



AFME Prime Brokerage Committee Response to ESMA Consultation Paper (ESMA/2011/209) on Draft Technical Advice to the European Commission on Possible Implementing Measures for the Alternative Investment Fund Managers Directive

To: ESMA
Date: 13-09-11

Introduction and Structure of Response

On behalf of the Prime Brokerage Committee of the Association for Financial Markets in Europe (AFME¹), we hereby respond to your 13-07-11 Consultation Paper (CP) on ESMA's draft Technical Advice to the European Commission (EC) on possible implementing measures for the Alternative Investment Fund Managers Directive (AIFMD).

In our response, we firstly set out our general comments on the CP. Against this background, we then respond to specific advice, questions and/or explanatory text in the CP where we consider it appropriate to do so. In the latter context, our comments are accordingly focused on the delegation of AIFM functions and on the depositary function.

We note that a separate response to the CP has been prepared and will be submitted by an AFME working group comprised of securitisation market participants. That response is focused on securitisation-specific points raised in the CP.

We stand ready to provide further detail on any of our comments if ESMA would find this helpful. In any event, we look forward to continuing to work with ESMA towards clear and appropriately framed AIFMD Level 2 measures.

Yours sincerely

Christian Krohn
Secretary to AFME Prime Brokerage Committee

General Comments

Directive or Regulation

We note that the CP does not address the issue of whether the implementing measures should be executed by directive or regulation. While not included in the EC Request for Technical Advice, this question was raised by CESR in its 03-12-10 Call for Evidence on Implementing Measures on the AIFMD. We continue to believe that the appropriate form of instrument for the implementing measures is the directive. In particular, in relation to the depositary aspects of the implementing measures, material differences in national legal regimes pertaining to proprietary

¹ AFME, the Association for Financial Markets in Europe, promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA). For more information, visit the AFME website, www.AFME.eu.

rights, insolvency law and the settlement and title transfer mechanics present significant challenges in adopting legislation which would be effectively applied in all regimes. We therefore feel that some degree of flexibility for national securities regulators to interpret and apply the legislation would be appropriate. If the AIFMD were implemented by regulation and not by directive, national regulators/legislators would be denied the possibility of 'interpreting' the standards set by the AIFMD and the implementing measures according to local law and/or market practice. For these reasons we believe directive(s) would be the most appropriate vehicle for implementing measures in the depositary function area.

Comments on Draft Advice, Explanatory Text and Questions

IV.IX: General Operating Conditions - Possible Implementing Measures on Delegation

We are of the view that delegation of functions has in the past, and will continue, to provide flexibility for managers in the appointment of service providers with expertise in various areas, in turn providing benefit to investors, as well as affording suitable protections as set out below.

Q24: Do you prefer Option 1 or Option 2 in Box 65? Please provide reasons for your view.

We prefer Option 2 (an indicative, non-exhaustive list of criteria for justification of delegation) on the basis that this Option captures the principal objective benefits of delegation: investors obtain access to global: investment capabilities, trading capabilities and strategies managed from outside the EU. While the high-level principle approach of Option 1 may be explicitly more closely aligned with the equivalent requirement of the UCITS Directive, we do not consider Option 2 to be inconsistent with that Directive.

Box 66: Sufficient resources and experience and sufficiently good repute of the delegate

We submit that where the delegate is an authorised firm, the AIFM should be able to rely on the authorisation of the delegate and conduct such additional checks as are judged warranted in the circumstances and as are appropriate depending on the functions delegated.

Box 70: Type of evidence necessary for an AIFM to demonstrate its consent to sub-delegation

We believe that a written/durable medium should be required for an AIFM to demonstrate that it has consented to a sub-delegation. In contrast to the draft Advice, we submit that this consent should be permitted to be broad enough to encompass any appropriate delegation or sub-delegation; so that, e.g., there would not be a requirement for a AIFM appointed depositary to seek fresh approval for every change in delegation to sub-custodians within its sub-custody network.

Box 71: Criteria to be taken into account when considering whether a delegation / sub-delegation would result in a material conflict of interest...

The criteria to be taken into account when determining and addressing (via segregation) material conflicts of interest should be based on current rules (such as those of the FSA) and practice in money management and the recommendations of the Hedge Fund Standards Board. Disclosure of these risks should rest as the responsibility of the AIFM.

Box 73: Letter box entity

We note that, given the AIFMD expressly provides that some functions cannot be delegated and that liability rests with the AIFM who will also as a result of the Directive be subject to enhanced regulatory supervision and scrutiny, it is difficult to conclude that any AIFM will become a complete 'pass through' entity [CP paragraphs 45-47 notwithstanding]. We suggest that annual audits of AIFM which indicate that the AIFM has reviewed/monitored its delegation

arrangements should be sufficient to satisfy the authorities that the entity has not become a 'letter box'.

V.I.1.1. Depositaries - Appointment of a depositary - Particulars of the contract appointing the depositary

Box 74: Particulars to be included in the written agreement evidencing the appointment of a single depositary...

The list of particulars to be included in the agreement evidencing the appointment of the depositary is preceded by the requirement that the '*...agreement should include at least the following elements...*' The use of the term '*at least*' gives rise to uncertainty as to whether the list of minimum required particulars is exhaustive. We ask ESMA to clarify that the list of minimum requirements is exhaustive.

Explanatory text, paragraph 10

The Explanatory text on the minimum required content of the contract with respect to the termination of the contract is considerably more detailed than the draft Advice (Box 74, item 4). We ask ESMA to clarify the minimum required content of the contract as regards the termination of contract.

V.I.1.2. Depositaries - Appointment of a depositary - ESMA's justification for not providing a model agreement

We fully support ESMA's decision to not provide a model agreement. Depositaries will necessarily review and amend their own forms of agreement to comply with the new requirements imposed by the AIFMD, but they should also have the flexibility to take their own business models into account when doing so.

V.III.1 Depositary functions - Cash monitoring

Box 75: Cash monitoring – general information requirements

We agree with the approach taken by ESMA in requiring AIFMs to provide depositaries with the general information necessary to monitor cash movements.

