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To: ESMA

Consultation: ESMA's draft Technical Advice to the European Commission on possible implementing measures of the AIFMD

Trustee & Depositary Services within The Royal Bank of Scotland provides trustee & depositary services to 906 UCITS and 314 non UCITS collective investment schemes, representing assets worth approximately £300,000 million.

We welcome the opportunity to respond to the consultation on the Draft Technical Advice to the European Commission on possible implementing measures of the Alternative Investment Fund Manager Directive ('AIFMD'). Other responses to the consultation may be submitted separately on behalf of The Royal Bank of Scotland Group.

We have restricted our comments to the Depositary section of the draft advice and include below responses to questions 25 to 54, together with an appendix providing commentary on some of the boxes and explanatory text. However there are three key messages worthy of attention.

1. With regard to both cash monitoring and duties relating to safekeeping of assets, a depositary's role is one of oversight and should focus on ensuring the manager has processes and controls. As a result the depositary should not be required to mirror transactions, which would significantly increase costs for depositaries and so potentially to investors.
2. In relation to subscription / redemption accounts, these are generally opened and operated by managers are not directly part of a fund's operation and may contain sums destined for funds or investors with no relation to a particular depositary. Consequently depositaries should not be required to open such accounts any duties relating to subscription or redemption proceeds should fall into a depositary's current oversight measures rather than be included in the ESMA advice.
3. As regards depositary liability, we are strongly of the opinion that provided the Depositary has acted properly and in particular has complied with the diligence requirements for appointing and monitoring the custodian as finally determined in the ESMA advice, loss of assets resulting from events occurring within a sub-custodian including insolvency and fraud, should be considered external and beyond the depositary's control.

Please find below our detailed response to the Depositary section of the Advice.

Yours faithfully

Nick Jenkins
Assistant Director, Regulatory & Technical

Responses to the consultation questions

Question 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?

This would not be feasible in the UK as regards subscription / redemption accounts. In the UK environment the subscription and redemption accounts are operated almost exclusively by the manager or their delegates, such as transfer agent. As such they are not part of fund. Further complications could arise as these accounts may contain amounts and be used to process transactions for funds where other organisations are depositary.

Question 26

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?

This would depend on the nature of the fund, however generally, reconciliations are performed daily or on the occurrence of valuations. It is the AIFM or its delegate who performs these reconciliations with the depositary's role being one of oversight.

Question 27

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

We see no practical problems with this.

Question 28

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

We regard prime brokers as counterparties so would recommend ESMA clarify that the same obligations exist as with cash placed with banks and credit institutions.

Question 29

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

We prefer option 2, which is similar to the current operating models of UK depositaries. ESMA has gone some way to articulating the reasons for this in paragraph 5 of the explanatory text, but we would stress that if depositaries were to act as a central hub and required to mirror cash movements, the costs would be prohibitively high which would likely increase costs generally within the fund operation. Further, option 1 would appear to increase the depositary's responsibilities stated within Article 21.

In relation to the explanatory text, we note the principles contained in Box 76 as they relate to Option 2 e.g. 'ensure appropriate procedures', 'review periodically the adequacy', does not tie up with paragraph 9 of the explanatory text which is quite prescriptive and time detailed e.g. the suggestion of weekly review of reconciliations where reconciliations are

conducted daily and 'going through the whole reconciliation process' on an annual basis. We request that ESMA clarify the extent of its expectations here.

Question 30

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

As stated Option 1 would be prohibitively expensive, whereas option 2 is similar to the current UK model.

Question 31

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

As stated this would be prohibitively expensive.

Question 32

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

We prefer option 2 and would refer you to the response submitted by the Depositary and Trustee Association ('DATA').

Question 33

Under current market practice which kinds of financial instrument are held in custody (according to current interpretations of this notion) in various member states?

We refer you to the comments on Box 78 contained within the response from DATA.

Question 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?

We would refer you to the response submitted by the Depositary and Trustee Association ('DATA').

Question 35

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

We draw no distinction between delegation of custody duties where non custody safekeeping duties are concerned. The duties ultimately delegated to a global custodian will be covered by agreement and subject to due diligence and ongoing monitoring.

