

THE ASSOCIATION OF GLOBAL CUSTODIANS

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12 September 2011

VIA ELECTRONIC SUBMISSION

The European Securities and Markets Authority
www.esma.europa.eu
c/o: "Consultations"

RE: Association Comments on ESMA's Consultation paper, "Draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive", 13 July 2011 - ESMA 2011/209

We herewith submit on behalf of the Association of Global Custodians ("Association" or "AGC")¹ comments in response to the Consultation Paper issued on 13 July 2011 ("Consultation") by the European Securities and Markets Authority ("ESMA"). The Association appreciates the opportunity to provide members' views and recommendations.

Members' detailed, technical comments to Part V ("Depositories") of the Consultation Paper are attached to this brief overview letter. The detailed comments include specific recommended changes to the text of the Consultation proposals as well as recommended changes to specific statements in the Consultation's Explanatory Notes. The detailed comments also include information descriptive of current depositary practices and established international standards, which is intended to be of assistance to ESMA in drafting its response to the European Commission's request for assistance on the content of the implementing measures for the Alternative Investment Fund Managers Directive (the "Directive").

¹ The Association is an informal group of eleven global banking institutions, listed on the letterhead above, with affiliates and branches in many countries that provide custody services and related securities asset-servicing functions to cross-border institutional investors around the globe. Association Members participate actively in European Union securities markets by, among other things, employing collectively more than 210 subcustodians in the 27 EU jurisdictions to assist in holding in custody well in excess of 15 Trillion EUR assets and by providing depositary services to well in excess of 18, 000 EU based funds. More detailed statistical information concerning members' global reach and EU activities is included in the attached detailed comments.

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Association members appreciate the value of appropriate regulation surrounding custody and fund services and fully support the objectives of the Directive to protect investors and prevent undue systemic risk. Members therefore generally concur with many of ESMA's well-stated and thoughtful proposals² and believe that, in general, ESMA's proposed approach would achieve the Directive's objectives.

Certain of the proposals, however, appear to go beyond the text of the Directive, thereby risking overbroad depositary liability consequences with resulting systemic implications and legal uncertainties like those which were raised, potentially, in early drafts of the Directive but which were resolved appropriately in the final, adopted text. In addition, certain of the proposals would impose significant, unnecessary costs on depositaries and subcustodians without offsetting improvements in investor protection. As discussed in the detailed comments, members believe that relatively simple changes to the proposals and explanatory notes would limit the more problematic aspects of the proposals while providing workable provisions that enable balanced risk management.

Below for your convenience is a summary of members' core comments as they emerge from the Association's detailed commentary. This summary is not intended to fully note or replicate the wide range of information and nuanced analysis in the attachment.

A. Certain proposals in the Consultation seem to go well beyond the scope and policy intent of the Directive, introducing possible legal and operational uncertainty and changing well-established standards that have served investors and the industry well. Members strongly recommend that ESMA review its proposals and Explanatory Notes with these potential consequences and the Association's specific recommended changes in view. Some of the key points falling into this category -- set out in priority order -- follow:

1. Box 91 (Detailed Comments at ps. 37-41): Explanatory Note 29 clarifies ESMA's proposal to attribute to a depositary a loss of a financial instrument due to an accounting error, operational failure or other problem at a sub-custodian based on an arbitrary stipulation that such an event would be "internal" to the depositary. The net effect of this stipulation via the overbroad "internal" designation effectively reinstates a strict liability standard in respect of the use of sub-custodians, regardless of resources expended by the depositary to properly appoint, monitor and supervise the sub-custodians. The ability of the depositary to "transfer" liability to sub-custodians, as explained in our response to

² Examples of proposals that members concur in generally include Box 89 (third party segregation requirements), and most of Boxes 88 (sub-custodian selection and monitoring duties) and 90 (definition of loss).

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Question 52 does not present a realistic prospect for relief (see Detailed Comments at ps. 50-52).

2. Box 90 (Detailed Comments at ps. 35-37) and Explanatory Note 15 thereunder indicate that depositaries would become accountable for fraud committed by third parties, if it transpires that the entry of custody assets into custody accounts has been based upon falsified documentation or other fraud. While a depositary should always be accountable for fraud on its part, it should be recalled that the custody obligation of a depositary does not include verification of the authenticity of assets delivered to the depositary for safekeeping. If, for example, a depositary is asked to keep bearer bonds in its safe for the benefit of an AIF, the depositary will take measures to record the bonds and to credit them to the custody accounts of the AIF. If the bonds are removed from the safe by employees of the depositary improperly, then the depositary will be liable for the resulting “loss” pursuant to 1(b) of the text in Box 90. If, however, the bonds properly remain in the safe, but it comes to light that the AIF has acquired forged documentation, it is difficult to understand -- on the basis of the Directive or normal legal and commercial principles on the allocation of risk -- why the depositary would be required to account for the fraud that a third party has committed and over which the depositary has no effective control.

In the Association’s view, it is no answer to suggest that the depositary can avoid liability, where a third party has falsified documentation, by proving that “despite rigorous and comprehensive due diligences it could not have prevented the loss” (among other conditions to be demonstrated by the depositary), since that requirement is too broadly cast, as noted below. Indeed, the Association suggests that there is a contradiction between such a broad and unclear standard for due diligence, in respect of assets held in custody, and the separate requirement that it satisfy itself about the ownership of all other assets. If the depositary cannot rely upon the authenticity of documentation presented to it in relation to assets held in custody, that will hinder the effective conduct of business. The approach proposed certainly seems to expect depositaries to act as insurers against the crimes of third parties, which is inconsistent with depositaries’ normal roles and normal legal principles concerning responsibility for criminal acts.

3. Box 91 (Detailed Comments at ps. 37-41): Imposing on the depositary liability for loss of financial instruments held in custody via sub-custodians unless the depositary can show that it pursued (unspecified) “rigorous and comprehensive due diligences” goes beyond the intent of the directive, which specifies the “exercise of reasonable efforts”. Use of the recommended latter phraseology -- coupled with other recommended text changes in Box 91 -- would conform ESMA’s proposal to the directive, ESMA’s mandate from the European Commission, and current international standards.
4. Box 91, sub-paragraph (c) (Detailed Comments at ps. 38): The imposition on the depositary of a duty to mitigate a “loss of financial instruments held in custody” in order to avoid liability for that loss, may create serious problems where the depositary does not

know whether it should independently take a decision, which in turn may pose significant systemic risk concerns deriving from uncertainty about who controls disposition of financial instruments in a crisis.

5. Box 80 (Detailed Comments at p. 18): Requiring depositaries to assess, monitor and report to the AIFM All relevant custody risks relating to use of “settlement systems” in all markets could inappropriately include CCPs, transfer agents/registrars and, possibly platforms. Recommended changes would promote uniformity in international standards.
6. Box 77 (Detailed Comments at p. 7-8): An important technical correction is recommended relating to operating cash of AIFs and how this cash may be held at third parties. Similar technical corrections should be made, including in how Question 25 is phrased, in respect of the descriptions of subscription/redemption accounts and how such accounts may be held (Detailed Comments at ps.8-9).

B. Several of the potential “Options” set out in the proposals pose new and burdensome duties, which would increase business costs to depositaries and custodians. Members believe that the incremental cost increases could be significant. The Association strongly recommends that these Options, as marked and discussed in the detailed comments, be eliminated in view of their cost effects and the obvious availability of more-efficient and less-burdensome alternatives:

1. Box 76 (in respect of cash) (Detailed Comments at p. 6) and Box 81 (in respect of “other assets”) (Detailed Comments at p. 20): A requirement to “mirror” all cash held with third parties and other assets in “position-keeping” records would result in extensive new workloads and increased costs with no value added, diverting attention from the oversight function. Undue energy and time would be spent re-keying transactions already recorded elsewhere, building redundant record-keeping systems and reconciling positions that have already been reconciled. Investors would be more effectively protected by analyzing third party records made available on a periodic basis.
2. Box 90, Explanatory Note 19 and Annex III, Part 12.6 (“Definition of Loss”) (Detailed Comments at ps.35-37): Conferring on the AIFM the power to determine whether a financial instrument is “lost” would create unacceptable incentives favoring one party to a dispute, which is inconsistent with core concepts underpinning both civil and common law legal systems.
3. Box 79 (“Treatment of Collateral”) (Detailed Comments at p. 17): The AGC believes that Option 3 is the only viable option as it is the only option that ensures consistency with other EU legislation and other legal regimes to which counterparty arrangements may be subject and it avoids the need for the depositary to analyze the legal effect of each individual collateral arrangement.

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4. Box 78 (“Definition of Financial Instruments”) (Detailed Comments at ps.13-15): The AGC believes Option 2 is the only viable option because it provides for legal certainty by adopting a clear *a contrario* approach by which assets fall within the scope of Art. 21.8(a) or Art. 21.8(b). Option 2 suggests a definitional framework that is clear, reflects current reality – especially where financial instruments are not held via recognized settlement systems - and is relatively easily employed over time as market infrastructure evolves.

C. Questions in the Consultation that call for cost information are addressed in the detailed comments in a necessarily descriptive, generalized manner. The Association’s response at Question 47 explains why, at industry level, custodian cost information is not readily available and, even if available, would be problematic. Included in that discussion are the following points:

- Individual members’ cost profiles are known to vary materially from member to member depending on a fairly wide range of factors, including scale of operations (locally and globally), types of client assets involved, and types of clients. Moreover, the profile of business is likely to change for depositaries following implementation of the Directive, with the result that a more heterogeneous client base will be seeking depositary services. Any assessment about operational risks associated with new structures, or mixtures of business, will need to take account of new capabilities and expertise that are being added or will be created in the future. At this stage, predicting costs at an individual bank level is a speculative exercise.
- The variances among members in scope of business, service mixes, pricing arrangements and customization flexibility in accommodating varying customer demands tend to make aggregated Association-level information useful only in a general way. Such aggregates – even if obtainable -- can imply a uniform standard or a degree of commonality that does not exist in practice.
- Information in any detail concerning a bank’s business costs is proprietary to the bank and is typically significant in terms of competitive implications (and therefore cannot be disclosed, even to the Association).

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Association members appreciate the opportunity to provide their collective views on the Consultation and strongly encourage ESMA to review the general points above and fully consider the attached detailed comments. If the Association can provide further information, please contact the undersigned as an initial matter.

Sincerely yours on behalf of the Association,

A handwritten signature in black ink, appearing to read 'Dan W. Schneider', written over a horizontal line.

Dan W. Schneider

Baker & McKenzie LLP

Counsel and Secretariat to the Association

ATTACHMENT: Detailed Association Comments

ATTACHMENT
The Association of Global Custodians
Detailed Comments on ESMA's Proposals and Options

INTRODUCTION

The following detailed comments are submitted by The Association of Global Custodians ("AGC") to the European Securities and Markets Authority ("ESMA") in response to ESMA's request for technical input in respect of its Consultation paper dated 13th July 2011 entitled, "ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (the "directive") - ESMA 2011/209" (the "Consultation").

The sections, "Boxes" and numbered questions and answers set out below correspond to those sections, Boxes and questions as set out in the Consultation. Recommended changes to the text of ESMA's proposals are marked within the applicable Boxes, and commentary is provided where indicated in respect of each boxed proposal.

V.I. Appointment of a depositary

1 Contract evidencing the appointment of a depositary

1.1 Particulars of the contract appointing the depositary

Box 74

Particulars to be included in the written agreement evidencing the appointment of a single depositary and regulating the flow of information deemed necessary to allow the depositary to perform its functions pursuant to Article 21 (2) of the AIFMD.

(Recommended Revisions Marked)

The depositary on the one hand and the AIFM and / or the AIF on the other hand shall draw up a written agreement setting out the rights and obligations of the parties to the contract.

This agreement should include at least the following elements:

1. A description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which may be entrusted to the depositary;
2. A description of the types of assets that will fall within the scope of the depositary's function which should be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents, regarding the assets in which the AIF may invest;
3. A statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with the requirements of Article 21 (13) or (14); and where applicable, the conditions under which the AIF or the AIFM may allow the depositary to transfer its liability to a sub-custodian-including the objective reasons that could support that transfer;

4. The period of validity, and the conditions for amendment and termination of the contract; and, if applicable, the procedures by which the depositary should send all relevant information to its successor;
5. The confidentiality obligations applicable to the parties in accordance with prevailing laws and regulations; these obligations should not impair the ability of Member States competent authorities to have access to the relevant documents and information;
6. The means and procedures by which the depositary will transmit to the AIFM or the AIF all relevant information that the latter needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate situation of the accounts of the AIF. The details of such means and procedures should be described in this agreement or set out in the service level agreement or similar document;
7. The means and procedures by which the AIFM will ensure the depositary has access to all the information it needs to fulfil its duties, including the process by which the depositary will receive information from other parties appointed by the AIF or the AIFM. **The details of such means and procedures should be described in this agreement or set out in a service level agreement or similar document;**
8. Information regarding the possibility for the depositary or a sub-custodian to re-use the assets it was entrusted with or not and where relevant the conditions related to the potential re-use;
9. The procedures to be followed when a modification to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary should be informed, or where a prior agreement from the depositary is needed to proceed with the modification;
10. All necessary information that needs to be exchanged between the AIF, the AIFM and the depositary related to the sale, subscription, redemption, issue, cancellation and re-purchase of units or shares of the AIF;
11. Where the parties to the contract envisage appointing third parties to carry out their respective duties, an undertaking to provide, on a regular basis, details of any third parties appointed; and upon request, information on the criteria used to select the third party and the steps taken to monitor the activities carried out by the selected third party;
12. All information regarding the tasks and responsibilities in respect of obligations relating to anti-money laundering and combating the financing of terrorism;
13. Information on all cash accounts opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and procedures by which the depositary will be informed prior to the effective opening of any new account opened in the name of the AIF or in the name of the AIFM on behalf of the AIF;
14. Details regarding the depositary's escalation procedure(s), **which may be set out in this agreement or in a service level agreement or similar document**, including the identification of the persons to be contacted within the AIF and / or the AIFM by the depositary when it launches such a procedure.

Subject to national law, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIF managed by that AIFM to which it applies.

The parties may agree to transmit part or all of this information electronically. Proper recording of such information shall be ensured.

The agreement shall include the procedures by which the depositary, in respect of its duties has the ability to enquire into the conduct of the AIFM and / or the AIF and to assess the quality of information transmitted including by way of on-site visits. It shall also include a provision regarding the possibilities and procedures for the review of the depositary by the AIFM and / or the AIF in respect of the depositary's contractual obligations.

The law applicable to the agreement shall be specified.