We welcome ESMA's approach in clarifying that cash accounts may be held at third party institutions other than the depositary. As detailed/re-iterated in our comments to Box 76 and Box 77, we would ask that ESMA clarify that non-bank institutions, including clearing houses and prime brokers (investment firms) who hold cash on behalf of AIF/AIFM will be so permitted to hold cash.

The approach taken in Box 75 should be achievable. Many prime brokers currently provide information (including on the cash accounts opened and held by their fund clients as well as trade file information on transactions undertaken by such clients) directly to fund administrators (with the relevant consents from the AIF/AIFM). Assuming that appropriate arrangements can be put in place between the depositary and the relevant third party entities providing cash account information, and the AIF/AIFM provides the appropriate consents, the arrangements envisaged in Box 75 should be possible. We would suggest that it be made clear that the information required by Box 75, in particular the third bullet point, is provided on an ex post facto basis.

Box 76: Proper monitoring of all AIF's cash flows

Holding of AIF cash at non-bank prime broker

Referring to the draft Advice references (under both Option 1 and 2) to '*...another entity of the same nature...*' we would welcome clarification in the Advice that the provisions of Article 21(7) permit the holding of cash by a prime broker even where that prime broker is not a credit institution.

The AIFMD does not prohibit the AIF/AIFM opening accounts, which may hold cash, outside the depositary. Such cash may be held as collateral but may also be held to facilitate investment, trade settlement, corporate actions etc. In the event that the prime broker affords such cash client money protection in accordance with MiFID, it will be held with a client money bank account with a credit institution in an appropriately designated account in the name of the prime broker but for the benefit of its clients rather than in the name of the fund.

Nevertheless, Article 21(7) could be construed as only permitting banks to hold AIF cash, whereas in practice, cash is held with prime brokers (investment firms). We note that if AIF cash is treated as collateral, Article 21(7) would preclude a UK prime broker investment firm from offering client money protection as Article 21(7) would only permit cash to be held at a third party bank if it is held in the name of the AIF/AIFM/Depositary, whereas the client money process provides that these accounts are opened in the name of the investment firm on an omnibus basis for (unnamed) clients. Also, there appears to be an inconsistency in Article 21 7) which might be construed as precluding a non-bank EU investment firm from holding AIF cash but permitting a non-bank third country investment firm to do so. On this basis we therefore request that the Advice clarify that the reference to '*...another entity of the same nature...*' would include, for example, an FSA-regulated investment firm.

Issues raised by Option 1 requirement for ex ante authorisation regime and rationale for preference for Option 2 requirement for adequate procedures/processes

The Explanatory text (see paragraph 8 on page 150) for Option 1 envisages an ex ante authorisation regime for depositaries in respect of cash movements. We believe that such a regime would increase systemic risk significantly and drive up costs for AIFs.

Delivery Versus Payment (DVP) was developed as a settlement method to remove the risk of sending payment for securities to a counterparty without certainty that the purchased securities would be delivered. The DVP system is based on bilateral agreement that cash and securities simply cannot move unless both legs are freely available and able to exchange. There is thus no need to impose any prior control requirement as the risk that this would mitigate in relation to settlement is already mitigated by the fact of DVP. We would also point out that the DVP system is not based upon a trilateral architecture and the imposition of the depositary as a third party approver would require all participants in the securities settlement chain such as prime brokers, broker dealers, depositories, global custodians etc to develop and implement new systems architecture and processes. It is difficult to accurately estimate the cost of an exercise to completely overhaul the global settlement system but for each such institution it is likely to be many times greater than their current combined annual technology spend on existing settlement related activities. It is also extremely unlikely that market participants in non European jurisdictions such as the US and Asia would be willing to enter into such an exercise and/or incur such costs. This would ultimately increase risk for AIFs managed by European AIFMs as the ability to settle DVP with counterparties outside Europe would no longer be available. There are certain jurisdictions or transaction types where DVP is not possible and Free Of Payment (FOP) settlement is the only option. In these cases, cash or securities are sent and there is no certainty that the other leg will settle. While one could impose a depositary as an ex-ante control prior to sending the cash, this would not change the FOP risk to which the AIF is exposed.

Furthermore, in relation to settlement movements, whether DVP or otherwise, imposing a depositary as an ex-ante control where the depositary has the power to refuse to approve each

payment of cash is likely to actually increase the risk to the AIF and risk, within the system generally. The reasons for this are twofold: firstly, the sheer numbers of payments (over 100,000 cash movements each day) would be beyond the ability of depositaries to service as they are currently resourced, and secondly, because no matter what the depositary decides to do in relation to approving or not approving a settlement payment, the legal obligation of the AIF to make the settlement payment will exist before the depositary is aware of the payment. The depositary will have no power to alter that legal obligation which will be a matter of local and contractual law as between the AIF and its counterparty. All the depositary could ever do would be to delay payment or cause a failure, both of which would expose the AIF open to regulatory fines and/or contractual damages for late or non-performance. Given that normal operational processes require reconciliations and checks against transaction data which can result in changes arising from reconciliation breaks, reversal of funds transfers, etc; the depositary would also need to be in a position to handle operational changes occurring outside of its own processes in real time, which is not practical. From a systemic point of view, an ex-ante control authorisation regime for depositaries in respect of cash movements would increase rather than decrease the incidences of settlement failure within the system.

We believe that Option 2 provides a workable framework for cash monitoring without the unduly burdensome approach in Option 1 by establishing the requirement to have proper procedures in place for the appropriate information flows to ensure ex post facto monitoring of the AIF's cash flows. Option 1 would (as set out above) replicate or duplicate information flows unnecessarily and at considerable administrative cost. For example, the requirement in point 2 c) of Option 1 to provide all instructions simultaneously would be costly to achieve but would not put the depositary in a better position in terms of its ability to monitor cash flows on an ex post facto basis, and therefore seems unnecessary. Also (as set out above) many system flows which exist in the markets today do not operate such that the introduction of the depositary into the flow would be possible. Furthermore, we believe that the statement in paragraph 8 of the Explanatory text which notes that in the context of Option 1 "*the depositary could intervene immediately if it considers the cash flows inappropriate*" is not necessarily a correct assumption in law, and even with the simultaneous information flow, the depositary would not in fact be able to intervene in most cases. We therefore believe that as a legal as well as practical matter, Option 2 provides the most achievable and appropriate framework for the depositary's function.

