

POSITION PAPER



ESBG contribution to ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive.

ESBG (European Savings Banks Group)

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ESBG Register ID 8765978796-80

September 2011



The European Savings Banks Group (ESBG) welcomes the opportunity to make comments on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (AIFMD).

After analysing the draft paper prepared by ESMA, please find below our comments.

General comments

In general terms ESBG has a positive opinion of the text prepared by ESMA on this issue. The goal of drafting a text taking into account the specificities of AIFs has been, in our opinion, achieved. Nevertheless, we consider that there is still room for improvement and therefore we feel it necessary to make some remarks.

V. Depositaries

V. I Appointment of a depositary

The list of particulars to be included in the written agreement should be wide enough to match the very broad range of the types of AIF. The list encompassed in the Box 74 appears too extensive and detailed, in particular the description of procedures. The Directive clearly speaks of a “standard agreement”, so it will be very convenient to have a high level of flexibility in the list of particulars included with it.

V. II Depositary functions

▪ Cash flow monitoring

ESBG does not support Option 1 of Box 76 which would lead to a complete change of the operating model and to very high additional costs without real added value. Meeting the requirements of option 1 would lead the depositary:

1. to duplicate part of the middle office function and of the valuation function;
2. to modify the relationship with the fund manager;
3. to implement a new system of architecture and to increase the number of depositary staff; and
4. to an additional running cost widely over than 100% of the current cost for AIFS and would cause a high number of cash movements.

We prefer option 2 on Box 76. On the other hand, we question the appropriateness of the depositary ensuring 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. This would



imply that the depositary should be in some way, anticipating the AIFM's investment decisions or on the subscriptions/redemptions, monitoring unusual shareholder activity.

- Safe-keeping duties

Regarding Box 78, we prefer option 2. Option 1 appears to be unclear and could be subject to diverging interpretations under EU national laws and between different entities acting as depositaries. And on the other hand, option 2 offers a clear delimitation of instruments that are not protected by a security settlement system.

Regarding Box 79, we also prefer option 2. It is certain that financial instruments provided as collateral, are not held in custody if they have been transferred out of the depositary's book. In these circumstances, when the FI are with a third party, the depositary's duty should be limited to recordkeeping. However, as it is difficult to differentiate between the types of collateral, a clarification of option 2 would therefore be welcomed.

Regarding Box 81, it should be the obligation for the AIF (or the AIFM acting on behalf of the AIF) to make sure that its assets cannot be assigned, transferred, exchanged or delivered without informing the depositary or its delegate. It is the obligation and responsibility of the AIF (or the AIFM acting on behalf of the AIF) to meet its organisational obligations and the obligation of the supervising authorities, respectively the auditors, to control if the organisational alignment is suitable to fulfil its obligations. We prefer Option 2. ESMA should make clear that the AIF (or the AIFM acting on behalf of the AIF) is liable to provide the relevant information on time and that the depositary should not be held liable if the AIF (or the AIFM acting on behalf of the AIFM) fails to fulfil its obligation.

- Oversight duties

The oversight duties of the depositary recommended by ESMA are very extensive. This could be problematic, since the corresponding duties of the AIFM are absent, e.g. to disclose all relevant information that the depositary needs to fulfil his oversight duties or granting of admission rights, to control the system used by the AIFM. Another point is the costs of these oversight duties (need of more professionals, IT etc.). To be a depositary could become very expensive since it is questionable if the AIFM will carry the cost. Moreover, there is the danger that the supervision duties of an authority could be shifted to the depositary.

- Due diligence requirements

The proposals made by ESMA for formulating the due diligence duties of depositaries when they appoint a sub-custodian seem to be appropriate. The envisaged requirements for the selection and ongoing monitoring process are largely in line with current market practice. Categorisation of depositaries' due diligence duties into "selection" and "ongoing monitoring" also appears to be appropriate.



- Segregation

ESBG welcomes ESMA's approach regarding the segregation requirement to be imposed on third parties. The segregation of assets is an essential contribution to investor protection and it prevents access of customers' assets by third parties. However, the assets don't need to be kept in a separate account, a simple electronic marking may be sufficient to fulfil the AIFM Directive provisions.

V. IV The depositary's liability regime

- Loss of financial instruments

Regarding Box 90, we agree with the proposed definition, under which one of three conditions should be met to consider the instruments "lost", and that the depreciation of the asset's value is not taken into account. Moreover, we also agree with the explanations given after pointing out such three conditions, as they provide clarity in order to assess when financial instruments should be considered "lost".

ESBG also welcomes the possibility to substitute or convert the instruments into another financial instrument to avoid the qualification of 'lost'.