COMMENT: In view of ESMA's mandate to define the elements which should be required in the written agreement evidencing the appointment of the depositary, the AGC is broadly supportive of ESMA's recommendations set out in Box 74. We agree it is sensible, as ESMA has stated in the Consultation, to use "the particulars required in the contract to be signed between the depositary and the management company in the UCITS framework as a starting point with a view to ensure consistency across the industry". ESMA has then suggested some amendments or new provisions to take into account the specificities of AIFs. The amendments or new provisions set out in Box 74 are sensible - with two exceptions. The AGC has the following reservations or concerns:

1. Point 3. The AGC reiterates its concern set out below in the AGC response to question 52, following Box 92, regarding the extreme difficulty of the depositary being able to "transfer" liability to a sub-custodian in a manner that is likely to be commercially accepted by sub-custodians or, even if accepted, to be legally effective. The AGC understands ESMA is constrained by the requirements of the Level 1 text but wishes to point out the unlikelihood of this clause being employed in practice.
2. Point 7. Elements of the requirements set out in Box 74 should be permissible in a service level agreement (SLA) outside the context of the operative legal agreement appointing the depositary. This would be consistent with UCITS, as referenced in Article 37 of Directive 2010/43/EC, which provides that an SLA may be utilised for information sharing both from and to the depositary. In addition to point 6 above (providing for the "means and procedures by which the depositary will transmit [information] to the AIFM or the AIF"), which expressly permits use of an SLA, point 7 above (the "means and procedures by which the AIFM will ensure the depositary has access to all the information it needs") should also fall within scope of the approach.
3. Point 14. The AGC suggests that similar flexibility be permitted in respect of the depositary's escalation procedures, which are appropriately included in SLAs or similar documents.

1.2 ESMA's justification for not providing a model agreement

COMMENT: While the AGC do not believe a "model agreement" is possible in the UCITS setting, we believe a model agreement is even less sensible as a policy goal in context of the extreme variation among AIF strategies and asset classes. We therefore welcome ESMA's conclusion that there is no need to define a model agreement for the reasons stated in the Explanatory text.

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V.III. Depositary functions

1 Depositary functions pursuant to §7 – Cash monitoring

1.1 Cash flow monitoring

Box 75

Cash Monitoring – general information requirements (*Recommended Revisions Marked*)

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (7) including by third parties and particularly that:

- the depositary is informed, upon its appointment, of all existing cash accounts opened in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF;
- the depositary is informed ~~prior to the effective opening~~ **as soon as reasonably possible** of any new cash account by the AIF or the AIFM acting on behalf of the AIF;
- the depositary is provided with all information related to the cash accounts opened at a third party entity, directly from those third parties in order for the depositary to have access to all information regarding the AIF's cash accounts and have a clear overview of all the AIF's cash flows.

Where the depositary does not receive this information, the AIFM will have been deemed not to have satisfied the requirements of Article 21 of the directive.

COMMENT: The AGC's key concerns regarding Box 75 are:

Prior Notice of Accounts (second bullet point). It should be acknowledged that there will be circumstances in which the second bullet point above will be difficult to achieve: cash accounts are often opened during the life of the fund and not prior to the fund's establishment. Cash accounts may derive from implementation by the AIFM of investment decisions requiring them to be opened **prior to informing the depositary**. Examples include:

- a. Foreign exchange away from the depositary
- b. Cash deposits with third-party financial institutions
- c. Dealing/ margin accounts with brokers

Such cash accounts are opened as a matter of course with counterparties in the above examples even prior to funding them. Ensuring there can be no transfer of cash (including to open new accounts) without the knowledge and/or consent of the depositary is unlikely in cases where capital expenditure accounts, transaction accounts, rent or property management accounts or other operating accounts are maintained in other jurisdictions (e.g., accounts maintained at local banks in jurisdictions where real estate holdings are located).

Box 76

Proper monitoring of all AIF's cash flows
(Recommended Revisions Marked)

Option 1

~~The depositary should act as a central hub to ensure an effective and proper monitoring of all cash movements and in particular, it should:~~

~~1. ensure the cash belonging to the AIF is booked in an account opened at the depositary; or~~

~~2. where cash accounts are opened at a third party entity:~~

~~(a) ensure those accounts are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked)~~

~~(b) mirror the transactions of those cash accounts into a position keeping system and make periodic reconciliations between the cash accounts statements and the information stemming from the AIF's accounting records~~

~~(c) ensure the AIFM has taken appropriate measures to send all instructions simultaneously to the third party and the depositary~~

Option 2

To ensure the AIF's cash flows are properly monitored, the depositary should at least:

1. ensure that cash accounts opened at a third party are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked);

2. ensure there are proper procedures to reconcile all cash flow movements and verify that they are performed at an appropriate interval;

3. ensure appropriate procedures are implemented to identify on a timely basis significant cash flows ~~and in particular those which could be inconsistent with the AIF's operations;~~

4. review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year;

5. monitor on an ongoing basis the outcomes and actions taken as a result of those procedures and alert the AIFM if an anomaly has not been rectified without undue delay.

COMMENT: The AGC strongly supports Option 2. Option 1, by requiring all cash movements to be exhaustively and individually replicated in a depositary “position-keeping” system, would be operationally challenging, costly and divert the depositary’s attention from meaningful oversight and supervision by having to satisfy technical data-entry requirements. Mirroring would require allocation of resources to receive data files, to incorporate them into the depositary’s systems and processes, to reconcile positions constantly, and to “quality check” all updates. This is incompatible with an *ex ante* approach described and would not in our view contribute to the objective of improving investor protection because it would detract from substantive, qualitative monitoring.

Recommendation: Option 2 is considered the only viable alternative as it:

- Would require focus on building and maintaining adequate supervision and control processes rather than devoting resources to “mirroring.”
- Would minimise time delays, thus not disrupting or unduly delaying the investment process;
- Would allow for better monitoring of unusual cash flows by referring to 3rd party input or reports.

The AGC’s sole concern in Option 2 relates to point 3, requiring the depositary to ensure “appropriate procedures are implemented to identify on a timely basis significant cash flows and in particular those which could be inconsistent with the AIF’s operations”. Although the depositary would expect to be informed about various aspects of the AIF’s operations and investment process, in part for AML purposes, it is not particularly suited to determine whether certain cash flows are “inconsistent” with the AIF’s operations. The depositary monitors the AIFM’s investment decisions – including the placement of cash with third parties - through its oversight of the AIF’s investment restrictions. For this reason, the AGC recommends deletion of this point, as indicated in Box 76.

1.2 ESMA’s justification for not providing further guidance in relation to the depositary’s duties regarding subscriptions in the AIF

COMMENT: We strongly support the position of ESMA, for the reasons provided by it.

1.3 Conditions for ensuring the AIF’s cash is properly booked

Box 77

Ensuring the AIF’s cash is properly booked (Recommended Revisions Marked)

The depositary should be required to:

1. ensure that the AIFM complies on an ongoing basis with the requirements of Article 16 of Directive 2006/73/EC in relation to cash and in particular where cash accounts are opened at a third party entity in the name of the depositary acting on behalf of the AIF, take the necessary steps to ensure the AIF’s 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

2. ensure the AIF's cash is booked in one or more cash accounts opened at an entity referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or at a bank or a credit institution of the non EU country in which the AIFM / AIF has ~~been compelled to open~~ a cash account in ~~relation to an investment decision in~~ the relevant markets where it is in the interests of the AIF

COMMENT: The AGC has the following concerns:

1. Point 1. Point 1 is problematical in the following respects:
 - a. It should be noted that MiFID does not apply in the UCITS setting with the result that investment managers act outside the scope of MiFID when investing fund assets (including the placing of cash of the fund). If ESMA or the Commission were to consider applying point 1 to UCITS, conforming changes would be required in MiFID. This raises the prospect of an important inconsistency between the AIFM directive and UCITS.
 - b. The example cited in point 1 ("in particular where . . .") refers to one narrow example of the various ways in which cash of the AIF may be booked: it refers specifically to the case where the AIF's cash account is opened at a third party entity "in the name of the **depositary** on behalf of the AIF", i.e., in an agency capacity. In this case, it is of course sensible to require the third party to hold the cash on deposit "distinct" from cash "belonging" to the **depositary** in order to protect this cash from creditors of the depositary. However, point 1 as written is also confusing - and inconsistent with MiFID - in one key respect: it requires the AIFM to "take the necessary steps" to ensure the AIF's cash is booked in cash accounts distinct from cash accounts belonging not just to the depositary **but also from cash accounts belonging to the third party** where they are "booked". The latter requirement is not possible to satisfy in practice. If cash is "booked" with a third party as a deposit (in which case third party must be a deposit-taking credit institution¹), the third party accepts that cash as "banker" with the result that the cash would not be considered to be "distinct" from cash "belonging" to it. The AIF (or, rather, the depositary acting on behalf of the AIF) would only hold a claim as a creditor on the third party. The cash would be reinvested (or not) by the third party credit institution as an asset of the credit institution, not as an asset of the AIF: the AIF's asset – via the depositary acting in an agency capacity - is the deposit (i.e., it is a "claim" on the third party credit institution). For the reasons set out above, The AGC recommends the deletion of the reference to cash of the third party, as indicated above in Box 74.

¹ This assumes the third party books the cash as a deposit obligation: however, even if it is a credit institution, the third party might also onward-place the cash - in an agency capacity - with yet another third party credit institution, which would actually hold the cash on deposit.

2. Point 2. Point 2 suggests that accounts outside the EU can only be opened and maintained in relation to “investment decisions”. However, the directive refers to accounts being opened “in the relevant market where cash accounts are required” without mentioning further limitations. It should be recognized that accounts may be opened for other purposes, which may include facilitating distribution of the AIF or to maintain “collection accounts” in the currency of a particular share class as appropriate to a domestic market or to satisfy local marketing/distribution requirements. The AGC’s suggested change is set out as indicated above in Box 74.

Questions 25-31

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?

Cash accounts are needed to facilitate the AIFs’ investment activities as well as distribution activities. Imposing a requirement that both subscription/redemption accounts and investment related accounts must be opened “at” the depositary in one given jurisdiction for all investment and distribution settings would be detrimental to the AIF and extremely difficult to implement operationally. Points that bear on where and how such cash accounts are held include:

1. As a preliminary point, although the phrasing of this question literally suggests that such accounts must be opened “at” the depositary, in fact depositaries may not be credit institutions capable of taking deposits. In such cases, the cash would be held on deposit with a third-party credit institution. The phrasing of the question should be corrected to reflect this.
2. Even if the depositary is a credit institution, an AIFM may take the view that holding all cash at the depositary presents an unacceptable concentration of credit risk to the AIF so may wish to hold accounts elsewhere to minimize this concentration of risk.
3. Subscription/redemption accounts may not be “assets” of the AIF and, indeed, may be opened by either the AIFM or a third party in the chain of distribution. EU firms operating in this capacity which are also subject to MiFID would be subjected to the relevant MiFID client money protections. Moreover, there could be multiple levels in the chain of distribution, with the depositary (assuming it is a credit institution) potentially holding cash at the top of the chain but other third parties holding cash further down the chain. There is no possibility of each link in the chain holding cash accounts in one place, let alone with the depositary.
4. A transfer agent – which typically is not a MiFID investment firm – often is appointed as an agent of the AIFM or AIF under a delegation arrangement as part of a broader fund “administration” role. In certain member states it is common for administrators to open omnibus cash accounts for subscriptions and redemptions. At all times these accounts are held in a way that clearly segregates the cash from cash belonging to the administrator.
5. An AIFM may act for multiple funds utilising different depositaries. Top-level subscription/redemption cash may be held in a pooled account for these various funds by the AIFM or its administrator with a credit institution. It would not suit such

managers to be required to open separate subscription/redemption accounts for each fund at different credit institutions.

6. Finally, and more broadly, the directive at Level 1 expressly recognized that cash accounts may be opened with entities different from the depositary in the relevant market. AIFs, like other UCIs, operate in various geographies and currencies. There are numerous situations justifying why an account may be held at a credit institution in another market, including:
 - a. domestic accounts in local currency might be required by local markets;
 - b. depositories (operating as credit institutions) may not provide deposits denominated in all currencies, nor may they have sufficient volumes necessary or desirable to offer deposits or foreign exchange transactions in particular currencies for risk or other internal reasons and thus not be in a position to offer coverage or competitive pricing; or
 - c. in order to satisfy local distribution requirements, domestic accounts located in the country and currency of the domicile of the investor may be required due to local regulations or particular cost structures.

The above points demonstrate why the cash of the fund and subscription/redemption cash cannot and should not be held only “at” depositaries. Moreover, investors are adequately protected without having to resort to such an extreme result. In the case of subscription/redemption cash, prospective and redeeming investors would be adequately protected without such a constraint in light of ESMA’s proposals set out in Box 83 below requiring the depositary to:

- ensure there is an appropriate reconciliation performed between the subscription orders in the AIF’s register and the subscription proceeds received;
- ensure there is an appropriate reconciliation performed between the number of units / shares issued and the subscription proceeds received; and
- check (regularly) the consistency between the total number of units / shares in the AIF’s accounting records and the total number of outstanding units / shares in the AIF’s register.

In the case of cash held as an asset of the AIF, whether or not the cash is held in an “operating account”, investment restrictions would serve to manage and control concentration of credit exposure to the depositary.

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?

There are different levels of reconciliations:

- reconciliation conducted by the depositary or the AIFM or its administrator (as applicable) between its records and the external financial institution where the AIF holds an account -

- in this case, the frequency should be proportionate to the type of activity and trading frequency and movement volumes. For high volumes of activity, reconciliations should be targeted to be done daily by the party establishing and controlling the account (i.e., the depositary, AIFM or administrator) but the depositary should be able to take into account the technical ability and competency of the third party to deliver electronic files in an adequate format;
- reconciliation conducted between the depositary and its correspondent financial institutions for cash accounts opened with correspondents in the depositary's name for the AIF (i.e., "agency accounts") -
 - in this case, full daily reconciliation is appropriate – indeed, necessary, to determine positions for the day;
- reconciliation between the depositary and other entities holding cash in the chain of distribution
 - in this case, reconciliations should comport with trading frequency.

Where reconciliations are not performed by the depositary itself (e.g., by the AIF's administrator, or by a global custodian who is not the depositary), it should verify the application of procedures by the 3rd party who is conducting the reconciliation with a minimum frequency. We would consider monthly to be a reasonable frequency for such verifications.

Q27: Are there any practical problems with the requirement to refer to Article 18 of MiFID?

No.

Q28: Does the advice present any particular difficulty regarding accounts opened at prime brokers?

If option 2 in Box 76 is selected we do not see any particular issues.