Box 77: Ensuring the AIF's cash is properly booked

Referring to our comments above on Box 75 and 76, we re-iterate our request that the Advice clarify that cash may be held at a non-credit institution. Referring to the condition in the draft Advice that '*...the AIFs' cash is booked in one or more cash accounts distinct from the accounts where the cash belonging to the depositary or belonging to the third party are booked*', we comment that this requirement does not appropriately reflect debtor/creditor nature of bank accounts or scenarios where the Central Securities Depository (CSD) cash account is a single account in the name of the sub-custodian. In the latter cases that cash account may potentially contain: the global custodian's cash, the global custodian's clients' cash, and the global custodian's clients' clients' cash. Financial institutions holding cash on behalf of AIF or AIFM may be subject to national regimes, such as the client money protection regime specified by the FSA in the UK in its Client Money Rules. These rules require that cash held on behalf of clients of such financial institutions is pooled and held segregated from the financial institution's own cash and held at third party institutions. This cash is held in accounts opened in the name of the financial institution for (unnamed) clients rather than 'in the name of' the AIF or the AIFM on behalf of the AIF. It would seem a perverse result if the protection offered by regimes such as the FSA Client Money rules (whose aim is to protect the assets of the clients) were undermined by the requirement of the AIFMD to hold cash in accounts with designations in the name of the AIF or AIFM.

Q25: How difficult would it be to comply with a requirement by which the general operating account and the subscription / redemption account would have to be opened at the depositary? Would that be feasible?

We believe that, in most cases, it will not be practical for a general operating account to be held at the depositary. Most AIF/AIFM will need to be able to hold cash with their prime brokers or other financial institutions in order to meet their DVP settlement obligations for their general trading activity, meet margin calls with exchanges and clearing houses on an ongoing, trade-by-trade basis, and in some cases hold cash as collateral for derivatives and other transactions. It would not be practical for an AIF/AIFM to move cash from a depositary to the financial institutions which it uses to conduct its trading activity on an ongoing basis, and this could result in less timely settlement of transactions, as well as unnecessarily hampering the AIF/AIFM's ability to conduct transactions swiftly where necessary or appropriate. We believe such an approach would limit the ability of the AIF/AIFM to conduct its business efficiently and could result in increased settlement failure risk if cash movements for trades were not made in a timely manner. We do not believe that the holding of a general trading account at the depositary would offer a greater level of protection to the AIF/AIFM's cash: the depositary retains oversight of the cash movements.

Q26: At what frequency is the reconciliation of cash flows performed in practice? Is there a distinction to be made depending on the type of assets in which the AIF invests?

Most reconciliations are performed on a daily basis ex post facto.

Q29: Do you prefer option 1 or option 2 in Box 76? Please provide reasons for your view.

We believe that depositaries should be responsible for monitoring rather than controlling AIF cash flows. For the reasons detailed above (in relation to Box 76), we prefer option 2.

V.III.2 Depositary functions – Safe-keeping duties

Box 78: Definition of financial instruments to be held in custody – Article 21(8)(a)

We welcome the exclusion of financial instruments provided as collateral from the definition of financial instruments to be held in custody. Where assets are held as collateral and the collateral taker has possession or control of the assets then the assets should be considered as assets which are not required to be registered in a financial instruments account in the depositary's books under Article 21(8)(a) as the depositary will not have possession or control of the assets.

With respect to the categorization of assets as either Article 21(8)(a) or Article 21(8)(b) assets, we also note our view that if assets are held by a sub-custodian of the depositary then they will be Article 21(8)(a) assets even if that sub-custodian has a lien. This is because the depositary retains control - it appointed the sub-custodian and if it permitted a lien to be taken this is at its risk.

Q32: Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view.

We prefer Option 2 which does not unnecessarily fetter the right of the AIF or the AIFM on the AIF's behalf to use the assets of the AIF to its fullest extent. If the financial instruments of the AIF are registered or held in an account directly or indirectly in the name of the depositary (as suggested in Option 1), this would limit the ability of the AIF to use the assets as security for loans, margin or other purposes. Holding the assets for the account of the depositary may create imperfections in the ownership title to the assets, which truly belong to the AIF, not the depositary. The approach in Option 1 would seem therefore to fetter the ability of the AIF to use the financial instruments in whichever way it deems appropriate in the operation of its business, whether to use those assets as margin or security or having to re-register them in the name of

the AIF in order to be able otherwise to deal with them (depending on the type of asset). We also note that, in many settlement systems, financial instruments are held in 'street' or nominee-name arrangements, and that Option 1 would seem at odds with those systems.

We would welcome further clarification on aspects of Option 2, and in particular the text that follows Option 2 in Box 78. We believe there are some issues with the assertion that *'financial instruments...remain in custody when the depositary is entitled to re-use them whether that right has been exercised or not'*. In circumstances where a right to use financial instruments has been 'exercised', this will typically involve a full title transfer of securities (but only those in respect of which, the right has been granted) resulting in a change in ownership of those securities. No ownership right in those financial instruments is retained by the transferring party (although there will be a contractual right to have equivalent financial instruments re-delivered). The distinction in law is that in such circumstances, the financial instruments cannot be said to be held in custody for the AIF/AIFM on the AIF's behalf. We assume that the language: *'Further, financial instruments which comply with the definition set out above will remain in custody when the depositary is entitled to re-use them whether that right has been exercised or not'* is intended to clarify that if a depositary uses assets, it should still be required to be liable to return those assets as if it had held them in custody. However, we would suggest that this sentence be replaced by the following: *'Further, for financial instruments which comply with the definition set out above, if a depositary has exercised its right of re-use of such financial instruments, it shall still be required to ensure return of such financial instruments to the AIF as if they had been held in custody'*.

