9 December 2014

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AFME response to IOSCO Consultation Report: Principles regarding the Custody of Collective Investment Schemes' Assets

Dear Sirs,

This letter contains the response of the Association for Financial Markets in Europe ("AFME") to the IOSCO Consultation Report on Principles regarding the Custody of Collective Investment Schemes' Assets of October 2014

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information, visit www.afme.eu.

Yours faithfully,

The Association for Financial
Markets in Europe

Association for Financial Markets in Europe

Consultation response

IOSCO Consultation Report: Principles regarding the Custody of Collective Investment Schemes' Assets

9 December 2014

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on IOSCO's Principles regarding the Custody of Collective Investment Scheme's Assets. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

Our consultation response reflects the consolidated views of the three banking constituencies of the AFME membership, universal banks, global custodians and investment banks (including prime brokers).

Where appropriate, in developing our response, we have cooperated with the Association of Global Custodians, AGC.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

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Executive Summary

- We propose that IOSCO provide a set of definitions to conform the meaning of certain words and phrases used in the Consultation Report ("Report"); in particular, the terms "collective investment schemes" or "CIS", "custody", "custody services" and "custodian".
- The core of custody services, in our view, is the provision of safekeeping services (e.g., recording rights to securities), which may be accompanied by trade settlement services and asset servicing services.
- Segregation between an intermediary's own and the assets of its direct clients, combined with adequate reconciliation, should be executed at each level of the chain of intermediaries, to assure investor protection.
- We do not favour a mandatory client by client segregation of CIS assets throughout the custody chain, as it does not necessarily provide any greater protection in the event of the insolvency of a custodian or sub-custodian but increases complexity and costs that ultimately have to be borne by investors.
- The liability of a custodian towards the responsible entity is based on the national laws that regulate the delivery of the relevant services. It essentially relates to the risks that: (i) the custodian fails to comply with its contractual obligations; (ii) the custodian causes harm for which it is legally responsible outside of its contractual responsibilities; and (iii) the custodian or a person for whom the custodian is responsible takes the property of the client without a legal basis for doing so.

Preliminary statement to the response

As a preliminary matter, we suggest that IOSCO provide a set of definitions to conform the meaning of certain of the words and phrases that are used within the Paper. For example, the term, "collective investment scheme" or "CIS" can apply to a very broad set of arrangements, if care is not taken to define the concept. For the purposes of this response, we would like to specify our use of certain terms:

- We refer to a "CIS" to describe an investment fund that is structured with independent legal personality (such as a company), or a trust or contractual arrangement, in which investors have a unitised interest. Each jurisdiction should be free to integrate this definition into its existing laws in order to prevent overlapping definitions within a single legal framework.
- We distinguish custody of securities from special custody ("specialist custodian") of other assets (such as metal, wine, art considered in Question 4 and 16) and, we refer to "custody" and "custody services" to describe the core service of a custodian crediting securities to a securities account opened in its books for its clients; i.e., reflecting positions in securities held by the custodian as an intermediary for its clients. Although they are not essential to the determination that a particular service is a custody service, the crediting of securities to a securities account is sometimes also accompanied by the following services:
    - Settlement of transactions in securities on the instructions and for the benefit of the custodian's client;
    - Asset administration services, such as the collection of income or support for discretionary corporate actions; and
    - Other services may also be provided together with the custody service, such as the provision of financing.
- We refer to a "custodian" as the person who is charged (whether as a statutory, contractual or trust matter) to perform the custody services described above on behalf of the relevant CIS. Any other person to whom the custodian entrusts the assets that it is holding for its CIS client to perform the core custody service described above in relation to those assets (such that that person is treating the custodian as its client) is generally referred to as a "subcustodian". When referring to either a custodian or subcustodian, interchangeably, we use the term, "Relevant Intermediary." We do not include in the definition of a "Relevant Intermediary" a central securities depositary performing the roles described in paragraph 1.11 of the "Principles for Financial Market Infrastructures" issued by the IOSCO Committee on Payment and Settlement Systems in 2012; i.e., when they are not acting as an intermediary for a client, the fact that a central securities depositary offers securities accounts and may perform asset administration services does not make them providers of custody services, as we have used the term.

We note that many of the comments that have been set out in the Paper describe arrangements under the European Union's Alternative Investment Fund Managers Directive and Regulation (together referred to in this note as the "AIFMD"), as well as the Undertakings in Collective Investments in Transferable Securities Directive ("UCITS Directive"). The descriptions, while recognisable, do not always accord with the arrangements provided in that legislation; and so our response elaborates the requirements where additional points need to be made to give the full context for them, having regard to the questions raised in the Paper.