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

The AGC strongly prefers option 2 – with the change recommended as marked - as being in the best interest of investors as it allows sufficient flexibility to leverage existing operating models adapted to types of AIF and choice of providers. It allows the depositary to concentrate its expert resources on accessible reports and to focus on controls and risk assessment, rather than having to spend a substantial effort and diverting resources on building and managing a "mirroring" function which by its nature is redundant. Option 2, with the recommended change, is more efficient both from a cost perspective and - more importantly - from a timing and risk monitoring perspective.

Q30: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76?

Option 2 – with the AGC’s recommended change - is principally in line with best practice as currently applied. Additional cost should be limited and consist of a one-off review aiming at adapting and documenting the current processes in line with the described requirements and recurrently assuring a regular and duly documented review and escalation process. No major IT investments should be required in this scenario.

In the case of Option 1:

1. The requirement to mirror all transactions would require the imposition of significant cost associated with the need to increase personnel and infrastructure.
2. The requirement to ensure all instructions flow simultaneously to the third party and the depositary would add nothing in terms of risk mitigation but would introduce new delays and possibility for error in the instruction process. Instruction protocols protect investors if they are simpler and less prone to error – and therefore more reliable. Protocols requiring additional complexity and multiple parties are more likely to be unreliable as recipients of instructions will be less certain the instruction is actually authorized.
3. Finally, if the AIF is to avoid the above costs, Option 1 would require cash accounts to be opened “at” the depositary (which is only possible if the depositary happens to be a credit institution). The incentive, therefore, is for the AIFM to concentrate credit risk with the depositary. Depositaries, to the extent they hold higher deposit balances as a result, will be impacted as their balance sheets are “grossed up” to reflect these higher balances. Increased costs could take the form of higher insurance premiums, reserves, capital and indirect costs associated with less favourable balance sheet ratios.

Q31: What would be the estimated costs related to the implementation of cash mirroring as required under option 1 of Box 76?

Full and exhaustive mirroring of all externally managed cash transactions would potentially entail substantial investment costs as well as cost for running the process on a daily basis as cash transactions occur independently of NAV calculations or fund dealing windows.

Costs incurred would include the building and maintenance of control teams capable of receiving and interpreting available cash reports provided by third parties under option 2.

While the estimates as to cost depend on a variety of factors, including the type of AIF, its investment strategy, the number of accounts as well as the number and quality of the counterparties, they will likely include:

- cost of designing and developing (or adapting/acquiring) a “position-keeping system” capable of capturing, storing, reconciling and adequately reporting on multiple accounts;
- cost of designing and developing the file format and communication protocol for electronic capture of movements with each counterparty. Sensible accommodation would be required for those third-party entities not equipped with automated communications capabilities. For example, certain communications mechanisms - such as SWIFT – are utilised by many but not by all entities

globally: it is likely to be difficult to force such entities to adapt their core message handling systems;

- cost of chasing or inputting certain files manually, failing or pending agreement on electronic exchanges in the required formats;
- cost of daily verification and chasing of data files and “quality control” of these files;
- cost of “quality control” of data loading into the “position-keeping system”;
- cost of enquiring and correcting technical errors detected at the data-loading stage (chasing, files, re-sending, missing data, etc.); and
- cost of producing the output files and reports and building a functional team analyzing these reports, etc.

2 Depositary functions pursuant to §8 – Safe-keeping duties

2.1 Definition of the financial instruments that should be held in custody

Box 78

Definition of financial instruments to be held in custody – Article 21 (8) (a) **(Recommended Revisions Marked)**

Pursuant to Article 21 (8) (a), financial instruments belonging to the AIF should be included in the scope of the depositary’s custody function when they meet all the criteria defined below:

1. they are transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC;
 2. they are not provided as collateral in accordance with the provisions set out in Box 79;
- and

Option 1

3. they are registered or held in an account directly or indirectly in the name of the depositary.

Option 2

3. they are financial instruments with respect to which the depositary may itself or through its subcustodian instruct the transfer of title or an interest therein by means of a book-entry on a register maintained by a settlement system as designated by Directive 98/26/EC or a similar non-European securities settlement system which acts directly for the issuer or its agent.

Additionally, financial instruments which **can-behave been** physically delivered to the depositary should be held in custody.

Financial instruments that are directly registered with the issuer itself or its agent (e.g. a registrar or a transfer agent) in the name of the AIF should not be held in custody unless **they can-bebearer instruments have been** physically delivered to the depositary. Further, financial instruments which comply with the definition set out above will remain in custody when the depositary ***takes a security interest in them or*** is entitled to re-use them **whether that right has been exercised or not**. Where the financial instruments have been provided by the AIF or the AIFM acting on behalf of the AIF to a third party under a temporary lending agreement, they will no longer be held in custody by the depositary and fall under the definition of ‘other assets’ in accordance with Article 21 (8) (b).

~~***In the context of Option 1, where the financial instruments are registered directly with the issuer or its agent making the depositary the only registered owner on behalf of one or more unidentified clients, the financial instruments should be held in custody. However, such financial instruments should not be held in custody if the depositary is clearly identified in the register as acting on behalf of the AIF and thus the AIF is clearly identified as the owner of the financial instruments.***~~

All financial instruments that do not comply with the above definition should be considered as 'other assets' under the meaning of the AIFMD Article 21 (8) (b) and be subject to record keeping duties.

COMMENT: The AGC favours legal certainty in order to more clearly delineate rights and responsibilities as between depositaries and AIFs (including the investors). The only sensible regime is a clear *a contrario* approach by which assets fall within the scope of Art. 21.8(a) or Art. 21.8(b). For this reason, the AGC prefers Option 2 as it suggests a definitional framework that is clear, reflects current reality and is relatively easily employed over time as market infrastructure evolves.

In the context of financial instruments, this *a contrario* approach is an appropriate mechanism for allocating the depositary's responsibilities – and liability – for the following reasons:

- (1) For purposes of identifying where the depositary's obligations arise under Article 21(8)(a), the AGC continues to believe it is important to distinguish:

- (a) financial instruments which are held in "nominee name" with a settlement system (CSDs, ICSDs) by a depositary/custodian or a nominee company

versus

- (b) financial instruments such as units of a fund not traded on a regulated market or private equity shares that are merely registered in nominee name directly with an issuer (which are usually inscribed in a register by a registrar or transfer agent appointed by the issuer or its agent).

Where the depositary/custodian is the participant in the settlement system:

- Rights and obligations of ultimate owners of securities are addressed via the "participation" agreement or "rules" of the CSD, which often have the force of law (e.g., DTC Rules under New York law).
- Securities are registered in a regulated settlement system (CSDs and ICSDs) that provide for the conditions necessary for the shares to be considered "held in custody" under the directive. These conditions include providing for certainty of transfer of ownership arising from "delivery versus payment/receipt versus payment" ("DVP/RVP") on settlement of the relevant transaction, which the depositary/custodian effectively controls via its participant account at the CSD/ICSD (either directly or indirectly via the sub-

custodian). This in turn provides assurance as to when customers (such as AIFs) become entitled to ownership of the relevant securities. The forthcoming Securities Law Directive is clearly relevant to providing a more uniform approach within the EU.

- The custody agreement with the depositary/custodian sets out the conditions (and rights) surrounding these shares: the AIF's rights to the relevant financial instruments are made subject to the rules of the CSD, for example.

Where the financial instruments are merely "registered in the nominee name" of the depositary/custodian or its subsidiary nominee company:

- In the case of funds or securities (such as private equity shares or interests in limited partnerships) not traded on a regulated market, there is no participation agreement (like there is with a CSD) linking the depositary/custodian to the registrar or transfer agent. Instructions to invest in such financial instruments involve an instruction to deliver cash "free of delivery" (unlike a CSD setting, where investments are legally effected by settling on a "DVP/RVP" basis).
- The choice of investment, including relevant due diligence, is carried out by the AIFM.
- The client of the depositary/custodian (the AIF or AIFM on behalf of the AIF) typically discusses all aspects of possible investment with the issuer (who is the fund or private equity investment into which the AIF or the AIFM on behalf of the AIF is considering investing) and then – if it prefers not to make the investment itself directly – might instruct the depositary/custodian to make the investment on its behalf by filling out the necessary subscription documents: the subscription documents would indicate that the depositary/custodian or its subsidiary nominee company is the registered owner, usually "for the benefit of ("FBO") underlying client". The client may or may not be named. The depositary/custodian's records would not normally indicate such investments as being "held in custody" per se. "
- As a result of the above, such financial instruments – those not involving a recognised settlement system – should not be considered "held in custody" subject to restitution liability under Art. 21.8(a): it is untenable to expect depositaries incur this kind of liability where they lack the kind of infrastructure and recognised rules afforded by recognised settlement systems (i.e., certainty of settlement and effective transfer of legal title extending to participants).

Both private equity shares and interests in funds may be invested in without use of a depositary/custodian's or its subsidiary's nominee name. It is common for such investments to be held "directly" (i.e., in the name of the AIF) as well. In some cases, this is necessitated by the legal structure of the target investment or other factors. If "Option 1" is selected, it seems likely that all such holdings will

migrate to a “direct” approach if depositaries are to avoid taking unwarranted risk that they cannot control.

(2) In respect of the following:

“ . . . financial instruments which **can** be physically delivered to the depositary should be held in custody” (*emph. added*),

the text should be revised slightly (as recommended as marked in Box 78) so that it does not **require** interests in funds to be “certificated” or physically issued simply because this is possible. Not all shares and other financial instruments should be required to be “physical” simply because this is allowed under the AIF’s rules. There are many potential reasons why this would not be desirable, including costs associated with printing and maintaining certificates, increased risk of error and continuation of the EU’s prudential policy goal of reducing fraud risk associated with bearer certificates.

(3) In respect of the following proposal that financial instruments should still be treated as being held in custody where the depositary re-uses them,

“ . . . 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”,

this should be revised. If re-hypothecation could result in title transfer, the suggested approach would be inconsistent with the proposed rule in Box 79 (allowing title transfer collateral to be treated as being “no longer held in custody” by the depositary).

(4) Finally, the last bullet point of Explanatory Note no. 29 refers to “cash deposits with a third party” as “financial instruments” which would fall under the “other assets” category. This bullet point should be deleted because cash is not considered a “financial instrument” within the meaning of MiFID. There is no need to include cash within the definition of “other assets” since the depositary’s cash monitoring and other obligations separately arise pursuant to Art. 21.7

Questions 32-33

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

Option 2 is preferred because it recognises the practical complications that arise where ownership of and rights in financial instruments are determined via mechanisms providing for relative legal certainty following DVP/RVP settlement and the use of CSDs. This certainty does not exist where investment is made in financial instruments held outside these mechanisms.

Q33: Under current market practice, which kinds of financial instrument are held in custody (according to current interpretations of this notion) in the various Member States?

"Custody" is a broad concept whose meaning varies depending on the context. The directive defines "custody" in a way that is intended to create "*obligation de resultats*" so that even intangible assets are treated like physical property, subject to a particular legal regime creating an absolute obligation to return the property to its owner. This particular results-oriented approach is inconsistent in many respects with the laws of other states across the EU and throughout the world, which tend to consider the custodian's role to encompass a test of conduct that varies depending on the facts and circumstances – such as the nature of the asset or financial instrument to be held - and the agreed understanding of the parties. The approach commonly understood in the U.K. and other common law countries is outlined above: common law fiduciary concepts apply in respect of assets that are held by the custodian as "bare trustee" on behalf of clients. The United States has generally adopted the Uniform Commercial Code concepts (at each state level), set out in Article 8, by which interests in "securities entitlements" – a bundle of rights deriving from but not the same as the security itself – are held "in custody" by securities intermediaries in the chain of custody. In this case, common law fiduciary concepts associated with responsibilities of "agents" or "bailees for hire" apply.

In civil law jurisdictions throughout the EU it is acknowledged that rights *in rem* in securities arise by virtue entering into a fiduciary contract such with a custodian so that segregation from the custodian (and insulation from creditors of the custodian) is assured². Legislation exists in certain civil law countries giving similar effect to positions reflected at CSDs. The net effect of all of this is recognition in civil law jurisdictions that rights to securities arise which are derived from records maintained at intermediaries in a chain of custody, with each link in the chain being dependent on the next. There is no direct "link" between a beneficial owner and the issuer: as a result, the approach being imposed under the directive will be difficult to make consistent with legal systems throughout the world.

Any *in rem* property interest in shares or interests which are not held via CSDs is more tenuous. In the case of interests in funds not traded on regulated markets or other financial instruments (such as private equity shares), there is no chain of custody at all as there is no arrangement to ensure the certainty of settlement that CSDs provide. It should be remembered that a hallmark of "custody" means holding a property interest on behalf of another. In the case of securities held via the Depository Trust Company, New York, the rules of the CSD are incorporated into applicable law, giving legal effect to DVP/RVP settlement. This in turn means that legal title has deemed to have passed as and when the CSD determines. This has implications for what is deemed "held in custody". Variations on this approach exist throughout the world, including in the EU. No such assurance exists where the investment is in a security or other interest (such as a fund unit or private equity share) that is intangible and is reflected outside of this framework.

² See, e.g., Luxembourg, Law of 27 July 2003, ratifying the Hague Convention of 1st July 1985.

Box 79

Treatment of collateral – Article 21 (8) (a)
(Recommended Revisions Marked)

Financial instruments provided as collateral **shall not be regarded as held in custody if and when** ~~should not be held in custody if~~ they are provided

Option 1

~~under a title transfer financial collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements~~

Option 2

~~under a title transfer financial collateral arrangement or under a security financial collateral arrangement by which the control over / possession of the financial instruments within the meaning of Article 2 (2) of Directive 2002/47/EC on financial collateral arrangements is transferred away from the AIF or the depositary to the collateral taker or a person acting on its behalf~~

Option 3

under a financial collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements **or similar collateral arrangements under other applicable law**

COMMENT: The AGC favours the third option, as revised, as the most pragmatic approach: not only does it ensure consistency with other EU legislation and similar non-EU legislation, it avoids the need for the depositary to analyse the legal effect of each individual collateral arrangement.

The text would benefit from a small change in the introductory portion, as marked above, so that it provides, "Financial instruments provided as collateral shall not be regarded as held in custody if and when they are provided...". Otherwise, there may be ambiguity which could lead to the interpretation that assets that are pledged as collateral should be taken out of custody; i.e., placed with a third-party collateral agent, which is not always the case. We understand that the intention is only to clarify that, so long as financial instruments are provided as collateral, they are not also to be treated as assets held in custody subject to Article 21.8(a). This drafting change will align the text with that intention more closely.

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?

In practice, both global custodians and prime brokers already have procedures to identify whether collateral provided to them is by title transfer or security transfer. This may require each type of collateral to be held in separate accounts, for example, giving effect to MiFID. Where a third party creditor has an interest in the financial instruments which are being used as collateral, the forthcoming Securities Law Directive provides a clear mechanism for identifying that financial instruments are subject to a third party interest.