We would also welcome clarification on the meaning of the term *'temporary lending agreement'* and would suggest that *'lending agreement'* should be sufficient. In many jurisdictions, as with the right to re-use, 'lending' arrangements involve the full title transfer of financial instruments and we therefore agree that these assets can no longer be said to be held in custody. As far as these instruments being classed as 'other assets' for the purpose of Article 21(8)(b), we note that in such circumstances (for example under a standard Global Master Securities Lending Agreement), the 'lender' only has a contractual right to redelivery of equivalent securities and therefore the 'other asset' is only this contractual right, rather than any residual ownership interest in the financial instruments 'lent'. We therefore consider that assets which have been used pursuant to a lending agreement (or under any other form of total title transfer) would in fact not constitute 'other assets' because they would cease to be the AIF's assets entirely. We would query how in such a circumstance, the depositary would, e.g. verify the ownership of such assets.

Q34: How easy is it in practice to differentiate the types of collateral defined in the Collateral Directive (title transfer / security transfer)? Is there a need for further clarification of option 2 in Box 79?

From a practical perspective it should be clear from prima facie books and records evidence as to how particular collateral arrangements operate, and specifically whether they are title transfer or security interest collateral arrangements. Further, industry standard master agreements which would require the provision of collateral are generally clear as to which type of arrangement applies.

In general, we welcome the introduction of an exclusion from the definition of financial instruments held in custody of assets provided as collateral. However, we would sound a note of caution regarding the possible approaches outlined in Box 79.

We do not think that Option 1 is a workable approach. Limiting the specification of collateral arrangements only to title transfer collateral arrangements is much too restrictive and does not allow for the full range of structures by which an AIF/AIFM may provide AIF assets as collateral. Title transfer collateral arrangements is one (in the case of collateral arrangements with prime brokers, rare) way of providing collateral. Security financial collateral arrangements

are frequently used as the basis for AIFs to provide collateral to prime brokers and other counterparties. Examples of such arrangements include standard form prime brokerage agreements with most (if not all) of the leading prime brokers, New York law Credit Support Annexes, English law Credit Support Deeds, and certain other bespoke funding/transaction arrangements. In such arrangements, possession or control (or both) of the collateral (as contemplated under the Collateral Directive) will pass to the collateral taker, and so such collateral should not be regarded as held in custody by the depositary, for the purpose of the application of the safekeeping and related liability provisions of Article 21.

One key danger of restricting the reference to collateral only to title transfer collateral arrangements is that Depositaries may be forced to take liability for collateral arrangements where they have no control/possession of collateral, which in turn (on the assumption that Depositaries will not be prepared or able to accept that liability) may encourage unnecessarily a title transfer collateral approach. This would have a significant negative impact on AIFs and their investors - it would increase the credit risk of AIFs to prime brokers and other relevant collateral takers (collateral providers under title transfer collateral arrangements only have an unsecured claim for return of equivalent collateral, the actual collateral assets which have been provided are owned by the collateral taker and are available to its general creditors), meaning that AIFs lose the protection of insolvency-remote client asset status they currently benefit from where assets are provided under a security financial collateral arrangement; it would also make it more difficult for AIFs to take active participation in voting and other corporate actions relating to collateral assets (if such participation requires underlying assets to be held in the name or for the benefit of the AIF itself, re-registration and related alternative custody arrangements would be required, which would have operational complexities, and related negative timing and cost implications).

We see little difference in the drafting of Options 2 and 3. Option 2 refers to both security interest financial collateral arrangements and title transfer financial collateral arrangements (i.e. both types of permitted financial collateral arrangements as per Directive 2002/47/EC), but that is qualified by a requirement that the collateral taker have control or possession of the collateral. Given that this requirement is a fundamental pre-requisite of either sort of financial collateral arrangement this qualification seems to add little, barring a comprehensive and exhaustive analysis of the various types of security interest commonly available in the relevant jurisdictions. On that basis, Option 3 seems marginally the better of the two. We would however recommend that ESMA considers widening this exemption to include collateral arrangements which are not financial collateral arrangements (as defined), in order to allow greater certainty over equivalent arrangements existing outside the EU.

We are concerned however that either Option 2 or Option 3 could be interpreted so broadly as to include all types of possessory security interests available at common law or otherwise e.g. custodial liens or liens arising via a settlement system or CSD. Were that the case the consequences would be that **all** assets held in dematerialised form could be said to be 'collateral'; such a determination could have the perverse result of assets held in custody by persons acting as custodians not being regarded under the AIFMD as 'financial instruments held in custody', with consequent implications for the investor protection regime surrounding the loss of such assets. To solve this issue we would suggest that the exemption be qualified so as to refer only to financial collateral arrangements entered into by the AIF and/or the depositary with prime brokers and counterparties, or, alternatively to exclude from the exemption financial collateral arrangements entered into by the AIF and/or the depositary with persons providing safekeeping-only services.

Further we recommend that ESMA clarifies liability with regard to assets held as collateral, so it is clear that the liability regime for loss of any financial instruments held in custody shall not apply to such assets.

Box 80: Safekeeping duties related to financial instruments that can be held in custody

Referring to the paragraph 1.(a) requirement for financial instruments to be registered in segregated accounts, we believe that unless all assets which are subject to a security arrangement or right of re-use etc are excluded entirely from the definition of custody assets (rather than only where that right has been exercised) it does not seem possible to completely segregate the assets of the AIF in the way suggested (*'identified at all times as belonging to the AIF'*). For example, where assets are held in custody with an agent bank or clearing house, these are (generally speaking) held in the name of the financial institution (for example the prime broker) rather than in the names of the underlying AIF.

We are unclear as the meaning of the paragraph 1.(b) obligation to *'exercise due care...to ensure a high level of protection'*. This is a vague and potentially very high level of obligation without any real legal or regulatory precedent or established standard against which it could be judged.

