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ESMA
103 Rue de Grenelle
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Re: Consultation on draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (AIFMD)

Dear Sir, Madam,

We appreciate the opportunity to comment on the draft implementing measures of the AIFMD and welcome proposed additional clarity this advice provides.

Specifically, we support your proposals on when financial instruments do not need to be held in custody, although we suggest some important changes to further improve clarity. Without this additional clarity, custodians/depositories might be driven to adopt the highest level of security – with associated costs – purely to avoid legal risk.

We strongly oppose the proposals on liability. The proposed rules seem to be based on a reverse burden of proof, where depositories have to prove they are not liable for an external event. This can often only be done after the relevant event has occurred. The increased risk stemming from this will be reflected in the capital requirements of depositories and their sub-custodians. The value of assets held in custody is so great that insuring liability would have a prohibitive cost. Apart from increased costs for investors, this could lead to some depositories/custodians deciding to exit the custody business altogether.

We have commented on those questions most relevant for Deutsche Bank's businesses. We trust the comments in this response are constructive. Please let us know if we can provide any further assistance.

Sincerely yours,

Andrew Procter
Global head of Government and Regulatory Affairs

Annex: Responses to some of your questions.

9. The risk to be covered according to paragraph 2(b)(iv) of Box 6 (the improper valuation) would also include valuation performed by an appointed external valuer. Do you consider this feasible and practicable?

The paper proposes that potential risks to be covered by additional own funds or by a professional indemnity insurance have to include "Risks in relation to fraud" and in particular "Losses due to dishonest, fraudulent or malicious acts by relevant persons". There does not, however, seem to be a clear basis in the wording of the AIFMD (Level 1) to require coverage of “risks in relation to fraud" in the description of potential risks. The level 1 text does mention liability arising from professional negligence, but fraudulent acts are normally intentional and not caused by negligence.

With regard to whether risks covered should include valuations performed by an appointed external valuer, we note that box 6 explicitly refers to acts by "relevant persons". "Relevant persons" according to the definition on page 29 of the consultation paper include third parties which have entered into a delegation arrangement. We feel that neither delegates nor external valuers should be included in the "potential risk" definition, except if they cannot evidence appropriate professional indemnity insurance on their own.

XX. Comment on Box 35 - requirements for retained interests

Investments made after 1 January 2011 and which do not comply with the relevant requirements (i.e. 5% retention requirement and information duties) have to be sold immediately after the AIFMD comes into force. We feel a 3 year grandfathering clause should be put into place for these vehicles as of mid of July 2013. This would avoid market disruption (or the possible illiquidity of some vehicles) as a result of abrupt sell offs. In this context we refer to the implementation of CRD 2 provisions on securitisation, which allowed for an 18 month implementation period and 4 year phasing in period for existing securitisations.

XX. Comment on Box 75 – Cash monitoring – general information requirements

We feel that the third bullet point in Box 75 should be limited with respect to the wording "*all* information related to the cash accounts...". Instead, we suggest: "the depositary is provided with *the necessary* information related to the cash accounts..."

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

We do not think such a structure would be feasible from a practical standpoint. Ordinarily, Alternative Investment Funds (AIFs) would be obliged, contractually or by necessity, to maintain cash at service providers (e.g. prime brokers) and counterparties. Having all payments flow through a general operating account would render processes less efficient, thus making it difficult for the AIF to meet its various payment obligations in a timely manner, and creating more settlement risk.

28. Does the advice present any particular difficulty regarding accounts opened at prime brokers?

We would welcome greater recognition of both of the debtor/creditor and trustee/beneficiary approaches to holding cash so that neither inadvertently breaches AIFMD requirements.

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

We strongly prefer Option 2.

We are concerned that Option 1, which requires the appointment of the depositary as a "central hub" for all cash flows, will increase systemic risk and create settlement inefficiencies, thereby driving up costs for AIFs. In particular, if a depositary were to act as a central hub and be included in the AIF's settlements activity, this could threaten the AIF's ability to settle trades on a delivery versus payment basis and meet payment demands in a timely fashion. To minimise such risks AIFs would be deterred from holding cash at their prime brokers, which would likely have a pricing impact on the services provided by prime brokers.

Option 2 would permit much of the existing payments framework to continue without the intervention of the depositary, whose role would become much more supervisory. On that basis we regard Option 2 as the only practical proposition.