2.2 Conditions applicable to the depositary when performing its safekeeping duties on each category of assets

Box 80

Safekeeping duties related to financial instruments that can be held in custody (*Recommended Revisions Marked*)

1. To comply with its obligations pursuant to Article 21 (8) (a), the depositary should be required to at least:

- (a) Ensure the financial instruments are properly registered in segregated accounts in order to be identified at all times as belonging to the AIF
- (b) Exercise due care in relation to the financial instruments held in custody to ensure a high level of protection
- (c) Assess and monitor all relevant custody risks associated with sub-custodians and central securities depositories. ~~In particular, depositaries should be required to assess the custody risks related to settlement systems and inform the AIFM of any material risk identified.~~

2. Where the depositary has delegated its custody functions, the depositary would remain subject to the requirements of §1 (c) and would further have to ensure the third party (hereafter referred to as the 'sub-custodian') complies with §1 (b) as well as with the segregation obligations set out in Box 16.

COMMENT: The obligations described above appear to create a somewhat more extensive oversight duty for depositaries than existing international standards – i.e., under point 1(c), to "assess the custody risk related to settlement systems and inform the AIFM of any material risks identified." The AGC believes imposition of this new requirement is inappropriate as it was not contemplated in the Level 1 text of the directive and raises new concerns. In particular, the scope of the rule described in Box 80 would need further clarification since Explanatory Note 35 states that it extends not just to CSDs but registrars as well: registrars are unlikely to be considered "settlement systems", while CSDs would be. This is especially important if Option 2 in Box 78 is selected (as we believe it should be): in this event, only book-entry financial instruments held in a settlement system "as designated by Directive 98/26/EC or a similar non-European securities settlement system which acts directly for the issuer or its agent" would be covered, but even this might include other mechanisms such as CCPs or platforms. Accordingly, if ESMA is to recommend requiring depositaries to assess and monitor these kinds of risks, the focus should be on commonly recognised mechanisms such as CSDs and ICSDs. The AGC's recommendation is set out as marked in Box 80 above.

Box 81

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

(*Recommended Revisions Marked*)

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (8) (b) including by third parties.

To comply with its obligations pursuant to Article 21 (8) (b), the depositary should be required to at least:

1. Ensure it has timely access to all relevant information it needs to perform its ownership verification and record keeping duties, including from third parties (e.g. prime brokers).
2. Ensure that it possesses sufficient and reliable information for it to be satisfied of the AIF's ownership right or of the ownership right of the AIFM acting on behalf of the AIF over the assets.
3. Maintain a record of those assets for which it is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership of those assets.

In order to comply with that obligation, the depositary should be required to:

- (a) register, on behalf of the AIF, assets in its name or in the name of its delegate; or
- (b) ensure, where assets are registered directly in the name of the AIF or the AIFM, or physically held by the AIF or the AIFM, it is able to provide at any time a comprehensive and up to date inventory of the AIF's assets.

To that end, the depositary should:

Option 1

- (i) ensure there are procedures in place so that assets so registered cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions; or
- (ii) have access to documentary evidence of each transaction from the relevant third party on a timely basis

Option 2

~~mirror all transactions in a position keeping record~~

In the context of § (b) the AIFM should be required to ensure that the relevant third party provides the depositary with certificates or other documentary evidence every time there is a sale / acquisition or a corporate action and at least once a year.

In any event, the depositary should ensure that the AIFM has and implements appropriate procedures to verify that the assets acquired by the AIF it manages are appropriately registered in the name of the AIF or in the name of the AIFM on behalf of the AIF, and to check consistency between the positions in its records and the assets for which the depositary is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership.

Additional requirement if Option 2 is retained in Box 78 with regard to the definition of financial instruments to be held in custody:

In the context of § (a), the depositary should ensure the AIF, its investors or the AIFM acting on behalf of the AIF, are able to exercise their rights if a problem arises that affects assets for which the depositary or its delegate is the registered owner either by clearly identifying the AIF as the ultimate owner of the assets or, where the depositary or its delegate is the only registered owner of the assets on behalf of a group of one or more unidentified clients, by taking appropriate actions to ensure the AIF's ownership right is recognised by the relevant parties. Where a legal action is required, the costs related to such an action would have to be borne by the AIF, the AIFM or as the case may be the AIF investors.

4. The depositary should set up and implement an escalation process for situations where an anomaly is detected (e.g. to notify the AIFM and if the situation cannot be clarified / corrected, alert the competent authority).

COMMENT: Option 1 is strongly preferred as it is the only pragmatic choice. It acknowledges the fact that the "other assets" may not be controllable by depositaries (i.e., they may or may not be capable of being rendered non-transferable) so there is scope for ex post documentary evidence. Crucially, the "documentary evidence" alternative is broad enough to encompass the wide variety of asset classes – and corresponding variety of relevant documentation – outlined in the AGC's previous submissions to ESMA.

"Mirroring" all transactions – as set out in Option 2 - is not pragmatic or in the interest of investors because physically rekeying or importing all transactions into the depositary's accounting or position-keeping system would result in a potentially huge workload and increased costs with no value added to the oversight function as undue energy and time would be spent "mirroring and reconciling" rather than analyzing third party records readily available on a day-to-day basis. It is unlikely that a depositary could have a window on transactions in "other assets" that is always contemporaneous and accurate. The only realistic approach is to provide for ex post monitoring, often relying on information provided to the depositary by the AIFM or its appointed delegate. Any records maintained by the depositary would reflect the results of this monitoring.

Questions 35-39

Q35: How do you see the delegation of safekeeping duties other than custody tasks operating in practice?

Similar to the way it is recognised in MiFID, a Depositary may need to draw on expertise and support that does not exist in-house. Especially in the alternative funds environment, when asset classes may vary widely with significant onward impact on the way in which a depositary may carry out its responsibilities, it is crucial that the directive be flexible enough to allow depositaries to draw on third parties where necessary. Factors impacting the ability of the depositary to oversee "other assets" may include geographic dispersal of the assets, the complexity of the assets, special circumstances such as nature of ownership interests in the assets, including evidence of how they are held, tangibility of the assets, etc. For example, the assets of shipping container funds (which do exist) constantly move around the world. "Ownership" of shipping containers may depend on a variety of factors: documents of title are not necessarily determinative. In the case of wine or fine art funds, use of specialist sub-custodians who can provide proper physical storage conditions is essential. Across the

broad spectrum of current and future AIF strategies, wider use of third parties to oversee how such assets are held and under what circumstances will be necessary in the future to meet the increased requirements of AIFMD.

However, it is also important to recognise that the depositary will not always appoint a third party who has control and maintains day-to-day records of the underlying asset: third parties may include an affiliate or delegate of the AIFM, or a professional service provider such as a law firm, notary or property manager. In these cases, it is the responsibility of the AIFM to ensure that the depositary has appropriate and timely access to records and documentary evidence held or controlled by the third party.

Q36: Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

As mentioned above, assets of all kinds – including MiFID financial instruments (such as private equity shares and interests in underlying funds) - may be invested in with or without use of a depositary's or its subsidiary's "nominee" name.

A key common law distinction applying to (iii) above is that holding assets in the "name of the depositary on behalf of a group of unidentified clients" is accomplished utilising a so-called "nominee account" or "nominee name". Depending on the asset being invested in, an omnibus account may be used which only reflects this "nominee" name without reference to any particular underlying beneficial owner. Often, the depositary/custodian itself or a so-called "nominee company" subsidiary of the depositary, is used for this purpose. An omnibus account implies lack of segregation on the books of the registrar/transfer agent among positions of beneficial owners, but this not a problem since the intermediary (the depositary) would "break out" these positions in compliance with its own record-keeping responsibilities (e.g., in compliance with client asset rules that separately apply to it).

Registering ownership of a financial instrument or other asset in nominee name may serve a variety of purposes (described further below) but registering in nominee name does not - *in itself* – suggest the share or other asset is held in "custody" in the sense of depositary responsibilities envisioned in AIFMD under Article 21.8(a). Registering an asset in the name of a depositary may provide for additional "control" but "control" is relative and would not rise to the level implied in Article 21.8(a) for reasons described in more detail in the Comment following Box 78 and responses to Questions 32 and 33 (*see above*). Moreover, it is not always possible to register assets in the name of a depositary in any case. *Direct investment* (set out as (i) in Q.36 above)) may be necessitated by the legal structure of the target investment or other factors. For example, a limited partnership structure seldomly permits limited partners to invest in someone else's name since the fund (or its general partner) will seek to ensure the beneficial investor is fully liable under the terms of the partnership agreement³. However, for other structures – especially open-end funds with

³ In this context, it is entirely reasonable to require the depositary to seek assurances from a registrar or transfer agent that the latter properly reflect ownerships.

significant distribution – “nominee” or “indirect” structures are often used according to the dictates of the chain of distribution and other factors. Omnibus accounts are commonly utilised for this reason.

As a result, all three methods of investment described above are quite common. For this reason, we strongly urge ESMA to recommend an approach that encompasses all three approaches described in Question 36.

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 believe this is possible and desirable, particular reports indicating daily mark-to-market and any assets of the AIF which are held off balance-sheet (e.g., pledged, subject to rehypothecation, but not rehypothecated).

Q38: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 8? Please provide an estimate of the costs and benefits related to the requirement for the depositary to mirror all transactions in a position keeping record?

The AGC assumes the reference to Box 8 should be corrected to refer to Box 81. With this in mind, the AGC responds as follows:

Costs and Consequences of Option 1 versus Option 2:

It is difficult for depositaries to provide estimates of the costs related to these options in a meaningful way, including in respect of capital charges. There are several practical problems:

1. The Basel II framework, as reflected in the Capital Requirements Directive and national rules, does not automatically require capital reserves to be increased if operational risk and potential liability for failure to comply with new requirements becomes more burdensome for banks - unless a bank assesses that the risk of operational losses or liability are likely to be greater. Each institution will need to make its own assessment about operational risk and increased liability associated with each of these options; but no formula can be applied which will represent the positions of all institutions.
2. The profile of business, risk and costs would be far more likely to change as a result of Option 2 than Option 1. However, either option would represent significant change – and potential new costs and risks – due to the fact that new AIFs will be brought within scope of the directive that hitherto have been unregulated or lightly regulated. There will be many examples of AIFs which never have had a depositary, let alone a custodian (e.g., certain private equity funds, real estate funds and hedge funds) with the result that a far more heterogeneous client base will be seeking depositary services. Not all depositaries have formed a strategic view about whether they will be in a position to support all types of AIF, and it is likely that there will ultimately be a

spectrum, from plain vanilla depositary business to support for the most exotic AIF structures, with different requirements – regardless of whether Option 1 or Option 2 is selected. That said, Option 2 presents a prospect of far higher costs and implications.

3. More broadly, it should be kept in mind that any assessment about operational risks associated with new structures, or mixtures of business, will need to take account of new capabilities and expertise that are being added or will be created in the future. At this stage, predicting costs is a speculative exercise.

At the AGC level, obtaining and describing member bank business costs is a substantial challenge. Individual members' cost profiles are known to vary materially from member to member depending on a fairly wide range of factors, including scale of operations (locally and globally), types of client assets involved, and types of clients. Additionally, information in any detail concerning a bank's business costs is proprietary to the bank and is typically significant in terms of competitive implications (and therefore cannot be disclosed even to the Association). Further, cost information -- as distinct from more public information such as "assets under custody globally" or "number of jurisdictions accessed" -- can be difficult for members to retrieve and susceptible to varying implications across members. Finally, the variances among members in scope of business, service mixes, pricing arrangements and customization flexibility in accommodating varying customer demands make aggregated Association-level information useful only in a general way. Such aggregates can imply a uniform standard or a degree of commonality that does not exist in practice.

Nonetheless, below we set out descriptive background concerning the general business profile and structure of global custodians, including when acting as fund depositaries, and brief commentary and data concerning categories of costs and estimated capital implications of ESMA's proposed advice:

Option 1 states a general proposition that is in line with best practice as currently applied. Additional cost would be relatively limited and consist of a one-off review aiming at adapting and documenting the current processes in line with the described requirements and recurrently assuring a regular and duly documented review and escalation process. It is not expected that major IT investments would be required in this scenario. What is uncertain are the implications for funds that would be brought in scope of the directive where third parties will be responding to new requirements imposed on them by depositaries. For example, in certain previously lightly regulated market segments, a private equity issuer's registrar, or a transfer agent acting for a limited partnership, may well resist being required to confirm that the shares or LP interests that they effectively control "cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions", nor may these parties welcome being required to facilitate the provision of "documentary evidence of each transaction" to the depositary "on a timely basis". These new requirements may be seen as severely disruptive by third parties and will likely entail additional infrastructure and cost in order to bring these third parties – whether directly or via the AIFM – in line with the directive.

Option 2 – as stated previously, the requirement to “mirror” all transactions would require the physical rekeying or importing all transactions into the depositary’s accounting or position-keeping system would result in a potentially huge workload and increased costs with no value added to the oversight function as undue energy and time would be spent “mirroring and reconciling” rather than analyzing third party records readily available on a day-to-day basis. It is unlikely that a depositary could have a window on transactions in “other assets” that is always contemporaneous and accurate. Costs incurred would include the building and maintenance of control teams capable of receiving and interpreting available documents, transaction information and reports required to “mirror” accurately.

While the estimates as to cost depend on a variety of factors, including the type of AIF, its investment strategy and the assets held and transacted in, they will likely include:

- cost of designing and developing (or adapting/acquiring) a “position-keeping system” capable of capturing, storing, reconciling and adequately reporting on all such assets;
- cost of designing and developing the file format and communication protocol for electronic capture of information with third parties. Sensible accommodation would be required for those third-party entities not equipped with automated communications capabilities. For example, certain communications mechanisms - such as SWIFT – are utilised by many but not by all entities globally: it is likely to be difficult to force such entities to adapt their core message handling systems;
- cost of chasing or inputting certain files manually, failing or pending agreement on electronic exchanges in the required formats;
- cost of periodic verification and chasing of data files and “quality control” of these files;
- cost of “quality control” of data loading into the “position-keeping system”;
- cost of enquiring and correcting technical errors detected at the data-loading stage (chasing, files, re-sending, missing data, etc.); and
- cost of producing the output files and reports and building a functional team analyzing these reports, etc.
- significant cost of building up staff qualified to review documents and other evidence, which would be necessary to conclude whether or not an asset should be “mirrored”.

Q39: To what extent does / should the depositary look at underlying assets to verify ownership over the assets?

The depositary should ensure that the AIF has robust procedures to confirm that assets not held at the depositary are verified by the AIF and reconciled by the administrator. The reconciliations will be to the records of the parties with whom the transactions are conducted (e.g. brokers, counterparties) and to statements / confirmations from third party administrators.