Referring to the paragraph 1.(c) obligation to *'Assess and monitor...custody risks'* we believe that there should be some limitations on the liability of the depositary in circumstances where it has identified potential risks in a custody or settlement related situation and the AIFM nevertheless decides to proceed to transact. The depositary is not the directing mind behind the AIFM and should not therefore be liable for the actions of the AIFM where it has identified those risks. Similarly, where a depositary has exercised appropriate care and diligence in the appointment of delegates, it should not be liable for the negligence of such delegates in the proper performance of functions delegated to them.

The combination of paragraphs 1.(b) and 1.(c) seem to place a risk identification, assessment and management function on depositaries which would be better performed by the AIFM. We suggest deleting paragraph 1.(c) and replacing 1.(b) with language referring to the exercise of due skill and care, reasonably expected of custodians in the relevant jurisdiction. We would in this context suggest that the obligation in the redrafted paragraph 1.(b) be equated to the obligation to make adequate arrangements so as to safeguard clients' ownership rights under Article 13(7) of MiFID.

Box 81: Safekeeping duties related to 'other assets' – Ownership verification and record keeping

Referring to paragraph 1., we assume that *'timely access'* to relevant information means access to information on an ex post facto basis, and usually after the end of the relevant trading or settlement day (as the case may be for the relevant information).

Referring to paragraph 2., we would welcome guidance on what information is envisaged would be anticipated to be obtained by the depositary to satisfy itself of the ownership requirement and whether this will vary by asset class or by the type of institution holding the asset or reporting it to the depositary. We suggest it would be sufficient for a depositary to rely on the client statements or other reports provided by authorised financial institutions as evidence of the ownership right of the AIF to those assets without any further verification. Where assets are held in physical custody (for example commodities) the depositary should similarly be permitted to rely on ownership information provided by the relevant custodian of those assets. A depositary may not have the requisite expertise in, for example, determining the ownership rights in real estate/land or other assets, and it will therefore be necessary to specify that the reasonable reliance by the depositary on ownership information provided to it by qualified third parties should be sufficient. Moreover, the difficulties of establishing 'ownership' are compounded in scenarios with multiple levels of intermediaries and multiple jurisdictions and applicable laws.

We believe that the depositary function is one which can only effectively be carried out on an ex post facto basis, and should not involve the depositary inserting itself into the decision making process with regards to the dealing in the assets of the AIF. The latter is not the function of the

depository and is one which could potentially conflict with its oversight role. Provisions which suggest the intervention or prior approval of the depository in relation to the dealings in assets of the AIF could fetter the ability of the AIF to conduct its business or deal with its assets as it deems fit and with no overarching ability to prevent the depository from exercising such interventions inappropriately.

On balance we believe that Option 1 is preferable to Option 2, for the reasons cited above; mirroring transactions at the depository is inefficient and does not provide tangible benefit. We believe that post-transaction information and monitoring are appropriate, but we do not believe that the requirement to inform the depository or its delegate of transactions prior to them occurring is appropriate or necessary. Such an approach could hamper the ability of the AIF to transact to deal in its assets.

In relation to paragraph 3.(b), we request clarification of the meaning of ‘...certificates or other documentary evidence...’ in relation to transactions in assets held in the name of the AIF or AIFM. In this context, we would suggest that confirms provided by executing brokers in relation to such transactions should constitute sufficient evidence of transactions.

As previously indicated, we also request that the Advice clarify that assets may not be held in the name of the AIF or the AIFM, but in the name of the custodian or other financial institution.

Q37: To what extent would it be possible / desirable to require prime brokers to provide daily reports as requested under the current FSA rules?

We noted that, as a result of recent enhancements to the UK FSA’s Handbook, it is now a regulatory requirement for UK-domiciled prime brokers (which constitute the majority of the major prime brokers in Europe) to provide daily reports to its prime brokerage clients, which provide comprehensive statements as to where assets are held and on what basis. As such we agree that it would be desirable to provide similar reports in the context of AIFs. However, the context and application of the FSA rules need to be appreciated, particularly that these reports are provided on an ex post facto (T+1 minimum) basis, and are produced by each prime broker. Moreover, while daily reporting to AIFs/AIFMs in the manner contemplated under the FSA rules in relation to FSA-regulated prime brokers is a workable proposal, the requirement should apply such that it is a requirement on the depository to ensure such reports are made available (consistent with the overall approach taken in Article 21. We would also anticipate further consultation may be required here to establish the scope and application of any such requirement, and that it may not be appropriate to be included in ESMA's technical advice).

Q38: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 81? Please provide an estimate of the costs and benefits related to the requirement for the depository to mirror all transactions in a position keeping record?

Regarding the mirroring of transactions by the depository - prime brokers currently provide reporting to their clients, which includes trade file information on transactions undertaken by such client. The costs of such mirroring will depend on the details of the requirement (e.g. a requirement for near-real time record-keeping could entail significant additional costs. We note that any obligation on the prime broker to pass on information would be an obligation owed to the AIFs, not a separate and parallel obligation owed to the depository.

V.III.3 Depository functions – Oversight duties

Box 82: Oversight duties – general requirements

We welcome the confirmation that the depository is expected to perform its oversight duties on an ex-post facto basis, and we assume that this applies to all the functions of the depository in Box 82, including with regard to the information required to comply with obligations under

Article 21(9). We request further clarification of the scope of the oversight duty of depositaries. In this context we would strongly argue that the oversight duty should not extend to the risk management of the fund as this is one of the non-delegable duties of the AIFM. We note also that, due to the fact that most AIFs currently work on a multiple prime broker basis, no single prime broker would be able to carry out such a function.

Box 83: Clarification of the depositary's oversight duties – subscriptions/redemptions

We believe that, where verification functions in relation to subscriptions and redemptions have already been delegated to an appropriate third party such as an administrator, the function of the depositary in this regard should be an oversight function, along the lines set out in Box 82, i.e. that the depositary has oversight for the processes and procedures on an ex post basis. We do not believe it is necessary to require that the verification function is actually performed by the depositary itself.

