSA a supervision plan consisting of one or more documents.

The FIN-FSA made the following observations on the supervision plans:

- The most common solution was to devise a separate supervision plan for common funds and another supervision plan for alternative investment funds.
 - o However, as a rule, the plans did not take the funds' special characteristics into account.
- With the exception of one plan, the supervision plans failed to indicate with party within the company is responsible for performing a given task.
- Half of the supervision plans were prepared at a general level and did not describe the concrete supervision process or its frequency of performance.
- A third of the plans failed to indicate when the plan had been adopted.
- A third failed to indicate whether the supervision plan had been updated regularly.

FIN-FSA's view

Regulation requires that the supervision plan is prepared on the basis of a risk assessment conducted by the depositary. The FIN-FSA points the attention of depositaries on the fact that they may not enter into a custody agreement before they have reviewed and documented the risks of the fund and the management company or AIFM managing it. When a depositary decides to enter into a custody agreement, the supervision plan for each fund must be based on a risk assessment by the depositary. The supervision plans must take into account the special characteristics of each fund and the consequent supervision needs. The plans should indicate how each supervision duty is performed and which party is responsible for performing it.

The FIN-FSA interprets that the requirement of regular updating of supervisory procedures means that the need to update the plans is reviewed at least on an annual basis with respect to each fund, and in circumstances where material changes take place in the operation of the fund. The FIN-FSA recommends that the plans indicate the date of preparation, any updates to the plans and the parties within the company which have participated in preparing the plan and in related decision making.

4.2 Duties regarding subscriptions and redemptions

Key regulatory requirements

Depositaries have the duty to ensure that subscriptions and redemptions of the shares of a fund are conducted in accordance with the law and the rules of the fund.¹⁰

In order to perform its duties, a depositary must ensure/check that:

- The number of fund units issued corresponds with the subscription proceeds received by the fund;
- Subscription orders are reconciled with subscription proceeds and that payments made by the investor have been received. Corresponding reconciliations must also be made in respect of redemptions.

¹⁰ See chapter 21, section 2(1)(1) of the Mutual Funds Act and chapter 15, section 3(2)(1) of the AIFM Act.

- The total number of units in the funds' accounts and the total number of outstanding units appearing in the fund's register are consistent.¹¹

The frequency of the depositary's checks shall be consistent with the funds' flow of subscriptions and redemptions.¹²

In addition, the depositary shall regularly ensure and check the subscription and redemption processes.

FIN-FSA's findings

The FIN-FSA requested depositaries to describe how and how often they check the subscriptions and redemptions of the funds.

According to the FIN-FSA's findings, depositaries check the regulatory compliance and effectiveness of the subscription and redemption procedures of management companies and alternative investment funds on an annual basis.

Based on the written responses, the FIN-FSA was unable to confirm that all depositaries perform all duties related to subscriptions and redemptions required by regulation, such as the reconciliation of the number of subscribed and redeemed units to the subscription and redemption cash flows in euro, and the verification of the total number of units in the funds' accounts and the total number of outstanding units appearing in the fund's register.

The FIN-FSA found out that there are significant differences across depositaries in the frequency of the checks required by regulation: the checks are performed on a banking-daily, weekly, monthly, semi-annual or annual basis. The differences were not always explained by the subscription and redemption possibilities allowed by the fund under supervision, but the responses suggested that the frequency of reviews varies by depositary.

FIN-FSA's view

Regulation requires that depositaries devise appropriate supervision procedures for each fund.

Regulation requires that the checks are performed with consistent frequency considering the funds' subscription and redemption flows. However, regulation does not require that these checks are performed daily, unlike the requirement concerning the monitoring of cash flows (see section 4.4). Therefore the FIN-FSA is of the view that there is no need to perform checks of subscriptions and redemptions more frequently than the fund is open for subscriptions and redemptions.¹³

However, if checks are conducted less frequently, the depositary must have a justification based on an assessment of the fund's risks. The justification must be documented for example in the supervision plan.

¹¹ Article 4 of the UCITS Regulation and Article 87 of the AIFM Regulation.

¹² Article 4 of the UCITS Regulation and Article 87 of the AIFM Regulation.

¹³ Note however that the cash flows related to subscriptions and redemptions must be reconciled on a daily basis.

4.3 Duties regarding the valuation of units

Key regulatory requirements

The depository has the duty to verify that the net asset value of a fund's units is calculated in accordance with the law and the rules of the fund.¹⁴

In order to fulfil this requirement, the depository must perform the requisite actions to verify appropriate valuation of the fund's assets either by sample-based checks or a comparison of the change in the fund's net asset value (NAV) to the change of the reference value. The frequency of the verifications by the depository must be consistent with the fund's valuation frequency.¹⁵ In addition, the depository shall regularly review the fund's valuation policies and procedures¹⁶.

FIN-FSA's findings

The FIN-FSA requested depositories to report how and how often they verify the valuation of the funds. With the exception of two funds, the FIN-FSA was able to confirm, based on the descriptions received, that the substance of the methodologies applied by the depositories was adequate. The verification methods include price checks concerning either the whole investment portfolio or spot checks of individual investments on a fund-specific basis.

Three depositories conduct verifications on a daily basis, two monthly, one quarterly and one semi-annually. Two depositories reported they perform supervision in connection with each valuation. Nine respondents review the fund's valuation processes on an annual basis.