3 Depositary functions pursuant to §9 – Oversight duties

Box 82

Oversight duties – general requirements **(Recommended Revisions as Marked)**

At the time of its appointment, the depositary should assess the risks associated with the nature, scale and complexity of the AIF's strategy and the AIFM's organisation in order to define oversight procedures which are proportionate to the AIF and the assets in which it invests. Such procedures should be regularly updated.

To comply with its oversight duties, the depositary is expected to perform *ex post* controls and verifications of processes and procedures that are under the responsibility of the AIFM, the AIF or an appointed third party. The depositary should in all circumstances ensure a procedure exists, is appropriate, implemented and frequently reviewed.

The depositary is required to establish a clear and comprehensive escalation procedure to deal with situations where potential irregularities are detected in the course of its oversight duties, the details of which should be made available to the competent authorities upon request.

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (9) including by third parties and particularly that the depositary is able to perform on-site visits of its own premises and any service provider appointed by the AIF or the AIFM (e.g. Administrator, external valuer) to ensure the adequacy and relevance of the procedures in place. **The depositary should be able to rely on the reports of recognised external certifications by qualified, independent auditors or other experts.**

COMMENT: The AGC agrees with the advice in Box 82, and the explanatory text #47-51. The AGC notes that assurance about the existence and effectiveness of procedures and controls is frequently provided by third-party assurance reports, such as SAS-70, SASE-16, ISAE-3402, ISAE-3000, or national equivalents such as AAF 01/06 which is used in the U.K. If such assurance reports exist, it should be made clear that the AIFM is responsible for ensuring the depositary receives a copy on a timely basis. An additional sentence is added to clarify that depositaries should be able to conclusively rely on reports of qualified third parties.

Box 83

Clarifications of the depositary's oversight duties - Duties related to subscriptions / redemptions

(a)

(Recommended Revisions as Marked)

To fulfil its duties pursuant to Article 21 (9) (a), the depositary should be required to:

1. ensure that the AIF, the AIFM or the designated entity has and implements an appropriate procedure to :

(a) reconcile

- the subscription / redemption orders with the subscription proceeds / redemptions paid, and
- the number of units or shares issued / cancelled with the subscription proceeds received / redemptions paid by the AIF

(b) verify on a regular basis that the reconciliation procedure is appropriate. To that end, the depositary should in particular regularly check the consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register

2. ensure and regularly check the compliance of the procedures regarding the primary market sale, issue, repurchase, redemption and cancellation of shares or units of the AIF with the applicable national law and the AIF rules and / or instruments of incorporation and verify that these procedures are effectively implemented.

The frequency of the depositary's checks should be proportionate to the frequency of subscription and redemptions.

COMMENTS: The AGC agrees with the advice in Box 83, except that the AGC believes (as noted) that it should be clarified that the depositary's duties in respect of sales and repurchases do not apply to transactions in the secondary market. The AGC agrees with the explanatory text #52-56. The AGC notes that eligibility for entry into an AIF is usually defined on a contractual basis, and that the responsibility lies primarily with the investor to respect the rules of the AIF in this regard. The AGC agrees that the depositary should not be required to confirm such eligibility, as this would duplicate the efforts of the investor and the AIFM.

Box 84

Clarifications of the depositary's oversight duties - Duties related to the valuation of shares / units

(b)

(Recommended Revisions as Marked)

~~1. The depositary should verify on an on-going basis that appropriate and consistent procedures are established for the valuation of the assets of the AIF in compliance with the requirements of Article 19 and its implementing measures and the AIF rules and instruments of incorporation.~~

21. The depositary should ensure that the valuation policies and procedures for the calculation of the value of the units or shares of the AIF are calculated are effectively implemented and periodically reviewed.

32. The depositary's procedures should be proportionate to the nature, scale and complexity of the AIF and conducted at a frequency consistent with the frequency of the AIF's policy for the calculation of the value of the units or shares of the AIF as defined in Article 19 and its implementing measures.

43. Where the depositary considers the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable law or the AIF rules or the provisions of Article 19, it should notify the AIFM and ensure timely remedial action has been taken in the best interest of the

AIF's investors.

~~5. Where applicable, the depositary should be required to check that an external valuer has been appointed in accordance with the provisions of Article 19 of the AIFMD and its implementing measures.~~

COMMENTS: The AGC believes that ESMA has made recommendations in Box 84 that go well beyond the requirements of the Level 1 text and which would not add to investor protection meaningfully but would result in increased cost and the possibility of confusion among roles of service providers to the AIF.

The Level 1 text of the Directive, at Article 21.9(b), requires that the depositary "...ensure that **the value of the units or shares of the AIF are calculated** in accordance with the applicable national law, the AIF rules or instruments of incorporation and the procedures laid down in Article 19...". The depositary is not required to directly "oversee" the valuation of AIF's assets. Accordingly, we believe that item #1 of Box 84 should be deleted.

To provide clarity regarding allocation of responsibilities, AGC also proposes to amend item #2 as follows: "The depositary should ensure that the policies and procedures **for the calculation of the value of the units or shares of the AIF** are effectively implemented and periodically reviewed."

Item #3 should also be amended to replace "valuation policy" with "**policy for the calculation of the value of the units or shares of the AIF**".

As the depositary is not required to oversee the valuations of assets or the decision to appoint an external valuer, AGC also believes that item #5 should be deleted. The decision as to whether to utilise an "internal" versus "external" valuer is the responsibility of the AIFM, and the AIFM must ensure compliance with the requirements of Article 19 in this regard.

In the explanatory text #58, AGC believes that the depositary should be expected "... to take **reasonable steps** to ensure that the procedures **for the calculation of the value of the units or shares of the AIF** are appropriate ...". The sentence "When setting up its oversight procedures, the depositary should ensure that it has a clear understanding of the valuation methodologies used by the AIFM or the external valuer to value the assets of the fund." should be deleted, as this is outside the direct remit of the depositary.

The AGC agrees with the explanatory text #57 and #59.

Box 85

Clarifications of the depositary's oversight duties - Duties related to the carrying out of the AIFM's instructions

(c)

(No Recommended Revisions)

To fulfil its obligation pursuant to Article 21 (9) (c), the depositary should be required to:

1. Set up and implement appropriate procedures to verify the compliance of the AIF / AIFM with applicable law and regulation as well as with the AIF's rules and instruments of incorporation. In particular, the depositary should monitor compliance of the AIF with

investment restrictions and leverage limits defined in the AIF's offering documents. Those procedures should be proportionate to the nature, scale and complexity of the AIF.

2. Set up and implement an escalation procedure where the AIF has breached one of the limits or restrictions referred to under §1.

COMMENTS: See response to Question 40. However, in addition, we suggest revision to explanatory text note 62, which refers to an obligation of the depositary to "monitor the AIF's transactions and investigate any 'unusual' transaction it has identified in conjunction with cash monitoring duties". This statement goes beyond level 1 text and creates the risk of confusion throughout the industry as to the meaning of "unusual". This could lead to diverging interpretations among industry participants and regulators, increased "false positives" with unnecessary associated costs, and increased error and delay in high-frequency settings. The AGC requests the deletion of the last sentence of Explanatory Note 62.

Box 86

Clarifications of the depositary's oversight duties - Duties related to the timely settlement of transactions

(d)

(Recommended Revisions as Marked)

Option 1

No additional requirement

Option 2

~~To fulfil its obligation pursuant to Article 21(9)(d), the depositary should be required to set up a procedure to detect any situation where the consideration is not remitted to the AIF within the usual time limits, notify the AIFM and where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.~~

~~Where the transactions do not take place on a regulated market, the usual time limits should be assessed with regard to the conditions attached to the transactions (OTC derivative contracts, investments in real estate assets or in privately held companies)~~

COMMENTS: The AGC agrees that no further clarification is needed and thus prefers Option 1 as it provides for flexibility encompassing a wide variety of possible situations that may occur depending on the AIF, the asset class and strategy. Global custodians typically monitor the settlement process in the ordinary course and follow up on late payments to their clients.

Box 87

Clarifications of the depositary's oversight duties - Duties related to the AIF's income distribution (e)

(Recommended Revisions as Marked)

To fulfil its obligation pursuant to Article 21(9)(e), the depositary should be required to:

1. Ensure the net income calculation, once declared by the AIFM, is applied in accordance with the AIF rules, instruments of incorporation and applicable national law

~~2. Ensure appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements~~

~~3. Once declared by the AIFM, c~~ Check the completeness and accuracy of dividend payments and, where relevant, of the carried interest.

COMMENTS: The AGC notes that a depositary's oversight duties related to the AIF's income distribution can only be interpreted as an obligation to oversee the allocation of a distribution to investors according to the rules of the AIF only once a decision has been made by the AIFM to distribute. Similarly, dividend payments are subject to domestic law and fall under the responsibility of the AIFM or AIF governance structure to declare them in accordance with applicable law, instruments of governance (such as the Articles of Incorporation) and the prospectus. In the alternatives setting in particular, distributions may take many forms and are often declared only after the AIFM has decided on working capital requirements and other strategic issues. Reasons for distributions may include, for example, income, capital gains, a return of capital or repayment of a shareholder loan.

The proposed requirement set out in point 1 to "ensure" the calculation of the net income for fund operations is consistent with AIF rules, etc., would require the depositary to enquire into the portfolio management decision regarding available cash, and possibly to duplicate the entire accounting process for all fund debits and credits to ensure their correct calculation under AIF rules, instruments of incorporation and applicable national law. This would not be possible to meet in most cases, may interfere unreasonably with management discretion or in any event would only be possible by incurring significant duplication and thus higher costs. Similar concerns arise in respect of point 3. The AGC therefore seeks clarification that these requirements arise once the relevant items are "declared" by the AIFM.

The AGC also recommends deletion of point 2 as it is not the depositary's role to ensure auditors' notes and qualifications on financial statements are observed by the AIFM or AIF governance structure. Depositary's certainly should respond to relevant matters affecting fund assets or other issues relevant to its duties, but a direct responsibility to follow up on financial statements goes too far.

Questions 40 – 45

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?

In countries where AIFs already use depositaries with roles that are similar to the role envisaged in the proposal, such as Luxembourg or Germany, the impact would be fairly minimal, although some significant adjustments nevertheless would still be necessary. In other countries, however, the impact on entire industry segments could be very significant. For example, in the UK, the use of depositaries is currently uncommon among real estate and private equity funds, and therefore formalisation of an oversight role that does not currently exist will entail the establishment of new procedures with significant added costs. This would be the case in many other EU countries as well.

Additional clarity would be helpful concerning the scope of the proposed depositary obligation in Box 85. While AGC does not believe that the explanation appearing in Box 85 is

objectionable, Explanatory Paragraph 62 suggests that the depositary should check whether “the AIF’s investments are consistent with its investment strategy . . . to ensure it does not breach its investment restrictions.” While a depositary might sensibly seek to “ensure” that investment restrictions are not violated, an obligation for a depositary to ensure that a real estate fund’s investments “are consistent with its investment strategy” would not be possible to meet in most cases and would involve an unacceptable level of subjectivity in the execution of the depositary function.

Q41: Could potential conflicts of interest arise when the depositary is designated to issue shares of the AIF?

It is difficult to envision when the depositary would carry out this role (“issuance of shares”): as a result, clarification is sought⁴. Ordinarily a transfer agent is appointed as an agent of the fund or the management company (AIFM) to maintain a share or unit register. If ESMA is referring to situations in which the depositary is also the transfer agent for the AIF, potential conflicts of interest clearly do arise, especially in light of the depositary’s oversight role in respect of AIF units/shares, set out in Article 21.9.

The AGC notes various provisions of the AIFMD Level 1 include measures to limit conflicts of interest, which require that the depositary:

“has functionally and hierarchically separated the performance of its depositary functions from its tasks as [prime broker/external valuer/etc] and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF”.

Similar provisions are contained in Article 20.2(b), covering delegation. The AGC believes these provisions are sufficient to manage such any potential conflicts of interest.

Q42: As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF is compliant with the applicable national law and the AIF rules and / or instruments of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

The current practice is that the depositary ensures that the AIF, the AIFM or its delegate (i.e., the transfer agent/administrative agent) establish and maintain appropriate procedures to reconcile subscription orders with subscriptions proceeds that are invested in the fund. The depositary also ensures that the procedure is reviewed on a regular basis and updated if necessary. The depositary may conduct *ex-post* verifications based on information provided to it. These reviews are conducted on a gross/aggregate basis and would not focus on individual shareholder/unitholder transactions.

In this respect, the depositary undertakes to verify the performance of the AIFM, AIF or its delegate (i.e., the transfer agent/administrative agent) for the purpose of reviewing procedures and methodologies, including sample checks as part of the assessment of the control environment. The frequency of this verification need not be correlated to the

⁴ It may be accurate to say that a trustee of an AIF taking the legal form of a unit trust it may “issue” the units of the trust, but it is hard to see how this in itself would create any issues.

frequency of subscription and redemptions. It is more important that the controls (procedures) that are implemented by the AIF, the AIFM or its delegate (transfer agent and administrative agent) ensure consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register. The frequency of these controls should be proportionate to the frequency of subscription and redemptions.

In addition, the relative complexity of investor-related processes for alternative funds, as described in more detail below, should be taken into account as more complex capital structures will present a significant burden on depositaries if they are required to verify reconciliation of investor transactions too frequently. Some of these complexities are set out below:

1. Many real estate, private equity and other funds operate on a **commitment and draw-down basis**, where the Fund Manager only issues capital calls when investments or expenses are anticipated, thus limiting the amount of cash remaining "un-invested" in the fund. This means that a contractual commitment agreement is initially established between fund and investors, but payments may then be drawn down across a number of events and years, at the discretion of the manager.
2. A significant number of alternative funds, particularly those structured as limited partnerships, **are not unitised**. As a result, no shares or units are actually "issued". Instead, as a matter of contract (the partnership agreement), investors receive an interest in the partnership that is proportional to their capital commitments and drawn capital as a part of the whole investor base.
3. Alternative funds may also issue **partly-paid shares** or interests, with the result that no further shares are issued when capital is drawn down, but investors' partly-paid proportions of their existing interests increase over time.
4. In closed-ended funds, investors may invest in multiple closings throughout the closing period. This process may require interests to be "equalised" over the closing period. At the end of the closing period, all investors are considered to have pro-rata interests which are treated as having existed from the initial closing date. There are a variety of **equalisation** methods, some of which may require payments from a late investor to an early investor outside of the fund accounts.
5. Current practices vary across jurisdictions. In the case of unregulated funds, the Fund Manager is frequently responsible for updating the records of investors' interests, and for reconciling cash received with the interests issued to investors in return. In contrast, in the case of regulated funds, maintenance of the investor register is frequently a regulated activity provided by an external transfer agent or registrar.
6. A practice in some jurisdictions is to establish a separate investor subscription/redemption/distribution account at the depositary, which allows the investor cash transactions to be more easily identified. Net balances are transferred from this account to the fund's main account, once investor amounts have been reconciled. In some cases payments to investors are actually a return of funds called in during capital calls which were ultimately not invested by the fund.