It will be important that there is a pragmatic interpretation of the requirements for timely and periodic action.

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

Both options would require substantial investments in terms of IT and additional staff. These costs will be passed on to clients. We refer to the industry wide impact study that has been commissioned by the Alternative Investment Management Association (AIMA).

31. What would be the estimated costs related to the implementation of cash mirroring as requirements under option 1 of Box 76?

Please see our answer to question 30.

32. Do you prefer option 1 or option 2 in box 78? Please provide reasons for your view.

We prefer Option 2, as this provides greater clarity and flexibility than Option 1. Also, the approach in Option 2 is more compatible with normal conventions of custody and sub-custody, where assets are often held by nominees.

Option 1 appears to capture all relevant instruments that are registered in the name of the depositary, but carves out any instruments where 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". The effect of this is not entirely clear, however it seems that provided the depositary (or its sub-custodian) insists on being registered in the register of the underlying investment "as custodian for [name of AIF]" or, in the case of the sub-custodian, as "sub-custodian for [depositary] as custodian for [name of AIF]", the asset will not be considered as

being held in custody for the purposes of AIFMD and therefore won't fall within Article 21(8)(a) - and therefore won't be subject to the liability/restitution provisions contained in Article 21(12).

Whilst the depositary could control registration with a registrar in cases where it holds assets directly, this could be problematic if assets are held via a sub-custody chain as there would be no direct control of registration by the depositary (although this could be mitigated to a certain extent by including a contractual requirement in the sub-custody agreement to register all assets with reference to the underlying client name). This could therefore lead to practical uncertainty as to which assets fall within Article 21(8)(a) and are therefore subject to the restitution regime.

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

From a practical perspective, it should be clear from “prima facie” books and records evidence as well as contractual arrangements, how particular collateral arrangements operate. It should be specifically clear if they are title transfer or security interest collateral arrangements.

Further, industry standard master agreements which would require the provision of collateral generally make clear which type of arrangement applies. However, we are aware of complexities in this regard in the operation of collateral provisions in New York law-governed master agreements, and further investigation into account movements would be required.

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

Option 1 would be too prescriptive. Whilst it would include title transfer collateral arrangements for OTC derivative transactions, repo/reverse repo and securities lending arrangements, typical prime brokerage arrangements (which extend to all assets held by the prime broker and operate on a security interest basis) would be excluded. This scope is too narrow to provide clarity on the effects of the AIFMD to the prime brokerage community, and there is a concern that if driven by this issue alone, prime brokers would seek to adopt a title transfer model for providing prime brokerage services. This would be to the detriment of AIFs.

We see little difference between Options 2 and 3. Option 2 refers to both security interest financial collateral arrangements and title transfer financial collateral arrangements (i.e. both types of permitted financial collateral arrangements as per Directive 2002/47/EC), but that is qualified by a requirement that the collateral taker must have control or possession of the collateral. Given that this requirement is a fundamental pre-requisite of either type of financial collateral arrangement, this qualification seems to add little. However, to be more certain of the impact of the proposal would require a comprehensive and exhaustive analysis of the various types of security interest commonly available in the relevant jurisdictions. On that basis, Option 3 seems marginally the better of the two.

We recommend, however, that ESMA consider widening this exemption to include collateral arrangements which are not financial collateral arrangements (as defined), in order to provide greater certainty over equivalent arrangements existing outside the EU.

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

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

We would welcome further clarification on the precise obligations by asset type (not least in the context of verification of ownership). We would also welcome clarification that any duties to be provided here are expected to be provided on an ex post facto basis.

36. 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 depository on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

The practical issues relate to the provision of the information that would be required to be obtained by the depositary in order to discharge its obligations. We note, however, that information sharing arrangements are relatively commonplace in the funds industry.

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

We would welcome clarification as to whether all assets held with a prime broker appointed by an AIF directly will be considered "other assets" and so would fall exclusively within the scope of Article 21 (8)(b), or whether the depositary will also be required to appoint the prime broker as its sub-custodian to the extent of any assets falling within the definition of financial instruments requiring to be custodied under Article 21(8)(a). If the depositary is required to appoint the prime broker as its sub-custodian, we would suggest a requirement to provide daily reports. In all other cases, we suggest a requirement to provide reports at least monthly, although this is more frequent than appears to be suggested in Box 81 ("at least once a year"). We note that both requirements would result in a material increase in costs which would be passed on to the AIF.