Response collaboration statement

To ensure that the principles developed by IOSCO can be applied effectively to the diverse operating models for custody that are found in different industry segments and in different regions, we have coordinated with the Association of Global Custodians to develop the responses to a number of questions where we have a common understanding of, and response to, the issues raised.

Questions

Q1. Do you have views on the recent trends identified above and are there any other relevant market developments that should be taken into account in developing the principles regarding the custody of CIS assets?

The following outlines the main differences in account structure that have developed within the market, together with an explanation of the nominee concept, which is now widely recognized in markets where the legal framework permits.

Custody holding structures

Securities are increasingly held in dematerialised or immobilized form. This means that the holding of an investor in a security is reflected in a book-entry account at a central securities depository, but either no physical certificate is issued or any physical certificate is held by a central securities depository; so that any transfer of such security is effected through book-entry and not through physical delivery of a certificate. However, some securities continue to be represented by physical certificates. As a result of the EU Central Securities Depository Regulation, within the European context these remaining physical certificates, with respect to shares traded on regulated, multilateral markets, are to be converted to dematerialised or immobilized holdings in the next few years.

Omnibus and segregated accounts

Across different countries, there are currently many different sets of legal, regulatory and operational requirements and needs that determine how Relevant Intermediaries can hold securities. There are two main types of account structures used: omnibus and segregated. An omnibus (or multiple beneficiary) account is a securities account in which securities that belong to multiple end-investors are held. Generally, a segregated account is a securities account in which securities that belong to a single end-investor are held. In some cases, a segregated securities account may be a single-beneficiary securities account. In other cases, a segregated securities account may hold securities on behalf of a specific category or sub-category of intermediaries or end-investors. The choice of account structures may reflect operational arrangements to ensure efficiency and safety: for example, a Relevant Intermediary may maintain accounts with another Relevant Intermediary which distinguish between clients who benefit from a particular double-taxation treaty and those who do not.

There are two fundamental principles driving the use of omnibus accounts, rather than the use of more segregated account structures. The first is the principle of simplicity, rather than complexity. The second is the principle of data uniqueness (i.e. the principle that data should be stored and maintained in one place only and not stored in multiple locations). Compared to the operation of multiple segregated accounts, the operation of one omnibus account is simpler and less complex. The operation of a single omnibus account involves the maintenance of one account, with one account name, one set of static data, one set of securities balances, and one set of securities movements. The operation of multiple segregated accounts involves, at a minimum, the maintenance of multiple accounts with multiple names, multiple sets of static data, multiple sets of securities balances, and multiple sets of securities movements. The risk of operational error grows with the complexity of account arrangements.

Nominee concept

The term "nominee" differs in interpretation across jurisdictions. We consider a nominee to be an entity which has no business other than having assets registered in its name. Custodians may register assets it holds in custody in the name of a nominee entity within the same corporate group as it. In jurisdictions in which this is permitted, the legal system may view the nominee as the legal owner of the assets, whereas the client will be considered as the beneficial owner of the assets. This structure provides a further degree of separation between the custodian and the assets because the assets are not in fact registered in the name of the custodian itself.

Other

Another legal structure for securities intermediation is holding the securities in the name of specific clients in accounts operated by the Relevant Intermediary. Most continental European jurisdictions don't know the legal concept of trust and nominee or street-name; accordingly, the principles should recognize that there are different legal structures for securities intermediation.

Q2: What is your understanding of the role of custodians with respect to CIS assets?

The role of a custodian is described in 'The preliminary statement to the response'.

The differences between the types of entities providing custody services for CISs should be highlighted. In the main, Intermediated Securities can be held for a CIS by a custodian who functions as:

(a) a domestic custodian;
(b) a global custodian; or
(c) a prime broker.

A domestic custodian is a custodian who is appointed to provide custody services for a single market. A global custodian is a custodian who is appointed to provide custody services for a plurality of markets. A prime broker is a service provider or counterparty who typically provides financing services for alternative investment funds and, as an ancillary service, provides custody services (typically, core custody services without additional settlement or asset servicing obligations).