The above is intended to show that simple requirements relating to verification of

reconciliation of subscription orders with subscription proceeds can become very complex in application and practice.

In the real state funds industry, current practice is that the depositary verifies that the fund manager / fund administrator has implemented and follows procedures for reconciling cash with investor interests; due diligence checks are generally conducted by the depositary at least annually, and any material failures in the process are generally notified by the fund manager / fund administrator to the depositary on an ongoing basis. Full reconciliation is therefore generally done on an ongoing basis.

The AGC believes that requiring the depositary to directly oversee these types of operations will duplicate processes that are already the responsibility of other parties and will lead to additional costs without significant added benefits in terms of investor protection.

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?

Reconciliation of the balances of cash positions and related share issuance or redemptions is currently standard practice in the funds industry. Suitability and eligibility requirements for entry into an AIF typically are imposed as a matter of regulation or are set out between the fund and the investor contractually. Responsibility lies primarily with the promoter/distributor for ensuring that necessary disclosures and conditions of investment are disclosed appropriately. The investor is responsible for providing the necessary confirmations. The AGC believes the depositary should not be required to confirm suitability, eligibility and other conditions of investment have been met, as this would duplicate the efforts of the investor and the AIFM with no added benefit.

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.

The AGC considers the scope of the depositaries duties related to the carrying out of the AIFM's instructions set out in paragraph 1 of Box 85 to be appropriate in general.

We would repeat the point raised in question 40, however, which notes that Explanatory Paragraph 62 introduces the idea that the depositary should check whether "the AIF's investments are consistent with its investment strategy . . . to ensure it does not breach its investment restrictions." While a depositary should and does check to ensure that investment restrictions are not violated, we believe that introducing an obligation for a depositary to ensure that a real estate fund's investments "are consistent with its investment strategy" would not be possible to meet in most cases and would involve an unacceptable level of subjectivity in the execution of the depositary function.

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

For the reasons stated below Box 86, AGC prefers option 1. Maximum flexibility should be given to depositary's duties to set up procedures that are tailored to a highly divergent array of transactions and strategies.

Section 2 Due diligence duties

Box 88

Due Diligence Requirements

(Recommended Revisions as Marked)

1. When the depositary delegates any of its safekeeping functions, it should implement an appropriate, documented and regularly reviewed due diligence process in the selection and ongoing monitoring of the delegate.

(a) When appointing a sub-custodian, the depositary should roll out a due diligence process which aims to ensure that entrusting financial instruments to a sub-custodian provides an adequate level of protection. Such a process should include at least the following steps:

- (i) assess the regulatory and legal framework (including country risk, **and** custody risk, **enforceability of contractual agreements**). This assessment should particularly enable the depositary to determine the potential implication of the insolvency of the sub-custodian
- (ii) assess whether the sub-custodian's practice, procedures and internal controls are adequate to ensure the financial instruments will be subject to reasonable care
- (iii) assess whether the sub-custodian's financial strength and renown are consistent with the delegated tasks. This assessment shall be based on information provided by the potential subcustodian as well as third party data and information where available
- (iv) ensure the sub-custodian has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security

(b) The depositary should perform ongoing monitoring to ensure the sub-custodian continues to comply with the criteria defined under §1 and the conditions laid out in Article 21 (11) (d), and at least:

- (i) monitor the sub-custodian's performance and its compliance with the depositary's standards
- (ii) ensure it exercises reasonable care, prudence and diligence in the performance of its custody tasks and particularly that it effectively segregates the financial instruments assets in line with the requirements set out in Box 16
- (iii) review the custody risks associated with the decision to entrust the assets to that entity and promptly notify the AIF or AIFM of any change in these risks. This assessment should be based on information provided by the sub-custodian as well as third party data and information where available. During market turmoil or where a risk has been identified, the frequency and the scope of the review should be increased

2. The depositary should design contingency plans for each market in which it appoints a delegate to perform safekeeping duties. Such a contingency plan may include the identification of an alternative provider, if any.

3. The depositary shall terminate the contract in the best interest of the AIF and its investors where the delegate no longer complies with the requirements.

COMMENTS: Under para 1(a)(i), the depositary's duty to assess the enforceability of contractual agreements seems very wide and potentially very costly to implement in practice. A more targeted approach (e.g., specifying key contracts and, if possible, key provisions in such contracts) would potentially be more useful and cost effective (e.g., segregation provisions in sub-custody agreements), although it should be recognised this may entail obtaining legal opinions for each contract in each market beyond what might ordinarily be

obtained - a significant additional expense. Absent more specificity here, AGC recommends deleting the reference to contracts (as marked).

Section 3 Segregation

Box 89

Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC implementing the MiFID Directive)

(No Revisions Recommended)

1. Where safekeeping functions have been delegated partly or totally to a third party, the depositary must ensure that the third party acts in accordance with the segregation obligation pursuant to Article 21 (11) (d) (iii) by verifying that the third party has put in place arrangements that are compliant with the following requirements:

(a) to keep such records and accounts as are necessary to enable it at any time and without delay to distinguish assets safekept for the depositary on behalf of its clients from its own assets and from assets held for any other client (including assets belonging to the depositary itself);

(b) to maintain records and accounts in a way that ensures their accuracy, and in particular their correspondence to the assets safekept for the depositary's clients;

(c) to conduct, on a regular basis, reconciliations between its internal accounts and records and those of any sub-delegate by whom those assets are safekept;

(d) to take the necessary steps to ensure that any financial instruments belonging to the depositary's clients entrusted to a sub-delegate are identifiable separately from the financial instruments belonging to the sub-delegate, by means of differently titled accounts on the books of the sub-delegate or other equivalent measures that achieve the same level of protection;

(e) to take the necessary steps to ensure that cash belonging to the depositary's clients deposited in a central bank, a credit institution or a bank authorised in a third country is held in an account or accounts identified separately from any accounts used to hold cash belonging to the third party or where relevant the sub-delegate.

2. Where the depositary has delegated its custody functions, monitoring the sub-custodian's compliance with its segregation obligations should ensure the financial instruments belonging to its clients are protected from the event of insolvency of that sub-custodian. If, for reasons of the applicable law, including in particular the law relating to property or insolvency, the requirements described in §1 are not sufficient to reach that objective, the depositary should assess what additional arrangements could be made in order to minimise the risk of loss and maintain an adequate level of protection.

3. The requirements in §1 and §2 should apply mutatis mutandis when the third party has decided to delegate part or all of its tasks to a sub-delegate as foreseen in Article 21 (11).

COMMENT: These provisions seem acceptable.

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.

At most, all that can be reasonably expected is for the depositary to seek clarification or confirmation as to the conditions under which assets are held, but sub-custodians will not be placed to provide certainty as to legal effect in this regard.

The depositary's liability regime

1 Loss of financial instruments

Box 90

Definition of loss

(No Recommended Revisions)

1. Financial instruments held in custody by the depositary or, as the case may be, by a sub-custodian should be considered 'lost' within the meaning of Article 21 (12) if one of the following conditions is met:

- (a) a stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed;
- (b) the AIF has been permanently deprived of its right of ownership over the financial instruments;
- (c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments.

2. The assessment of the loss of financial instruments must follow a documented process readily available to competent authorities and lead to the notification of investors in a durable medium taking into account the materiality of the loss.

Where an AIF is permanently deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments, for example in situations where shares are cancelled and replaced by the issue of new shares in a company reorganisation, this is not considered to be an example of the loss of financial instruments held in custody.

In case of insolvency of a sub-custodian, financial instruments should be considered 'lost' as soon as one of the conditions set out in §1 is met with certainty and at the latest, at the end of the insolvency proceedings. To that end, the AIFM should monitor closely the proceedings to determine whether all or part of the financial instruments entrusted to the sub-custodian are effectively lost.

In case of a fraud whereby the financial instruments have never existed or have never been attributed to the AIF (e.g., as a result of a falsified evidence of title, accounting fraud, etc.), all conditions described in §1 should be deemed to be met.

COMMENT: In general, the concept of "loss" as presented above is sensible. As noted in the AGC's previous submissions, a financial instrument should only be considered "lost" in the ordinary sense, i.e., when it is irretrievably and permanently lost without any reasonable

prospect of being recovered or realised on such that the AIF is permanently deprived of its ownership interest in the relevant financial instrument(s).⁵ However, the AGC disagrees with ESMA's belief expressed in Explanatory Note 19 that "it is up to the AIFM to determine whether the financial instruments are lost . . ." Whilst the AIFM has a key role to play, including informing investors of material losses as the note suggests, its views are not and should not be solely determinative. Whether the financial instruments are lost or not is a question of fact which ultimately is a matter for the courts to decide, which might be strongly influenced by what the parties agree in the agreement appointing the depositary. It is more sensible to allow the parties to enumerate the kinds of events they agree in advance might give rise to "loss" for which the depositary may or may not be liable and allow proper dispute resolution mechanisms to run their course so that the essential principle of legal certainty is observed. To vest the power in one of the parties to dictate a factual determination would create an intolerable moral hazard. AIFMs would be incentivised to conclude a financial instrument is "lost" where recourse to the depositary becomes more convenient or less costly than pursuing recovery through proper dispute resolution channels.

More fundamentally, the AGC disagrees strongly with the following characterisation by ESMA – set out in Annex III of the Consultation ("Cost-Benefit Analysis"), Part 12.6 ("Loss of Financial Instruments")⁶, of the role of the courts as possibly disruptive to the "harmonization objective":

"In general, the industry supports the idea that it should be up to the courts to decide whether an asset is lost when the amount at stake is material. However, the harmonization objective would not be achieved since the room for interpretation left to the different national courts is important."

The AGC believes this statement misinterprets the role of the court system. The harmonization of the directive is prejudiced potentially through differing **implementation**: it is governments and their regulatory bodies who implement, not the courts. If ESMA is concerned about preserving the harmonisation objective, this can and should be (indeed, can only be) accomplished through precise drafting in secondary legislation – i.e., the implementing measures – to reduce the scope of discretion in **implementation** at the member state level. More prescriptive rules would correspondingly reduce scope for **interpretation** by courts, but this approach is far less worrisome than suggesting that courts should have no power to interpret at all.

If courts are not permitted to interpret the law, someone else will. If the power to interpret is vested in one of the antagonists to a dispute, the consequences inevitably would be destructive to legal certainty and other longstanding societal norms and would undermine functioning legal systems. Society is protected – and legal certainty is provided – by having

⁵ As we also noted, this approach seems consistent with the approach suggested by the European Commission's when it requested technical advice on Level 2 measures requested that CESR (now ESMA) "*specify circumstances when financial instruments should be considered permanently "lost", to be distinguished from circumstances when such financial instruments should be considered temporarily "unavailable" (held up or frozen)*".

⁶ The reference is to "Box 89"; however, we suggest the reference should be corrected to refer to "Box 90".

a neutral arbiter resolve disputes between antagonists. This concept underpins both civil and common law legal systems throughout the world.

2 External events beyond reasonable control

Box 91

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

(Recommended Revisions as Marked)

The depositary will not be liable for the loss of financial instruments held in custody by itself or by a subcustodian if it can demonstrate that all the following conditions are met:

1. The event which led to the loss did not occur as a result of an **improper** act or omission of the depositary or one of its sub-custodians to meet its obligations **under the directive**
2. The event which led to the loss was beyond its reasonable control, i.e. it could not have prevented its occurrence by reasonable efforts
3. Despite ~~rigorous and comprehensive due diligences~~ **the exercise of reasonable efforts**, it could not have prevented the loss.

Subject to requirements of §1 and §2 being fulfilled, the depositary or the sub-custodian could be regarded as having made reasonable efforts to avoid a loss of a financial instrument held in custody if it can prove that it has taken all of the following actions:

- (a) it has ensured that it has the structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF, to identify in a timely manner and monitor on an ongoing basis any **event it could reasonably identify as "external"** which it considers may result in a loss of a financial instrument held in custody
- (b) it has reviewed on an ongoing basis whether any of the events it has identified under point (a) present a significant risk of loss of a financial instrument held in custody.
- ~~(c) where it has identified actual or potential external events which it believes present a significant risk of loss of a financial instrument held in custody, it has taken appropriate actions, if any, to prevent or mitigate the loss of financial instruments held in custody~~

~~The above described conditions will apply to the delegate when the depositary has contractually transferred its liability to a sub-custodian.~~

COMMENTS: Suggested changes to the text in box 91:

1. First, in point 1, the word "improper" should qualify "act or omission" in order to ensure there is no liability for acts or omissions that are "proper";
2. The end of point 1 should be amended to read "obligations under AIFMD" in order to clarify the scope of the depositary's obligations giving rise to potential liability for loss under the directive.

3. The AGC continues to maintain that to ensure legal certainty and predictability of outcome, “reasonable efforts” to prevent loss – on which the European Commission requested ESMA advise - should be referenced in point 3 in lieu of “rigorous and comprehensive due diligences”. This revision would remain true to the directive and ESMA’s mandate - and it would be in accord with the long-standing legal definition as interpreted and understood by market practice and the courts.

Sub-paragraph (a) should be revised to qualify the depositary’s obligation to monitor for any “external” events with a duty to act reasonably and not with the expenditure of limitless resources in order to “ferret out” that which cannot be reasonably anticipated.

Sub-paragraph (c) provides that the depositary must take “appropriate actions” to “prevent or mitigate a loss of financial instruments held in custody” in order to avoid liability for that loss. This language - though striving for flexibility - may create serious problems where the situation is not sufficiently clear enough under the circumstances for the depositary to know whether it should independently take a decision. The AGC fully accepts that, where appropriate under the circumstances, and absent legal or regulatory prohibitions from doing so, the depositary should make information in its possession available to the AIFM. If the AIFM fails to act or respond in a manner that indicates that it has taken this information into due consideration, the depositary should be expected to consider raising the issue to the AIF’s governance structure for final disposition.

However, as ESMA has noted, there is a balance to be struck. As discussed in more detail below (in relation to proposals suggested in ESMA’s explanatory text), it may be systemically dangerous to require depositaries to intervene too much with the result that AIFMs are no longer incentivised to closely assess risk. Even more importantly, depositaries should not be required to take action under their own initiative as this could interfere with a cardinal principle of investment management: the investment manager (or the AIF governance structure) controls disposition of assets, not the depositary. A depositary’s actions may constitute unwarranted interference from the perspective of the AIFM, the AIF governance structure, or the investors. By way of example, events may look dire one moment but the situation may recover, with consequent positive implications for assets. If a depositary independently “takes appropriate actions to prevent or mitigate a loss” irrespective of the determination of the AIFM, there could be negative consequences for the AIF or, ultimately, the depositary if it is blamed for loss of investment opportunity.