FIN-FSA's view

Regulation requires that verifications are performed in a frequency consistent with the fund's valuation frequency. However, regulation does not require that these verifications are performed daily, unlike the requirement concerning the monitoring of cash flows (see section 4.4). Therefore the FIN-FSA is of the view that there is no need to perform verifications of valuation more frequently than the fund's NAV is calculated.

However, if verifications are performed less frequently, the depository must have a justification based on an assessment of the fund's risks. The justification must be documented for example in the supervision plan.

4.4 Duties related to the monitoring of cash flows

Key regulatory requirements

The depository must ensure that the fund's cash flows are monitored appropriately and that the subscription proceeds are received and cash assets booked in cash accounts.¹⁷

To perform its duty of monitoring cash flows, the depository shall, among other things, reconcile the fund's all cash flow movements on a daily basis or, in case of infrequent cash movements, when such cash flow movements occur.¹⁸

¹⁴ See chapter 21, section 2(1)(2) of the Mutual Funds Act and chapter 15, section 3(2)(2) of the AIFM Act.

¹⁵ Article 5 and Recital 5 of the UCITS Regulation and Article 94 of the AIFM Regulation.

¹⁶ Article 5 and Recital 5 of the UCITS Regulation and Article 94 of the AIFM Regulation.

¹⁷ Chapter 21, section 2(2) of the Mutual Funds Act and chapter 15, section 3(1)(2) of the AIFM Act.

¹⁸ Article 10(b) of the UCITS Regulation and Article 86 of the AIFM Regulation.

The depositary must review the process regularly, and review the results of the reconciliations and actions taken on the basis of the results.

FIN-FSA's findings

In the thematic review, the FIN-FSA requested depositaries to describe how and how often they reconcile the cash flows of the funds. The depositaries had opted for several different solutions in the reconciliation of cash flows: some reconcile cash flows, some reconcile account balances instead, and one depositary performs spot checks. Some have an automatic system for reconciliations, while others reconcile cash flows manually in Excel. Some depositaries had launched projects to develop their systems.

The majority of companies conduct supervision on a daily basis. Some depositaries, however, monitor cash flows less frequently than daily. The lower supervision frequencies than daily reported in the review were not based on the low amount of cash flows of individual funds, but the same process applied to each fund held in custody by the depositary.

FIN-FSA's view

Depositaries must have systems and procedures in place to reconcile the cash flows of the funds on a daily basis. The procedures must be appropriate and their preparation and implementation must reflect the nature, scope and complexity of the funds. The reconciliation of cash flows means that each transaction booked in an account is compared to the fund's accounting records. The reconciliation of balances or spot checks are not enough to satisfy the requirement of cash flow reconciliation, but regulation requires that the accuracy of cash flows must be confirmed entirely.

The FIN-FSA reminds that regulation requires depositaries to reconcile cash flows on a daily basis. However, where a fund does not have daily payments, reconciliations must be performed when there are cash flows. Hence, for example monthly reconciliation is not enough if the fund has cash flows more frequently than on a monthly basis.

4.5 Documentation of supervisory findings

Key regulatory requirements

A depositary keeping common funds in custody must perform its duties diligently, independently and expertly in the best interests of the investment fund and the unitholders. A depositary keeping alternative investment funds in custody must perform its duties independently, honestly, equitably and professionally in the best interests of the alternative investment fund and the investors.¹⁹

FIN-FSA's findings

The FIN-FSA requested depositaries to report in their responses any observations concerning the supervision of subscriptions and redemptions, observations concerning the supervision of valuation and any observations made in the context of the reconciliation of cash flows in the period from 1 July 2017 to 30 November 2018. As regards the observations, the depositaries were requested to report their number

¹⁹ Chapter 21, section 1(3) of the Mutual Funds Act and chapter 15, section 1(2) and (3) of the AIFM Act.

on a fund-specific basis, examples of the most significant observations and actions taken by the depositary due to the observations.

One of the depositaries reported observations on a fund-specific basis in all of the three topic areas. The majority of respondents did not report individual observations. Based on the responses or meetings held, three companies maintain a deviation report on the observations. Based on the responses, the FIN-FSA was unable to ascertain that other depositaries adequately monitor the observations made by them in supervision.

FIN-FSA's view

In the FIN-FSA's view, the documentation of supervisory findings is a prerequisite for the appropriate and effective performance of supervision. Documentation would be advisable to perform on a fund-specific basis, and the depositary should also document situations where there are no observations concerning a fund. If the reviews and verifications performed by the depositary do not generate any observations, the depositary must ensure that its supervisory methods are adequate.

5 Follow-up measures

The FIN-FSA requires that the depositary's board of directors or another party deemed appropriate by the company discusses the findings presented in this supervision letter in its meeting. The minutes of the meeting of the board of directors or a report by another appropriate party must demonstrate which conclusions were drawn on the basis of the supervision letter, which actions, if any, the company intends to take, and in which schedule these actions are to be performed.

A copy of the minutes or the report must be submitted to the FIN-FSA by 1 October 2019.

After receiving the reports by the depositaries, the FIN-FSA will monitor the effectiveness of the remedial actions taken by the depositaries. In addition, the FIN-FSA will consider potential follow-up actions.