In relation to most funds marketed in the EU, the current model is that a single eligible institution is responsible for both the custody of a CIS's securities and for certain supervisory functions (i.e., providing oversight with respect to certain activities of a CIS or its responsible entity). In some circumstances, the latter are undertaken by specialist firms, while custody is delegated to a global custodian or a prime broker, as appropriate. Such an arrangement is described in EU terminology as a "depositary" appointment.

The appointment of a third party custodian (i.e., a third party with respect to the investment appointment given by a CIS to a fund manager or an investment advisor) provides a level of independent scrutiny that can identify and promote the rectification of issues that arise. By building policy around this point, investors have been given reassurance that their contributions to collective investment schemes will not be misused; or, if they are, then such problems will be detected and addressed appropriately. It is the responsibility of the responsible entity to determine whether in the context of the CIS, a single custodian would be beneficial.

Q3: What is your understanding of the term 'segregation' in relation to the safekeeping / custody of CIS assets?

Our understanding of the term 'segregation' is that of an act of separation or setting apart. A segregated account in relation to custody services for CIS assets is an account that is opened so that it can be used to separate the CIS's assets from other assets held by a Relevant Intermediary; in particular, from proprietary assets of the Relevant Intermediary.

Q4: Are there any special considerations or operational issues when holding non-standard assets such as physical commodities (e.g. gold bullion), financial derivative instruments, private placements, wine, arts etc.?

Yes, in as much as specific requirements have to be considered for safekeeping physical non-standard assets to mitigate specific risks to which such non-standard assets may be exposed; e.g., the risk of theft of gold bullion can be mitigated by special vaults and security transport facilities, while the risk of inadequate atmospheric conditions for wine or art objects can be mitigated by bespoke and specialised storage facilities. As outlined in Chapter 3 – Key risks around the custody of client assets, services provided by specialist custodians may be required.

Some typical challenges associated with the custody of non-standard assets are below:

(a) physical deterioration, movement or destruction;
(b) multiple claimants of ownership (in the absence of a CSD, registrar or other robust third party record);
(c) shallow markets, including difficulty of valuation and illiquidity;
(d) improper liens;
(e) being the subject of security or charges, which may or may not be registered.

OTC derivative instruments and private placements are deemed outside the scope of custody arrangements (please also refer to response to question 6)

Q5: Should there be specific regulatory requirements for holding non-standard assets?

No, as it is for the responsible entity of CISs that include or specialise on non-standard assets to mandate specialised custodians by considering the specific risks to which such non-standard assets may be exposed.

Q6: Should additional consideration be given to the treatment of derivative instruments, collateral arrangements, etc., and, more in particular, to the role of custodians in this regard? If yes, what special issues should be addressed?

There is no need for consideration of regulatory requirements with respect to derivatives contracts, since they are not susceptible of custody. Derivative contracts are simply bundles of contractual rights and so there is no "asset" capable of being held.

With respect to collateral, when the custodian of a CIS receives it for the account of the CIS, then the arrangements for holding it will depend upon the nature of the property. If it takes the form of Intermediated Securities, then essentially the same approach as for other securities holdings of the CIS will apply. If it takes the form of physically-held assets (such as art or wine), then the arrangements described in our response to Question 4 would apply. If it takes the form of cash,

then the approach will depend upon whether the Relevant Intermediary is a bank which is capable of accepting deposits and which does accept it as a deposit or some other arrangement has to be made with a bank which will do so.

A distinction should be drawn, however, between collateral received by a Relevant Intermediary for the account of a CIS and collateral delivered by a CIS to a third party – such as a counterparty or broker to the CIS, or a collateral agent who is providing collateral management services to them. Once the collateral is delivered to a third party, it is outside the control of the CIS's custodian, and so the custodian is no longer responsible for it.

If Intermediated Securities are delivered to the Relevant Intermediary under a title transfer collateral arrangement, they are outside of the scope of the Relevant Intermediary's responsibilities as custodian; i.e., it cannot and does not perform custody services in respect of such assets, until they have been returned to its custody network for the account of the CIS.

Q7: To what extent or under what circumstances should administration / ancillary services form part of the role of a custodian? What are the benefits of having a custodian perform these services? Are there other ancillary services that are critical to the operation / function of a CIS?

While ancillary services (for example: fund administration; transfer agency; securities lending; foreign exchange; treasury services; or financing) may be provided by the same entity as the custodian, they are distinct from the role of the custodian as a provider of custody services.