Events impacting holdings of AIF will become a risk factor to be taken into account by the manager. It is generally accepted that return on investment is a function of risk. The test for the AIFM is whether it has properly “priced” the risk when the asset was purchased, over time as the asset is retained and when the asset is sold. If this is not taken into consideration appropriately, the directive may have the unfortunate effect of artificially injecting distortions like those described above into the risk calculation.

Comments on Explanatory text

The AGC generally supports the statements of findings and views set out by ESMA in the explanatory text. Except as noted below, the points expressed are generally consistent with

best market practice and reflect a sensible approach to allocating risks and responsibilities associated with global investment activities of AIFs.

The AGC's concerns are set out as follows:

Note 29 – as noted in the response to Question 52 below, the AGC remain highly concerned by the following statements in Note 29:

“... if the loss was due, for instance, to an accounting error or an operational failure at the depositary or its sub-custodian, that would be considered as an ‘internal’ event and would trigger the depositary’s obligation to return a financial instrument of an identical type or a corresponding amount. Similarly, in case of a fraud which would have taken place within the depositary’s network or one of its sub-custodians, the depositary would be held liable on similar grounds.”

It is clear that if paragraph 29 referenced above is followed literally, there may be no ability for depositaries to be discharged from liability for “events” occurring at sub-custodians unless the contractual discharge requirement suggested in Box 92 (below) is satisfied, which the AGC believes is highly unlikely for reasons explained in the response to question 52. The AGC believes that the only way sensible way of providing a means of discharge from liability is if events occurring at sub-custodians are not always deemed “internal” so that “external events” occurring at sub-custodians can be a basis for discharge from liability. Otherwise, the net result, in effect, is strict liability for depositaries even where every effort is taken to select, supervise and monitor the sub-custodian with utmost care. The AGC recommends requiring depositaries to exercise such care in respect of sub-custodians so that depositaries continue to be held responsible for undertaking “all reasonable efforts” to protect AIFs without taking on risk that cannot be controlled regardless of resource expended. The AGC therefore requests that the references to sub-custodians be deleted in Note 29.

Note 34 – The last sentence (“However, the depositary would have to alert the AIFM or the AIF where it has identified such an event and assessed there was a high risk of occurrence.”) should be deleted as the subject matter seems out of context in note 34 and is better addressed in the following notes (i.e., note 35, et seq., in respect of the meaning of ‘reasonable efforts’).

Note 37 – The last sentence (“... but that such information is not sufficient as such for the depositary to discharge its liability (sic)”) is problematic grammatically and logically. After properly recognising that there may be no appropriate action for the depositary to take in certain circumstances (such as in the event of a nationalisation) other than informing the AIFM⁷, the last sentence in effect nullifies the point by stating that informing the AIFM “is not sufficient” to discharge the depositary [from] liability. This can be corrected if the last sentence is deleted.

Notes 38 and 39 – These notes are extremely problematic in a number of ways:

⁷ This is consistent with the analysis described above below Box 91.

1. Where a depositary believes that the only appropriate action is to dispose of the financial instruments and it informs the AIFM, if the AIFM disregards this advice, the depositary ordinarily would escalate to the AIF's governance structure for final disposition. If the AIF's governance structure cannot or will not take action the depositary deems appropriate, the only remaining appropriate actions are notifying the AIFM's competent authority and/or terminating the depositary's appointment. A notification to the AIFM's competent authority should be sufficient to discharge the depositary from liability.
2. Note 39's proposed strictures create uncertainty – which would be particularly dangerous in a time of crisis – and therefore increases legal and potentially systemic risk. The requirement to notify the AIFM “several” times is vague and suggests the depositary risks notifying the AIFM too many or too few times before resorting to the next contingency.
3. The idea (in the second sentence of note 39) that the depositary can request the “authorisation to transfer its liability to a sub-custodian” is legally problematic. A competent authority's efforts to so “transfer” this liability are likely to have no effect whatsoever unless the sub-custodian has agreed in advance with sufficient specificity in the agreement appointing it.
4. Note 39 also indicates that the AIF is to be given a period of time to find another depositary. If a depositary is terminating an agreement because the AIFM chooses not to act upon its advice in the midst of a crisis, it is extremely unlikely that the AIFM will find another depositary willing to take on the AIF under such circumstances. In effect, terminating its contract as a means of discharging its liability in this setting provides little comfort to depositaries.

The process outlined in these notes would not work in practice and would leave a depositary with open-ended liability until such time as it is able to terminate the contract, which seems highly unlikely under the likely circumstances.

The AGC recommends that the Explanatory Notes be revised as follows:

- a. In a situation where a depositary believes that the only appropriate action is to dispose of the financial instruments and it informs the AIFM, if the AIFM disregards this advice, the only remaining appropriate actions are escalating to the AIF's governance structure and, if this does not address the issue to the depositary's satisfaction, notifying the AIFM's competent authority. Such actions should operate to ensure the depositary is discharged from liability.
- b. The AIFM and/or the AIF's governance structure should be required to consider the depositary's views. If the AIFM and/or the AIF's governance structure nevertheless decide to retain the investments, this should be seen as an investment decision and, unless the AIFM has acted negligently, liability in the event of a loss rests with the AIF.
- c. ESMA should consider requiring AIFMs to address these possibilities in disclosures to investors pursuant to Article 23(d), thus providing for informed decisions by investors.

The approach suggested above would “strike the right balance between the directive’s objective to set strict rules to ensure a high level of investor protection while at the same time not putting the entire responsibility on the depositaries”.

3 Objective reasons to contract a discharge

Box 92

Objective reasons for the depositary to contract a discharge

(Recommended Revisions as Marked)

The depositary will be deemed to have an objective reason to contractually discharge itself of its liability in accordance with the requirements set forth in Article 21 (13) if it can demonstrate that:

Option 1

~~1. it had no other option but to delegate its custody duties to a third party (e.g. as a result of legal constraints); Or~~

~~2. it has agreed with the AIF or as the case may be the AIFM through a written agreement that it is in the best interest of the AIF and its investors to delegate such duties (e.g. if the delegate is in a country where the depositary does not operate).~~

Option 2

Where the AIF or, as the case may be, the AIFM and the depositary have explicitly agreed through a written contract that the depositary can discharge its responsibility, it should be considered that the requirement to have an objective reason is fulfilled.

COMMENT: Of the two options suggested, Option 2 is preferable, on both practical and principled grounds. Option 1 has two weaknesses:

1. a depositary may well have an option on paper to retain custody duties, but the exercise of this option will so significantly impair the ability of the AIF to conduct its business (for example, when financial instruments need to remain with a prime broker, in order to facilitate corporate actions, or for ready use as collateral); and
2. the criteria required for a depositary to meet the “best interests” test are particularly unclear in these circumstances as there would be considerations of efficiency and associated costs, which only the AIF (or AIFM, as appropriate) will be in a good position to judge.

In practice, the way to resolve both of these issues is to adopt Option 2. This approach is sensible because it would allow the AIF (or AIFM, as appropriate) to evaluate, in the discharge of their respective functions, whether the delegation of custodial tasks is appropriate, and would require the transfer of responsibility to be documented through a written contract.

However, the AGC must point out that it takes little comfort from ESMA’s reassurance in Explanatory Note 45 that “the AIFMD clearly states that the transfer of liability can intervene all along the custody chain”. The AGC’s reasons for this are set out in the response to

question 52 below. Please see answer to Question 52 for special considerations in relation to Sub-custodians.

Questions 47-54

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?

Costs and Consequences of the depositary liability regime.

From a cost standpoint, it is difficult for depositaries to provide estimates of the costs related to the liability regime in a meaningful way, notably in respect of capital charges. There are several practical problems:

1. The Basel II framework, as reflected in the Capital Requirements Directive and national rules, does not automatically require capital reserves to be increased if the statutory or contractual liability regime becomes more burdensome for banks - unless the bank assesses that the risk of operational losses, for example, is likely to be greater. Each institution will need to make its own assessment about the possibility of losses, and to address the impact of the liability regime in their deliberations; but no formula can be applied which will represent the positions of all institutions.
2. The profile of business is likely to change for depositaries, following implementation of the Directive, with the result that a more heterogeneous client base will be seeking depositary services. Hedge funds and private equity funds, for example, which do not require depositary services today, will come to engage with depositaries at different stages in the life-cycle of the Directive. Not all depositaries have formed a strategic view about whether they will be in a position to support all types of AIF, and it is likely that there will ultimately be a spectrum, from plain vanilla depositary business to support for the most exotic AIF structures, with different requirements. Any assessment about operational risks associated with new structures, or mixtures of business, will need to take account of new capabilities and expertise that are being added or will be created in the future. At this stage, predicting costs is a speculative exercise.

As stated previously in the response to Question 38, at the AGC level obtaining and describing member bank business costs is a substantial challenge. Individual members' cost profiles are known to vary materially from member to member depending on a fairly wide range of factors, including scale of operations (locally and globally), types of client assets involved, and types of clients. Additionally, information in any detail concerning a bank's business costs is proprietary to the bank and is typically significant in terms of competitive implications (and therefore cannot be disclosed even to the Association). Further, cost information -- as distinct from more general information that is made public by some individual banks, such as "assets under custody globally" or "number of jurisdictions accessed" -- can be difficult for members to retrieve and susceptible to varying implications

across members. Finally, the variances among members in scope of business, service mixes, pricing arrangements and customization flexibility in accommodating varying customer demands make aggregated Association-level information useful only in a general way. Such aggregates can imply a uniform standard or a degree of commonality that does not exist in practice.

Nonetheless, below we set out descriptive background concerning the general business profile and structure of global custodians, including when acting as fund depositaries, and brief commentary and data concerning categories of costs and estimated business impact of ESMA's proposed advice.

1. *Members' depositary business profile.*

Global custodians, even when acting as fund depositaries, offer a one-stop shop for a wide variety of global institutional investors, and those investors have varying investment strategies and varying multiple destinations. To provide clients with investment access to diverse markets, depositaries must operate in coordination with a network of financial institutions in a chain of intermediaries. The necessary arrangements can include the appointment of proprietary (affiliated) sub-custodians, but typically requires the use of independent third-party local market sub-custodians and the use – directly or indirectly -- of local market central securities depositaries.

A typical global custodian may have well in excess of 70 third-party subcustodians. Association members report (with 8 of 11 members reporting) that as of mid-year 2011 they use collectively the services of 745 subcustodians globally⁸ – an average of 93 subcustodians per member globally. Of that number, members use 211 subcustodians to assist in holding assets in the 27 EU jurisdictions (a weighted average of 30 subcustodians per member across the EU). These eight members further report that they maintain 114 offices and employ over 159,000 employees in the 27 EU jurisdictions, and with that overall footprint hold in excess of 15 Trillion EUR assets under custody in those jurisdictions. Additionally, members report (with 5 members reporting) that they provide depositary services to 18,184 UCITS and non-UCITS funds based in the 27 EU jurisdictions.

In delivering depositary services and related asset-servicing functions to investment funds, a global custodian addresses risk asset safety by having in place financial, operational and legal standards and arrangements that are robust, up-to-date and consistently quality-tested. These standards and arrangements already meet today's extensive, international regulatory and market-driven controls applicable to global custodians. Similarly, appointed sub-custodians are expected to -- and routinely do -- adhere to a wide range of local and market-specific operating and financial requirements. The global custodians' task of ensuring continuing risk management testing of the intermediary chain is carried out by expert, dedicated global custodian network managers.

⁸ This figure – 745 subcustodians globally -- represents a combined aggregate for 8 of the AGC's 11 members. Multiple members may well use the same subcustodians in the same locations.

In this context of diversely-configured service mixes, member costs and cost-tolerances vary significantly, just as customers' negotiated fee/service arrangements vary widely. Some customers, for example, negotiate for an "all-in" fee, which necessarily applies without regard to volume of activity or specific risk level in any particular market. Other customers negotiate for a variety of client-care banking and related services, which can make calculation of costs for specific activities, including incremental compliance costs, infeasible.

Notwithstanding those complexities, members set out below their comments concerning certain categories of incremental costs and business implications that would flow from ESMA's proposed – and expanded – depositary liability regimes.

2. *Categories of incremental costs and available aggregates.*

Association members, as EU fund depositaries, would face new and incrementally increased costs under the liability regime set out in the ESMA advice in several respects. Below members identify and describe, as illustrations, two categories of new and incremental costs.

- Under the advice, permanent "loss" of a financial instrument held in custody is to be determined by the AIFM pursuant to a "documented" assessment. Where the depositary and the AIFM disagree about the AIFM's conclusions or the quality of its review, the advice leaves the parties to litigation to resolve economically meaningful disputes – including in cases where the AIFM concludes there is a loss prior to the conclusion of a sub-custodian insolvency proceeding. No guidance details are provided around these features of the loss-determination regime, and the potential range of uncertainties likely will produce litigation, with incrementally increased litigation costs and increased litigation funding reserves that custodians will likely maintain.
- Where a permanent loss is determined by the AIFM, the depositary bears the burden of proof. Under this burden the depositary must demonstrate that the loss was due to an "external" event beyond its reasonable control and that the loss could not have been prevented despite "rigorous and comprehensive due diligences". Included as necessary due diligence actions are the following: (a) it must ensure it has adequate structures and expertise, relative to the assets in question, to timely monitor on an ongoing basis "external" events that may lead to loss; (b) it must review the risk significance of such external events in fact and on an ongoing basis; and (c) where significant loss potentials are identified appropriate actions must be taken to mitigate or prevent the loss.

This formulation lacks elaboration or guidance concerning the particular levels and types of review and oversight actions required. As such, the formulation appears likely to expand meaningfully the scope and frequency of a depositary's sub-custodian monitoring activities through the depositary's network. In addition, custodians may employ auditors and auditor internal control testing even more extensively than they do at present. These new levels and types of oversight/review would increase incremental costs to each depositary and each sub-

custodian across their offices and personnel – perhaps to a material magnitude -- and the extent of new or duplicative work that will prove necessary to meet the required “rigorous and comprehensive due diligences” -- are uncertain. Uncertainty counsels in favor of more work, which produces more cost, of course, rather than de minimis adjustments.

Q48: Please provide a typology of events which could be qualified as a loss in accordance with the suggested definition in Box 90.

It is not possible to prescribe a “one-size-fits-all” approach with a view to establishing objective criteria other than utilising the plain meaning of “loss” as set out in point 1 of Box 90.