Box 85: Clarification of the depositary's oversight duties – carrying out the AIFM's instructions

We would welcome guidance from ESMA on how a depositary should assess whether procedures are '*...proportionate to the nature, scale and complexity of the AIF*'. We note that many AIF which will be regulated under AIFMD seek to be flexible in their investment strategy and purposely broad in their investment scope and objectives. In the context of such structures, monitoring compliance with investment restrictions may not result in meaningful data or benefit for either the AIF or its investors. We also believe that compliance with investment restrictions and leverage limits (where they exist) should be the primary responsibility of the AIFM and we would welcome clarification of this in the Advice. We agree with ESMA's comments in paragraph 61 of the Explanatory text that in most cases it would not be possible for the depositary to perform ex ante controls of all instructions received from the AIFM.

We note that ESMA comments in paragraph 63 of the Explanatory text that the depositary may be required to take action following settlement failure to reverse transactions or require investment in a different asset class. We believe that this approach is not feasible in many cases (where, for example, it may not be possible to 'reverse' a transaction or where the transaction is subject to applicable exchange or market rules or conventions). Furthermore, the intervention of the depositary in determining either the unwind or 'reversal' of a transaction, or in making assessments over the assets in which the AIF invests, would put the depositary in a position where it is directing the investment activity of the AIF, a function we do not believe is either intended or appropriate.

Box 86: Clarification of the depositary's oversight duties – settlement of transactions

Referring to the depositary's duties in relation to the timely settlement of transactions, we do not believe any additional requirements are necessary and therefore prefer Option 1 .

Q40: To what extent do you expect the advice on oversight will impact the depositary's relationship with funds, managers and their service providers? Is there a need for additional clarity in that regard?

We believe that the Advice on depositary oversight functions could lead to significant additional burdens on the depositary and potentially to significant administrative costs for the AIF/AIFM. In particular, any requirements for mirroring of existing processes or duplicating processes will significantly increase the cost of operating an AIF, which may not necessarily equate to additional quality assurance in the information which is gathered in respect of an AIF.

Q43: Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

We agree with ESMA's comments in paragraph 54 of the Explanatory text that the provisions should not be read to include a broader requirement than that specified in the UCITS directive.

Q44: With regards to the depositary's duties related to the carrying out of the AIFM's instructions, do you consider the scope of the duties set out in paragraph 1 of Box 85 to be appropriate? Please provide reasons for your view.

Please see our comments on Box 85

Q45: Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

Please see our comments on Box 86

V. [Section 3] Depositaries – Segregation

Box 88: Due Diligence Requirements

We do not agree that the depositary should be under an ongoing duty to notify the AIF or AIFM of any change in custody risks. This is an additional requirement beyond the current MiFID requirements and is overly onerous on depositaries. We would welcome clarification that the obligation to 'perform ongoing monitoring' will require the same frequency of monitoring as that currently required under MiFID.

Box 89: Segregation obligation of third parties to which depositaries have delegated part or all of their safekeeping functions...

We welcome the acknowledgment in the draft advice in paragraph 1.(d) that sub-custodians may use omnibus accounts. As stressed in our response to the CESR Call for Evidence, we believe that implementing measures should take full account of the fact that the local laws/market practices of certain jurisdictions in which a sub-custodian operates may require that *all* assets deposited with such sub-custodian be held in a single account. The use of omnibus accounts also promotes operational safety as there are fewer data points to be checked to identify issues.

Q46: What alternative or additional measures to segregation could be put in place to ensure the assets are 'insolvency-proof' when the effects of segregation requirements which would be imposed pursuant to this advice are not recognised in a specific market? What specific safeguards do depositaries currently put in place when holding assets in jurisdictions that do not recognise effects of segregation? In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

We welcome the language in Box 89, paragraph 2 acknowledging that the applicable local law may limit the protection provided by segregation. We believe, therefore, that this is a matter for the local law of the relevant market or jurisdiction, and is not an area in which a depositary can make '*...additional arrangements...to minimize the risk of loss and maintain an adequate level of protection*' where such protection is not afforded by the local legal system. To impose a higher standard of protection on the depositary than that applied by the local regime is unduly burdensome and may not be practical or proportionate even where it is theoretically possible.

V.IV.1. The Depositary's liability regime – Loss of financial instruments

Box 90: Definition of loss

We believe that the conditions in paragraph 1.(a) and 1.(b) require clarification. Condition (a) appears to include any and all claimed rights of ownership. We suggest it be made clear that the right of ownership to which reference is made is exclusively that of the AIF (and not e.g. rights claimed by any third parties). If condition (a) is intended to refer to the AIF's right of ownership (rather than to the financial instruments themselves) permanently ceasing to exist or ever existing, then condition (b) appears unnecessary as it is completely covered by condition (a). Referring the condition (c) requirement that the AIF is permanently unable to dispose of the instrument, we note that a permanent inability to dispose of an instrument may not mean that that instrument has been 'lost' in the ordinary sense of that word: The instrument may still exist, the AIF may still own it and yet it may be considered that the instrument is incapable of being 'disposed of' due to changes in local law or other restrictions attaching to the instrument. This should not be considered a 'loss'. In addition, we suggest that ESMA explicitly confirm that any enforcement of a security interest by a party benefitting from a security would not constitute a 'loss'.

V.IV.2. The Depository's liability regime – External events beyond reasonable control

Box 91: Definition of 'external event beyond the depository's reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary'

External Event?