The benefits of a custodian performing these services include:

(a) the ability to leverage the operational and technical platform of the custodian to process data more efficiently, including synergies between different functions that might otherwise duplicate activities or systems; and

(b) the ability to obtain a more holistic view of the activities of a CIS or its responsible entity, facilitating the identification and remediation of issues that might arise due to, for example, operational errors.

Q8: Do you agree with the risks presented above? Are there any other key risks associated with the custody of CIS assets?

No, there are no additional key risks.

Q9: Would there be merit in requiring the appointment of a single custodian in order to have certainty over who is ultimately responsible for safekeeping all CIS assets within a given CIS?

The responsible entity evaluates and appoints the custodians for a CIS and should be able to determine whether a single custodian or multiple custodians is most appropriate to meet the needs of the CIS.

Q10: Should the custodian segregate assets, only between its own and CIS assets, or should it segregate assets through individual, separate accounts for each client?

Segregation between a Relevant Intermediary's own assets and CIS assets for each of its direct clients, combined with adequate reconciliation, should mandatorily be executed at each level of

the chain of intermediaries. As described above in the response to Question 1, the decision to provide individually segregated accounts, separating the records of the assets of individual clients, at a sub-custodian level, should be a commercial question only, as it introduces additional complexity into the account structures and therefore increased operational risk.

Q11: Should the rule of segregation apply throughout the custody chain, i.e. through the levels of delegation to sub-custodians?

We do not favour a mandatory end-client-by-end-client segregation of CIS assets throughout the custody chain, as it does not necessarily provide any greater protection in the event of the insolvency of a custodian or sub-custodian but increases complexity and costs; in particular, in the context of complex elective corporate action events. These costs will ultimately have to be borne by the investors of the relevant CIS. However, as set out in our response to Question 10, above, we do favour segregation between proprietary assets and client assets at each level of Relevant Intermediary.

Q12: Should the requirement of proper segregation be combined with an additional requirement of the recognition of the segregation at custodian or sub-custodian level in the event of the insolvency of the custodian or the sub-custodian?

The segregation requirements considered in Questions 10 and 11, and recognition of segregation in the event of the insolvency of the custodian or sub-custodian, aim at ensuring protection of investor assets. One of the ways to achieve this would be to require custodians to segregate client assets from their own, proprietary assets, as discussed before; however, it is also understood that even a complete segregation of assets throughout the chain of custodians won't necessarily provide full asset protection, if insolvency laws, applicable to each intermediary in the chain, are not effective to exclude client assets from the liquidation estate of the Relevant Intermediary.

If local laws ensure that the assets of all clients of the Relevant Intermediary can be identified as belonging to such clients at any time, and if they provide that client assets cannot be included in the liquidation estate of the Relevant Intermediary, then the expectation is that client assets will be properly segregated, provided that any required formalities are complied with. Omnibus account arrangements that meet these conditions should be just as effective as segregated account arrangements.

Given that the probability of segregation being effective depends, among other things, upon the effectiveness of domestic legal systems, it should be a matter for the responsible entity to determine whether the conditions of any given jurisdiction are suitable for investment by or on behalf of the relevant CIS.

Q13: Are there any other conditions that should be considered when a CIS uses self-custody?

No, we do not propose any further conditions to be considered.

Q14: Do principles 1 to 5 adequately address the key risks associated with the safekeeping of CIS assets?

Yes.

Q15: Are there any other selection criteria that may be relevant for the proper selection and appointment of a custodian?

Yes, please also refer to the response to Question 4.

Q16: Should additional consideration be given to the selection of specialist custodians? If so, what factors should a responsible entity take into account when selecting a specialist custodian?

We understand a "specialist custodian" to be the provider of warehousing or safe custody services for property other than Intermediated Securities, such as artwork or wine. When a CIS is the owner of such property, which it wishes to entrust to the care of a custodian, then the availability of specialist services will be relevant, since such property requires specific atmospheric conditions to maintain its integrity (and, therefore, its value). Whether and how any custodian will make available such services is, however, properly a commercial matter between the CIS and the custodian. The factors that will be relevant could include:

(a) the suitability of facilities for the relevant property;
(b) the risk of loss due to environmental factors, fire, theft, and so on, and the allocation of risk between the CIS and the custodian (including the availability of insurances); and
(c) the methods of identifying the ownership of the relevant property, to ensure that the relevant law will recognise its segregation from the property of the custodian and any other customer of the custodian.

Q17: What should be the scope of the custodian's liability to the responsible entity as its client? What should be the sub-custodian's liability to the master custodian or responsible entity (if any)? And what are the appropriate limitations of liability, if any?