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

The benefit of maintaining a position keeping record is that on a best efforts basis it should enable the depositary to be in a position to comply with the overriding requirement to provide a comprehensive and up to date inventory of all of the fund's assets at any given time. The level

of costs related to the requirement for the depositary to mirror transactions in a position keeping record depends on whether this requirement would extend to all transactions of the fund i.e. including all transactions carried out by sub-custodians, prime brokers and other third parties, or whether this could be satisfied by receipt and safekeeping by the depositary of regular asset statements issued by the relevant third parties.

If option 2 envisages mirror booking of all transactions carried out by a sub-custodian, prime broker or third party, this will materially increase costs as it will require the recruitment of additional staff to input data and in due course, the development of system enhancements to increase automation of the process. If Option 2 were introduced, we would need to consider the viability of our business model carefully and, in particular, the provision of depositary services.

We also refer to the impact study that has been commissioned by AIMA.

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

Except in the case of a 100% owned special purpose investment holding company (i.e. non-trading company), there should be no requirement for the depositary to look through a fund (whether a feeder fund or otherwise) or other collective investment vehicle and verify ownership of the underlying assets. Verification of ownership should be carried out at the level of the investment in the fund/collective investment scheme/trading company.

We also note that the implications here would vary by asset type. We would therefore welcome further clarification from ESMA as to what the precise obligations would be in particular scenarios.

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

A significant increase in the depositary's obligations in this area will lead to increased costs for the AIF and service providers (including prime brokers). We do not feel that the duplicated exchange of information will deliver any heightened quality assurance or investor protection.

47. 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?

General liability regime

We strongly oppose the liability regime that is set out. Whilst the requirement to demonstrate that an asset is lost due to an external event beyond the depositary's reasonable control would seem to be potentially broadly workable, subject to further definitive clarification of the respective terms, the suggested steps that the depositary must prove it has taken in order to demonstrate that it has made reasonable efforts to avoid a loss are too wide-ranging and uncertain.

On the face of it, it would seem that the depositary has to (i) identify every potential or actual external event beyond its control which could give rise to a significant loss of assets; (ii) analyse and monitor on an ongoing basis each such event so that it is in a position to report to the Alternative Investment Fund Manager (AIFM) and make recommendations regarding the investment and/or disposal; and (iii) take "appropriate" action in the event that the AIFM directs the depositary to retain the asset.

As such, the liability regime contains a presumption of liability unless it can be disproved on an objective, reasonable basis. This may often only be possible some time after the relevant event has occurred – i.e. a determination as to whether an event following the insolvency of a sub-custodian was “external” or “internal”. This will lead to significant risks for depositaries/their sub-custodians which would have to be reflected in their capital requirements. As such, we assume that depositaries may seek to pass these additional costs on to their customers, and/or seek to contractually impose increased liabilities on relevant delegates.

The possible consequences of the liability regime for those who are subject to it are significant. The value of assets held in custody is so great that the quantum of liability would be virtually uninsurable without prohibitive cost, and, even leaving aside the increased costs to investors of investing in AIFs, this could lead to depositaries/custodians not offering services in particular markets, or withdrawing from the custody business entirely. The result would be that what is today a significant EU onshore business, would move offshore.

Prime brokerage

Specifically with regard to prime brokers we note that whilst the relevant provisions of the liability regime should not directly impact the prime brokerage community (on the basis that assets held by prime brokers are held as collateral and not as financial instruments in custody, to which the liability regime as it applies to loss of those financial instruments does not apply), it is entirely possible that from a contractual standpoint depositaries may seek to impose higher standards of liability onto all its delegates, including prime brokers. Therefore, we would welcome further clarification by ESMA about the liabilities to which prime brokers are subject in their role as delegates.

One important consequence may be that prime brokers that operate alternative structures for assets which are expressed to be “unencumbered”, will not benefit from the collateral exclusion referred to above. As such they will attract liabilities for the loss of financial instruments held in custody as described above. As a result of the increased liability these models may be withdrawn by prime brokers, thereby removing choice from AIFs and concentrating custodian risk in those few institutions who remain able or willing to absorb the increased costs arising from the Directive’s liability regime.

49. 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?