ESMA considers losses caused by accounting errors, operational failure or fraud at the sub-custodian as 'internal' events. We believe that while the acts and omissions of a sub-custodian who is affiliated to the depository should be considered an 'internal' event, where such sub-custodian is not so affiliated then its acts and omissions should be considered an 'external' event on the basis that:

- 1) Categorizing the acts and omissions etc of an unaffiliated custodian as an 'internal' event will likely trigger systemic risk. Recent events demonstrate that systemic reactions are triggered even before actual liabilities are known and incurred (e.g. credit institution exposures to euro- zone sovereign debt led to rumours of credit rating downgrades and regulatory intervention). In the case where a large unaffiliated sub-custodian were to become insolvent, a depository would likely have to disclose its total exposure to that custodian at the beginning of the insolvency process, regardless of the qualification that loss is determined at the end of the process as the depository would have no way to quantify its actual liability. Such disclosure may result in the systemic reactions recently witnessed.
- 2) Categorizing the acts and omissions of an unaffiliated custodian as an 'internal' event will create a significant contingent financial liability for depositaries and their possible delegates such as prime brokers and clearing counterparties. This type of exposure is unlikely to be insurable for depositaries. Moreover, if depositaries and their sub-custodian delegates are fixed with strict liability for loss of assets occasioned by sub-custodian failure then this will very likely be considered a contingent liability against which regulatory capital would need to be held. The extent of capital required would discourage many firms from offering their services and force those that remained to pass on substantial fee increases to AIFs. This would destroy the ability of AIFMs to generate competitive returns and shareholder value. European managed AIFs would be dramatically uncompetitive versus non-European managed AIFs and it is unlikely that the industry would survive in Europe.
- 3) Categorizing the acts and omissions of an unaffiliated custodian as an 'external' event will not automatically absolve the depository of liability for loss as the two other legs of the test (i.e. is the event beyond the depository's reasonable control? and could the consequences have been avoided with reasonable efforts?) still need to be satisfied.

- 4) It appears unjust that a depositary be made liable for the loss of any financial instruments where such loss has arisen due to the disruption occurring during a third party sub-custodian's insolvency. Such disruption would occur to any entity which is entering insolvency and affect any investor or creditor so it seems odd to single out a depositary to be responsible for this even when it has carried out its duties properly.
- 5) Depositaries will frequently be in a position where they have to delegate custody of certain assets to sub-custodians, including unaffiliated sub-custodians. This will be a function of the investment strategy adopted by the AIF/AIFM and not a matter of choice or control of the depositary. It is not appropriate to make a depositary liable for the risks and consequences of investment strategies and decisions made by AIFs/AIFMs to invest in certain markets.
- 6) Where unaffiliated sub-custodians are used, a depositary will have no control over the actions of sub-custodians. Given that reality, it cannot be a logical interpretation that the actions or omissions of unaffiliated sub-custodians can be regarded as 'internal' events for the purpose of determining liability. To do so would fundamentally shift the responsibility and liability of depositaries from an oversight role into underwriting the performance of sub-custodians and any risks associated therewith. This is both inequitable and unmanageable: Depositaries cannot be expected to identify or exercise any control over the risk that a sub-custodian or other delegate makes an operational error or perpetrates a fraud, and should therefore not be liable for that risk.

Beyond reasonable control?

ESMA proposes that the 'external' event would be considered beyond the depositary's control if there was nothing the depositary could reasonably have done to prevent its occurrence. We believe it will not be possible to provide an exhaustive list of the events which would be beyond the 'reasonable control' of the relevant depositary. Furthermore, what is within the 'reasonable control' of a depositary will be dependent on the relevant regime applicable in any given jurisdiction where the assets are held or relevant parties are situated, and therefore it will be important to apply these criteria at a national level. We believe that a depositary, who has appropriately delegated functions in accordance with the provisions of the AIFMD, has contracted for the discharge of liability to the delegate for those delegated functions, and has not itself acted negligently in the course of that delegation, should properly be regarded as not having 'reasonable control' over the delegate where the delegate has wilfully or negligently acted in a way which has caused loss to the AIF or the AIFM, or has acted beyond the scope of its delegated powers or breached its obligations under that delegation.

In our view, the determination of whether there was anything the depositary could reasonably have done will turn on the level of due diligence performed by the depositary in the selection and ongoing monitoring of the sub-custodian. This test can be articulated as follows: did the depositary comply with its due diligence obligations under the AIFMD and if so, was the event of fraud, negligence or default at the sub-custodian which caused the loss, one that no reasonable depositary performing due diligence in accordance with the requirements laid out in the implementing measures [Box 88] should have discovered in reasonable time to enable it to take action to prevent the loss? (For this purpose, 'taking action' should include informing the AIF/AIFM or another appropriate party so that action can be taken by that party to prevent loss). In this context we note that any failure by a sub-custodian to segregate or use what should be segregated client assets for its own purposes is likely to happen immediately before any failure, thereby giving the depositary no realistic opportunity to prevent the same.

Could consequences have been avoided with reasonable efforts?

ESMA proposes that the depositary be required to: ensure it has the means to identify and monitor events deemed beyond its control which could lead to a loss; regularly update its assessment of those events; and take appropriate action when needed.

Referring to paragraphs 36 to 39 of the explanatory text on events beyond the control of the depositary and the actions the depositary should take in relation to those events, we believe that these are far beyond the scope of the role of the depositary as envisaged in the AIFMD. The requirements apply significant risk management responsibilities to depositaries and also expand the role of the depositary even further to include a quasi-investment management function. It is not appropriate for a depositary to make any decision (or take any related liability) regarding liquidation of investments. We would also note the practical difficulty that the depositary will not necessarily know who the investors are or have the means to individually notify them. In addition there is risk that such a requirement could exacerbate systemic risk: in a country specific banking crisis, a requirement for a depositary to notify all investors in an AIFM of the risk of failure of a local bank through which such positions may be held could exacerbate volatility.

V.IV.3. The Depositary's liability regime – Objective reason to contract a discharge

Box 92: Objective reasons for a depositary to contract a discharge

We prefer Option 2 for determining whether a depositary is deemed to have an *objective reason* to contract a discharge of liability. We consider that a determination that the *objective reason* requirement is satisfied if both parties explicitly consent to delegation is most appropriate to the reality that there are multiple and varied scenarios in which the depositary should properly be regarded as having an objective reason for the discharge of its liability to a delegate performing custody functions. For example, where a depositary is acting for an AIF or AIFM in relation to numerous different asset classes or jurisdictions, it will be necessary for the proper performance of the depositary functions to delegate custody functions to custodians who are appropriately authorised and who have the relevant expertise to conduct that business in each relevant jurisdiction or market. Depositaries may also seek to use more than one custodian in any given market or to appoint a delegate even where the depositary itself is able to perform the functions in the particular market, based on criteria such as the intention to minimise key service provider risk or to maximise efficiency by the use of more than one custodian in a market. Where those functions are effectively delegated, it is appropriate to delegate the liability for those delegated custody functions as the delegate in those circumstances is objectively the entity which is in control of the relevant assets.