The liability of a custodian towards the responsible entity is not an abstract concept, but based on the national laws that regulate the delivery of the relevant services. There is nothing unique about custody services from the standpoint of the relationship between the customer for and the supplier of them, when compared to other services which are largely operational and involve an 'agency' style arrangement. The fact that the customer is a CIS or its responsible entity does not change that analysis. If we take the essential features of the custody service, then the main risks that the client is exposed to are:

a) The risk that the custodian fails to comply with its contractual obligations, including the standard of performance it has committed to meet.
b) The risk that the custodian causes harm for which it is legally responsible, outside of its contractual responsibilities (for example, under the law of obligations in many countries or the laws of tort or agency in common law countries, remedies are provided which do not depend on the breach of a contractual term, as such).
c) The risk that the custodian or a person for whom they are responsible takes the property of the client without a legal basis for doing so.

There is no need to try to settle principles for liability (including with respect to standards of liability or the extent of liability) that can apply universally, where there is an existing national

framework to ensure that there are appropriate remedies to right wrongs that fit into these categories.

Questions of liability and remedies are sometimes raised in a one-sided way, but the commercial relationship between a custodian and its client normally allocates risks by taking into account the harm that a custodian is exposed to, as well. It should be remembered that, due to the character of custody services, the custodian is exposed to a range of risks by its client. As a rule, the custodian acts on the instructions of its client in the settlement of transactions, transfer of securities or cash, execution of discretionary corporate actions, provision of information to authorities in relation to the transactions of its client or the extent of their holdings for the purpose of assessing concentration limits, and so on. Accordingly, if the client instructs the custodian to act in a way that contravenes the rights of third parties, applicable laws or regulations or market rules, then the custodian may be exposed to sanctions, incur costs or be exposed to financial losses as a result. Custodians can even face costs and incur losses through the simple act of holding Intermediated Securities in their accounts, if there are tax levies or third party claims that are addressed to them or their subcustodian because of their status as the registered holder of an Intermediated Security.

The position of a subcustodian towards the custodian appointing it is fundamentally no different to that described above.

It should also be kept in mind that the decision to make an investment in a particular asset or market carries with it (and the investor therefore properly bears) risks associated with more than the movement of the market price of the asset, including without limitation:

(a) the risks of relying upon local market infrastructure;

(b) the risks of legal systems not functioning as expected; and

(c) the risks of official or unofficial corruption.

The misallocation of risk carries with it, not only potential costs, but also consequences that cannot be foreseen entirely. For example, the transfer of risks to custodians, which are properly borne by a CIS or its responsible entity, could potentially create an incentive for improper risk-taking by the CIS or its responsible entity. The best way to ensure that there is an appropriate allocation of risk is for the parties to negotiate written contracts that document their respective responsibilities for certain risks, having regard to available risk-mitigation measures and the overall balance of risk and reward.

Q18: Are there any other steps that the responsible entity can take to ensure proper monitoring of its custodian? Are there any other steps the custodian can take to ensure proper monitoring of the sub-custodians?

The responsible entity for a CIS is typically under a contractual, statutory or trust obligation to exercise all due skill, care and diligence in the selection, appointment and periodic review of the custodians appointed by it. Factors for it to take into account commonly include: (i) the expertise and market reputation of the custodian; (ii) any local legal or market practices related to the holding of the safe custody assets that could affect clients' rights; (iii) the custodian's arrangements for holding and safeguarding the assets; (iv) its performance of its services measured against its contractual obligations; (v) its capital or financial resources and credit rating; and (vi) any other activities undertaken by the custodian and, if relevant, its affiliated parties.

Provided that the above is complied with, we believe that no other additional steps are required for the responsible entity to ensure the proper monitoring of its custodians.

The custodian, however, should monitor the performance of its sub-custodians by complying with similar requirements in relation to the responsible entity. Each custodian should have a written agreement with each sub-custodian, which provides for the custodian to be able to receive information appropriate to the services being provided by the relevant sub-custodian at a frequency and in such a manner as is appropriate in the circumstances. Such information should include detail around the practices of holding the assets, how such holdings are reflected in its books and records, and its account naming practices.

Q19: Do principles 6 to 9 adequately address the key risks associated with the appointment and monitoring of CIS custodians and sub-custodians?

Yes, we agree that the principles 6 to 9 adequately address the key risks associated with the appointment and monitoring of CIS custodians and subcustodians.