Best practice as to when assets should be “written off” as “lost” depends on the circumstances surrounding the asset itself, which makes the judgment of the AIFM and/or a pricing committee of the AIF important, but GAAP or other applicable principles or rules may not be determinative. Circumstances surrounding the AIF or the investors are not relevant to this determination.

However, the following events are offered as non-exclusive examples of events which are likely to qualify as of “losses” as suggested in Box 90; in addition, to provide contrast with current practice, we compare current perspectives on the consequences of these events versus how they would be viewed per Box 90:

Event Description	Current View	Result of Box 90
Mis-delivery of a financial instrument held in custody to a party which is not entitled to it, as a result of a culpable error of the depositary	This would be recognised as a “loss” event. The depositary would be responsible for mis-delivering a financial instrument, if in doing so it failed to act on the instructions of the AIF (or the AIFM acting on behalf of the AIFM)	This would be recognised as a “loss” event, as the AIF would have been “permanently deprived of its right of ownership over the financial instruments” [Box 90, 1(b)]
Mis-delivery of a financial instrument held in custody to a party which is not entitled to it, as a result of a culpable error of a sub-custodian	This would be recognised as a “loss” event. The depositary would be responsible for mis-delivering a financial instrument, if in doing so it failed to act on the instructions of the AIF (or the AIFM acting on behalf of the AIFM)	This would be recognised as a “loss” event, as the AIF would have been “permanently deprived of its right of ownership over the financial instruments” [Box 90, 1(b)]
Misappropriation by a sub-custodian, in order to meet a shortfall in another custody account.	This would be recognised as a “loss” event.	This would be recognised as a “loss” event, as the AIF would have been “permanently deprived of its

		right of ownership over the financial instruments" [Box 90, 1(b)]
Expropriation by a national authority.	This would be recognised as a "loss" event.	Despite the Explanatory Notes, this would be recognised as a "loss" event, as the AIF would have been "permanently deprived of its right of ownership over the financial instruments" [Box 90, 1(b)]
A class of shares which has been improperly issued by a company has to be cancelled	This would not be recognised as a loss event	This would be recognised as a "loss" event, as "a stated right of ownership is uncovered to be unfounded because it either cases to exist or never existed" [Box 90, 1(a)]
The transfer of shares from a vendor is not properly effected at the registrar, as there is a defect in registration	This would not be recognised as a loss event, unless the depositary was responsible for the defect in registration as a result of its culpable failure to carry out the settlement and custodial obligations assigned to it	This would be recognised as a "loss" event, either as "a stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed" [Box 90, 1(a)], or the AIF would have been "permanently deprived of its right of ownership over the financial instruments" [Box 90, 1(b)]
The transfer of shares from a vendor is not properly effected, as there is a defect in title (for example, the shares were subject to a security interest which was not discharged or the vendor's acquisition of the shares was otherwise conditional or defective)	This would not be recognised as a loss event, as it is a risk of investing and the AIF would normally have contractual rights against the vendor	This would be recognised as a "loss" event, either as "a stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed" [Box 90, 1(a)], or the AIF would have been "permanently deprived of its right of ownership over the financial instruments" [Box 90, 1(b)], or "the AIF is permanently unable to directly or indirectly dispose of the financial instruments" [Box 90, 1(c)]
A security interest granted by the AIF (or by the AIFM acting on behalf of the AIF) is	This would not be recognised as a loss event, as it is the normal	This would be recognised as a "loss" event, either as "a stated right of ownership is

properly executed, with the result that property in the relevant financial instruments passes to the secured party	consequence of secured transactions entered into by the AIF (or by the AIFM acting on behalf of the AIF)	uncovered to be unfounded because it either ceases to exist or never existed" [Box 90, 1(a)], or the AIF would have been "permanently deprived of its right of ownership over the financial instruments" [Box 90, 1(b)], or "the AIF is permanently unable to directly or indirectly dispose of the financial instruments" [Box 90, 1(c)]
A security interest granted by the depositary or a sub-custodian in relation to financial instruments held via a settlement system is properly executed, with the result that property in the relevant financial instruments passes to the settlement system as secured party	This would not be recognised as a loss event, as it is the normal consequence of the exercise of non-negotiable rights and remedies by CSDs and other settlement systems.	This would be recognised as a "loss" event, either as "a stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed" [Box 90, 1(a)], or the AIF would have been "permanently deprived of its right of ownership over the financial instruments" [Box 90, 1(b)], or "the AIF is permanently unable to directly or indirectly dispose of the financial instruments" [Box 90, 1(c)]

From our analysis, ESMA may wish to consider whether the drafting in Box 90 would need to be adjusted, in order to ensure that the results achieved in specific cases are consistently aligned with the intentions described in the Explanatory Notes.

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?

No, we do not foresee 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. Providing for this as an "external event" is helpful, in that it is entirely consistent with expectations and the express clarification will add to the certainty of market participants. It is recommended however that the reference to local legislation not recognising the "effects of segregation" be extended to the decisions of "courts and regulatory bodies".

Q50: Are there other events which should specifically be defined/presumed as 'external'?

There are many events and circumstances which can impact the interests of investors in financial instruments around the world. As a starting point, every country has its own rules

for the issuance of financial instruments, settlement of transactions involving them, and the holding of financial instruments by agents acting for national and international investors, and the application of such rules is not always predictable even by leading legal counsel in the relevant jurisdictions. Even in regions where harmonisation of laws has been attempted, rules concerning the recognition and enforcement of property rights vary considerably. Political risks, including public expropriation, are not purely theoretical consideration. In some parts of the world, legal systems which are not well developed, corruption and discrimination in favour of domestic market participants can defeat the expectations of foreign investors and their international agents, when disputes concerning property arise.

Having these considerations in mind, global custodians have long been in the practice of disclosing to their clients certain of the “external events” with respect to which they should be discharged from liability, due to their inability to control the risks associated with them, even if these risks are theoretically foreseeable.

The categories presented touch on some of these, but not comprehensively. A broad categorisation might be suggested as follows:

- | | |
|---|--|
| 1. Settlement system rules, market practices or other market infrastructure-imposed constraints | <ul style="list-style-type: none">• Rules which apply in the event of settlement failures in non-DVP markets;• Compulsory liens and transaction reversal requirements imposed by central securities depositories (including liens imposed by sub-custodians as a result of CSD requirements);• Non-exclusive control of accounts under client-specific account structures. |
| 2. Local Market Problems | <ul style="list-style-type: none">• Market infrastructure outages or failures;• Sub-standard market infrastructure (such as systems of registration);• Fraud by or insolvency of sub-custodian. |
| 3. Local Market Conditions | <ul style="list-style-type: none">• Market volatility;• Widespread issuer defaults;• Market closures and currency devaluations;• Acts of state (sovereign events). |
| 4. Appointment of Counterparties by AIFM | <p>Failure of the AIFM's chosen counterparty in the context of:</p> <ul style="list-style-type: none">• Securities lending and repo arrangements;• Prime brokerage arrangements involving rehypothecation of AIF assets; or• Derivatives transactions. |
| 5. Other External Events | <ul style="list-style-type: none">• Acts of God;• Acts of third parties (such as an issuer or its agent). |

These categories can be described in more detail by providing more specific examples. The AGC would be pleased to provide such examples on request.

Q51: What type of event would be difficult to qualify as either 'internal' or 'external' with regard to the proposed advice? How could the 'external event beyond reasonable control' be further clarified to address those concerns?

One area where it is difficult to qualify an event as either "internal" or "external" concerns errors in or the unavailability of infrastructure. Infrastructure used by a depositary is often owned or operated by third parties, and the only relationship of the depositary with the owner or operator of the infrastructure is through a services contract or software licence. Common examples include IT infrastructure (such as the SWIFT messaging system) and market infrastructure (such as links to clearing and settlement systems, or the CLS system for FX transactions). It is neither possible nor commercial practicable for the depositary to use its contractual relationship with the provider of infrastructure to pass on full liability for the loss of financial instruments to such providers; but the depositary typically has neither the power nor the ability to prevent or correct errors in or the unavailability of infrastructure. There is always a risk for investors, therefore, that errors in or the failure of infrastructure may impact AIF investments.

Unless the depositary itself owns or has primary responsibility for operating the relevant infrastructure (as would be the case where the depositary is the provider of the relevant infrastructure to the market, rather than the user of a system), issues caused by errors in or the unavailability of the relevant infrastructure are not, properly speaking, "internal" to the depositary. Given the language used in the Level 1 text, it would be helpful to clarify that such events or circumstances are understood to be "external" to the depositary. Conversely, if a depositary develops its own IT tools, in-house, to carry out its functions, then errors in such systems could be regarded as "internal" to the depositary for these purposes. The legal test would then move on to evaluate whether the relevant event or circumstance was "beyond its reasonable control", as might be the case where the event causing the relevant loss was caused by miscoding or negligence in the maintenance of such IT tools by the depositary.

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 arrangements referred to in the Directive for the transfer of liability may be capable of being implemented in some scenarios. For example, they might be successfully employed in hedge fund arrangements, where the appointment of a prime broker is a normal and often essential act. Prime brokers who themselves do not act as depositaries, either because they are not able to meet the eligibility criteria or because they are only one of several prime brokers supporting a hedge fund, will often nevertheless be in a position to provide custodial services to the AIF. In such circumstances, provided that the depositary is able to obtain suitable information from the prime broker to perform its supervisory responsibilities, it may well be efficient and effective for the prime broker to assume responsibility (and therefore the associated liability) for the custody of assets of the AIF.

However, in the global custody setting involving the use of sub-custodians in markets throughout the world, the AGC remain highly concerned by the construct suggested in the Explanatory Notes following Box 92. Paragraph 42 of the Explanatory Text following Box 92 states:

"The AIFMD states that the depositary's liability shall not be affected by the delegation of its safekeeping duties to a third party. However, under certain conditions defined under Article 21 (13) of the directive, the depositary has the possibility to discharge its liability in the event of loss of financial instruments held in custody by a third party. Those conditions ***which include a transfer of responsibility to the sub-custodian*** must be specified in a written contract signed between the depositary and the sub-custodian, contract which must define the 'objective reason' justifying this contractual transfer of liability." (*emph. added*).

In paragraph 45, ESMA emphasises the point:

"It is important to stress that the AIFMD clearly states that the transfer of liability can intervene all along the custody chain (see before last § of Article 21 (11))."

The AGC remains very concerned there is no realistic prospect of utilising the "transfer of liability" provision in practice due to possible legal confusion. The requirements of the UK "Contracts (Rights of Third Parties) Act 1999" have been previously provided to ESMA as an example of the conditions that must be satisfied under the law of one state in order for that courts in that state to recognise the effectiveness of the "transfer". Some of these requirements – such as a requirement that the contract with the sub-custodian cannot be changed without the permission of the third party (in this case, most likely the AIFM acting on behalf of the AIF) – would mean that no sub-custodian arrangement could be changed without the consent of each and every AIFM acting for AIFs holding assets through the sub-custodian.

More fundamentally, the foregoing paragraph describes a requirement of a law of one jurisdiction that envisions invoking that same law in the relevant contract. It would not be possible to invoke the laws of jurisdictions where funds or investors are located in contracts with **every** sub-custodian (some of whom may hold omnibus accounts established by the depositary) for each individual AIF. Moreover, it is uncertain if a court in the jurisdiction of the sub-custodian – where a judgment may need to be enforced - would recognise the effectiveness of the transfer under its law, or that the chosen law of the parties would be observed under conflicts of laws principles.

As a result, it does not seem possible to implement a "one-size-fits-all" theory of liability on legal systems throughout the world which may not recognise such a new concept with respect to which there is little, or very isolated, precedent in the law. Similarly, we are uncertain how an AIF might assert rights directly against the third party under all legal regimes. As a result, this condition as written will make contractual discharge from liability insupportable and – most likely - effectively unavailable in the global custody setting.

The above in turn raises significant concern about systemic risk unless that concern can be successfully addressed in some other way, such as by ensuring that the other avenue for discharge from liability (“external events beyond the reasonable control of the depositary . . .”) is broad enough to prevent that risk from becoming untenable. **For this reason that we remain very concerned about sub-custodians being considered “internal” such that “external events” cannot be used as a basis for discharge from liability.** The net result, in effect, is strict liability for depositaries even where every effort is taken to select, supervise and monitor the sub-custodian with utmost care.⁹

Finally – and perhaps most importantly - a proposal providing for potential “transfer” of liability to sub-custodians would detract from the depositary’s fundamental role, which is to select a sub-custodian which is the best provider in the interest of the AIF and its investors, and not to focus on whether the depositary can find a sub-custodian who will accept the “transfer” of liability. Sub-custodians should be selected on the basis of reputation, financial strength, commitment, technical capacity, responsiveness and other factors bearing on quality and safety. It would be highly counterproductive to incorporate criteria that force the depositary to focus on prospects for liability transfer. This factor may also create market distortion by favouring large proprietary sub-custody networks (with attendant risk concentration) over networks of sub-custodians who are not affiliated with the depositary.

Q53: Is the framework set out in the draft advice considered workable for non-bank depositaries which would be appointed for funds investing mainly in private equity or physical real estate assets in line with the exemption provided for in Article 21? Why? What amendments should be made?

So long as **Option 2** is chosen in Box 78, this framework would be workable in the context of private equity funds because private equity shares – although considered “financial instruments under MiFID - would not be considered “held in custody” within the meaning of Article 21.8(a): they would be considered “other assets” falling under Article 21.8(b) subject to the depositary’s duty of oversight. In the context of real estate assets, which are clearly “other assets”, this framework would also be workable. In both cases, the “liability for loss” regime would not apply. Also, this framework is more likely to work if **Option 1** is chosen in Box 81 since “mirroring” of all transactions is highly unlikely to be possible in respect of these asset classes.

Q54: Is there a need for further tailoring of the requirements set out in the draft advice to take into account the different types of AIF? What amendments should be made?

The key is to tailor the depositary’s responsibilities as between safekeeping duties in respect of financial instruments held in custody under Article 21.8(a), which extend through use of

⁹ As noted previously, paragraph 29 of the Explanatory Text following Box 91 provides:

“29. . . . if the loss was due, for instance, to an accounting error or an operational failure at the depositary or its sub-custodian, that would be considered as an ‘internal’ event and would trigger the depositary’s obligation to return a financial instrument of an identical type or a corresponding amount. Similarly, in case of a fraud which would have taken place within the depositary’s network or one of its sub-custodians, the depositary would be held liable on similar grounds.”

sub-custodians, versus “other assets”, pursuant to which duties of oversight apply. Given the wide variety of “other assets”, which will continue to evolve and change significantly over time, investors are best served by a regime that provides for flexibility depending on the peculiarities of asset classes and changing technology, market practice and approaches to risk management.