Q47: What are the estimated costs and consequences related to the liability regime as set out in the proposed advice? What could be the implications of the depositary's liability regime with regard to prudential regulation, in particular capital charges?

If the event of fraud, negligence or insolvency at the sub-custodian is deemed to be 'internal' to the depositary and depositaries are thus fixed with a de facto strict liability for loss of customer assets then this will very likely be considered a contingent liability against which regulatory capital would need to be held. If one assumes that a theoretical depositary or custodian has USD 50 billion of assets held under custody at sub-custodians, this is USD 50 billion of contingent liability, for which the depositary would take an 8% capital charge (i.e. USD 4 billion)².

The effects of a USD 4 billion capital charge per intermediary would be financially catastrophic and beyond the ability of the AIF industry in Europe to absorb. An industry norm of around 20% return on capital would mean that for every USD 50 billion of customer assets held at sub-custodians such house would need to allocate USD 4 billion of capital and make a return of USD 800 million. Applied across a conservative estimate of USD 400 billion of European managed AIF

² This example ignores large exposure issues – if the USD 50 billion was concentrated amongst a few custodians then there would be regulatory limits on such exposure. It is also important to note that the global custodian market itself is currently limited to a very small number of houses, so aside from any regulatory limit issue there could be significant implications in terms of market and systemic risk concentration.

custody balances, this represents additional revenue required of over USD 6.4 billion, solely for the provision of custody services.

At the current time, the vast majority of hedge fund AIF balances are custodied by prime brokers not depositaries. Prime brokers do not charge for custody services provided to AIFs and instead make revenue from financing and securities lending activities. The additional costs described above effectively mean that no house would have the appetite for the risk created nor the willingness to allocate such vast sums of capital. Moreover, even if they did have the appetite, the effect of passing on the costs to AIFs would be to more than double the fees paid by such funds for prime brokerage services at the current time. These costs would be solely in relation to custody and in addition to the fees currently paid for financing and securities lending. This would impair the ability of AIFMs to generate competitive returns and shareholder value. European managed AIFs would be dramatically uncompetitive versus non-European managed AIFs and it is unlikely that the industry would survive in Europe.

We request that ESMA consults with the Basel Committee to determine how the risk of 'loss' of assets under the quasi-strict liability regime proposed under AIFMD would be categorized for regulatory capital purposes.

In addition, we also refer ESMA to the January 2010 Report by the Financial Markets Law Committee entitled 'Issue 145 - AIFM Directive: Legal Risks' (the 'FMLC Report' - <http://www.fmlc.org/papers/Issue145Report.pdf>) which concludes that the imposition of a strict (or very wide) liability regime for depositaries, 'may result in the insolvency of sub-custodians having systemic 'knock-on' implications for the wholesale financial market' (paragraph 1.7(b)). It is difficult to quantify the impact of such a systemic 'knock-on' but we consider this a risk which should be taken very seriously.

The FMLC Report further highlighted that: 'the imposition of vicarious liability on a depositary for the failures of its sub-custodians and for the failures of the third parties to which its sub-custodians sub-delegates the depositary function would also have the effect of creating pressures and incentives to use sub-custodians which are within the depositary's own corporate group, which would be problematic, inter alia, because it is doubtful whether the use of intra-group sub-custodian arrangements are desirable from the point of view of prudential risk management and systemic stability' (paragraph 3.1.7.1). The imposition of strict liability could therefore lead to a concentration of risks in just a few global custodians and will also foster an anti-competitive environment.

The FMLC Report also highlighted that 'insurers are likely to be wary of providing insurance to a depositary against financial loss for breach of its obligations...because the risk of breach is high and, to some extent, outside the depositary's control. If, as a result, depositaries are unable to obtain adequate insurance protection, this would lead to a concentration of risk in the hands of those institutions acting as depositaries under the Directive, which would increase the likelihood of a systemic failure' (para 3.1.7.2).

In addition to the above capital and systemic risk consequences, it is worth noting the risk that depositaries may be unprepared to offer services for certain jurisdictions, which would obviously impact upon potential investment strategies for AIFs/AIFMs and, indirectly, investors

Q49: Do you see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD?

We do not see any difficulty with this suggestion. Given the likelihood that any loss due to the negligence, fraud or insolvency of a sub-custodian is likely to be manifested in the sub-custodian having failed to segregate assets, we believe that the external event concept should include the

insolvency of a custodian in jurisdictions where there is no concept of segregation or it is otherwise not recognized or not standard in the relevant market.

Q52: To what extent do you believe the transfer of liability will / could be implemented in practice? Why? Do you intend to make use of that provision? What are the main difficulties that you foresee? Would it make a difference when the sub-custodian is inside the depositary's group or outside its group?

The 'transfer' of liability in such a way that the AIF will have a direct right of recourse against the sub-custodian rather than to the depositary raises a number of potential difficulties which could have the effect that the liability could be transferred to the prime broker, but no further, therefore, unfairly prejudicing prime brokers. A direct right of recourse will require a direct contractual relationship between the AIF and the sub-custodian. That will be the case for the prime broker under the prime broker agreement, but is highly unlikely to be the case further down the custodial chain. From the sub-custodian's point of view, it is unlikely that sub-custodians within the prime broker's custodial network will accept any direct right of recourse from the prime broker's clients, given that there is no direct relationship with the AIF. Even if a sub-custodian were prepared to assume a higher level of liability, actually putting in place a contractual agreement for the discharge of responsibility would mean each AIF/AIFM having to enter into (i.e. negotiate) contractual arrangements with potentially dozens of sub-custodians.