However there is still some legal uncertainty as not all the possible cases are indicated in the box. Point 11, 15 and 17 of the explanatory text are useful in this regard, thus we consider that they should be also included in the definition.

Regarding the length of time during which the situation persists (applicable to conditions 2 and 3), the text declares that it must be taken into account, explaining afterwards that financial instruments will only be considered effectively lost if the AIF has been deprived of its right of ownership or is unable to dispose of them on a permanent basis and not simply temporarily. We consider that a definition of "permanent basis" should be given, as otherwise interpretation problems may arise. It may be specified by stating that "on a permanent basis" means that it is extremely clear that the depositary will not be able to dispose of the financial instruments again.

Moreover, point 19 states that ESMA believes that it is up to the AIFM to determine whether the financial instruments are lost. We do not agree with that point of view, as such determination should be agreed by both the manager and the depositary. Depositaries expertise in this regard is crucial and should not be left out. And, moreover, if such a determination is exclusively left in managers hands, this may be detrimental for depositaries, as they should return the instruments or the corresponding amount. Therefore we consider that both managers and depositaries should determine whether the financial instruments are lost. Point 21 seems to give us the reason as declares that "it is assumed that in most cases, for non controversial situations or where the amounts at stake are low, they will find a common ground within their contractual relationship".



- External events beyond reasonable control

Box 91 provides a definition for an “external event beyond the depositary’s reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary”.

It is explained that the depositary will not be liable for the loss of financial instruments held in custody by itself or by a sub-custodian, if it can demonstrate that the event which led to the loss was external, was beyond its reasonable control, and that it had made rigorous and comprehensive due diligences in order to prevent the loss. Moreover the box points out actions that the depositary or the sub-custodian should have carried out, in order to prove that it has made all reasonable efforts to prevent the loss.

ESBG would like to make some comments regarding the provisions suggested by ESMA:

We advocate that the first condition should be amended as follows:

“1.The event which led to the loss did not occur as a result of an act, **failure** or omission of the depositary or one of its sub-custodians to meet its obligations.”;

And that the third condition should be supplemented as follows:

“Despite rigorous and comprehensive due diligences **and reasonable efforts** it could not have prevented the loss.”

- Objective reason to contract a discharge

Regarding Box 92, ESBG considers option 2 as a better solution. In order to allow the depositary to prove there is an objective reason to contractually discharge itself of its liability, it is enough to demonstrate that AIFM (or the AIF) and the depositary had explicitly agreed through a written contract that the depositary can discharge its responsibility. We would welcome thus a broad definition of “objective reasons”.



Answers to the questions raised in point V.IV “The depositary’s liability regime”

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?

We are sure that the depositary’s cost will increase, as under this regime depositaries are assimilated somehow to insurance companies. Moreover, this will also imply that many entities may choose to not provide AIF depositing services. However, the potential impact of changes in the liability regime is not yet estimable, as is it strongly related to the country of the sub-custodian and the individual counterparty risk related to that sub-custodian.

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

As already mentioned, examples may be found in points 11, 15 and 17 of the explanatory text. Furthermore, we would add the incorrect processing of corporate actions, and the expropriation or restrictions of property during a political or legal disorder.

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. Ultimately, the depositary should not be responsible for the loss of the security if it was known that the local legislation did not recognise the effects of the segregation requirements, without deterring the AIFM to invest in that country.

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

Lists or examples may be given (such as the evident natural disasters, war or terrorism) but we consider that the assessment should be done on a case by case basis.

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?

As box 91 declares, “external” are all those events that did not occur as a result of an act or omission of the depositary or of its sub-custodians to meet its obligation. Thus, anything done without the depositary’s influence.

In the particular cases of operational failures, system breakdowns, fraud and insolvency of a sub-custodian or Central Securities Depository, it is often difficult to qualify those events as “internal” or “external”. At first sight these events all happen within the risk sphere of the depositary, so they may be considered as “internal”. But since they don’t happen within the ordinary course of business and are beyond any reasonable control, they also could be considered as “external”.



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?

All the depositaries will transfer their liability if possible.

Difficulties can be foreseen in case where a sub-custodian uses services from another sub-custodian. In that case, the liability of the depositary regarding the behaviour of the sub-sub-custodian can be invoked.

If the sub-custodian is inside the depositary's group, it indeed makes a substantial difference.

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?

ESBG considers that this is neither relevant nor desirable.

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?

We deem that a further tailoring of the requirements could be convenient, mainly with regard to private equity and real estate funds.



About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6.000 billion, non-bank deposits of € 3.100 billion and non-bank loans of € 3.300 billion (all figures on 1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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Published by the ESBG, September 2011