In the context of the advice, this would seem to be consistent with ESMA's proposed general principle of differentiating between events due to acts or omissions committed by the depositary or its sub-custodian i.e. "internal" events and other (“external”) events. It would also seem to be an event outside the reasonable control of the depositary. However, within the

context of its duties to notify the AIFM of any event deemed beyond its control which could lead to a loss (i.e. in order to satisfy the third limb of the test), it would seem that the depositary (or the sub-custodian) is potentially under a positive obligation to analyse local legislation in each and every case in order to assess the risk of a non-recognition of AIFMD segregation requirements and to advise the manager accordingly.

The depositary would also seem to be under a positive duty to assess whether it would be appropriate to take any additional action, namely whether it should recommend not investing in the asset or disposal of the asset etc. to the investment manager. These additional duties seem potentially very onerous, as does the general obligation to identify and monitor all actual and potential external events which could give rise to a loss. Responsibility for determining the risks involved with an investment should lie with the AIFM and not the depositary.

50. Are there other events which should specifically be defined/presumed as "external"?

The ESMA advice proposes that acts or omissions of <u>any</u> sub-custodian should be treated as "internal", thus making the depositary strictly liable for any related loss of assets at the sub-custody level. As we consider the transfer of liability provisions to be practically difficult to implement/agree with any sub-custodian without incurring potentially significant additional cost (via a likely increase in sub-custody fees) (see response to question 52 below), we propose categorising acts or omissions of a sub-custodian which is not affiliated to the depositary as "external".

51. What type of events 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?

If acts or omissions of a non-affiliated sub-custodian can be categorised as "external" events, then we would propose that provided the depositary has complied in full with its delegation obligations in Article 11 (notably 11(c) relating to exercise of due care and skill in selecting, appointing and monitoring the sub-custodian), and has notified investors of the appointment, then any act or omission of a non-affiliated sub-custodian which gives rise to a loss would automatically be deemed to be an "external event beyond [the depositary's] reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary."

52. 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?

Initial indications from internal and external sub-custodians suggest that they would not be prepared to accept such a transfer (unless an appropriate level of additional remuneration could be agreed) as they would be agreeing to a higher level of risk as a result of the reverse burden of proof. It may be assumed that the majority of sub-custodians in the market would adopt a similar position.

XX. <u>Comment on the definition of "material change" (Box 101)</u>

According to Article 22 of the level 1 text, the AIFM has to include in its annual report any material changes in information which have been given to the investors prior to their investment pursuant to Article 23. Box 101 defines "material change" as "changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF...". We feel a more precise definition could be formulated as, depending on how this is interpreted, this definition could lead to the AIFM having to disclose any information given in advance to the investors. At minimum, we feel the second part of the sentence ("including for reasons ...in the AIF") should be deleted.

We also note that – although it should be placed in a different context, Article 10, para 1 of the level 1 text also refers to "material change". This article relates to material changes in information which have been presented by the AIFM to the authorities together with the application for authorisation as AIFM. There should be a common understanding of the definition of "material change" in the Directive.

XX. Comment on the content of Balance Sheet (or Statement of Assets and Liabilities) (Box 104)

According to section 7 (a) (iii) "unrealised gains on investments" representing gains on the revaluation of investments shall be "income" and therefore part of the income and expenditure account pursuant to section 7 (first sentence). However, such a procedure would heavily collide with the distribution rules of DB's funds. The income and expenditure account is the basis for the distribution to the investors. But only liquidity can be distributed to the investors, whereas unrealized gains do not produce any liquidity. Unrealised gains should not be part of the income and expenditure account.

69. Do you agree with the proposed frequency of disclosure? If not, please provide alternative suggestions.

We do not agree with the fact that the proposed frequency of disclosure does not take into account specific characteristic of AIFs. While we agree that quarterly reporting might be appropriate for investment strategies of hedge funds, funds of hedge funds and those funds as listed in column 1 of page 434 of the consultation paper (Annex V), the frequency seems excessive for most of the funds listed on page 434, such as for instance real estate funds, which would fall in the category of "other funds". In view of their investment strategies, for these funds an annual reporting requirement would be sufficient.

We suggest ESMA provide criteria for differentiation between funds that report on an annual basis and funds that report on a quarterly basis. The same criteria could apply to the content of the report which, at least with regard to Annex V, does not fit – for example – for a fund with real estate assets, other less volatile assets or investment strategies less risky than those which are generally used by funds listed in column 1 on page 434, as well as hedge funds and funds of hedge funds as listed in column 3.

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