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

We do not differentiate in levels of control between (i) and (ii), however we would point out that at global custodian level the majority of assets are held in the name of the depositary on behalf of the AIF with those assets at local depot level being held by custodian nominees. The exception would be where local legislation dictates that assets must be in the name of the fund directly. We are not aware of assets being held as per (iii).

Question 37

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

This is possible and desirable.

Question 38

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?

Option 1 is preferable. It is unclear as to exactly what is meant by 'mirroring' in Option 2, however if this amounts to replicating the AIF's records on a separate system based on daily trade activity, then this would amount to re-doing the AIF activity so would be too costly for depositaries and consequently investors.

Question 39

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

We would welcome further guidance here in Level 3. We support the pragmatic response espoused in paragraph 38 of the explanatory text in relation to allowing the depositary to determine the level of certification required.

Question 40

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?

Our responses on 'oversight' reflect how we consider current depositary monitoring practices to work within the UK and so specifying these practices in rules should make clear that it is incumbent on AIFMs and their delegates to ensure the depositary is provided with the information to enable the depositary to conduct appropriate oversight.

Question 41

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

Within the UK a depositary bank is required to be completely independent of the manager. By way of example, at present a strict interpretation of the rules for a unit trust requires a trustee to issue and cancel units, however the independence structure outlined ensures any potential conflicts here are mitigated. We consider this would be replicated should such requirements extend to different fund structures.

Question 42

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?

In the UK environment the subscription and redemption accounts are operated almost exclusively by the manager or their delegates, such as transfer agent. As such they are not part of fund. Further complications could arise as these accounts may contain amounts and be used to process transactions for funds where other organisations are depositary. Consequently it is difficult and impractical for depositaries to exercise full control or oversight of the process. Currently depositaries generally receive reconciliations of issues / cancellations with the register from managers, and on site visits may review a sample of unit transactions including settlement.

Question 43

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?

By referring to assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, we assume a connection here with §1 of Box 83 as well as §2. To that extent the wording in the box appears to suggest super equivalence to Article 21 (9)(a) as the article restricts itself to the transactional aspects of issues, cancellations, subscriptions and redemptions. However section 1 in the box, along with paragraph 53 of the explanatory text, impose a standard of reconciliation with subscription and redemption proceeds. As previously stated these are generally operated by the manager separately to the AIF with the depositary having no duty of oversight, however the depositary may conduct periodic sample checks, based on a risk assessment, of the cash settlement of transactions.

Question 44

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 box text is reasonable however paragraph 62 in the explanatory notes imposes a duty on depositaries to check the AIF's 'investment strategy'. We believe this is in excess of

requirements in Article 21 and could mean depositaries are involved in the investment management process. Further paragraph 62 requires the depositary to 'investigate any 'unusual' transaction it has identified'. We would request ESMA clarifies that by 'unusual' it means the depositary can decide what is usual based on its knowledge of the AIFM or AIF, rather than generic transaction types.

Question 45

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

We prefer option 1 as current levels of oversight and control by depositaries are adequate.

Question 46

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.

Standard custodian agreements are structured so as to pass responsibility to the custodian to ensure assets are adequately protected. It is difficult to envisage additional measures which could be put in place to insolvency proof assets and there is a danger that custodians would be less inclined to stand behind certain markets which in turn would limit investment opportunities in such markets. Where custodians perceive difficulties in segregation in some jurisdictions, depositaries should obtain details of the custodian's diligence to ensure any risks are minimised. To this extent we question the need to replicate the MiFID requirements within Box 89.

Question 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?

At present, in certain circumstances the depositary is required to accept responsibility for third party delegates in relation to fraud, negligence and even insolvency. Clearly robust and thorough diligence can mitigate against the occurrence of such acts however ultimately such occurrences are outside the control of the depositary.

As the new regime would appear to place the depositary in the position of underwriter in relation to activities of sub-custodians informal discussions have taken place with Insurance counterparts who have anecdotally advised that the risks are almost unquantifiable. If it were possible to obtain insurance in relation to such risks, such insurance would attract significant premiums but in reality it is likely the risks would be considered to be uninsurable.

On that basis whilst increased costs are therefore considered to be inevitable it is not possible to adequately quantify such costs at present.

Question 48

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

We feel a typology of events would be unhelpful as any situation would need to be examined individually in order to assess whether it falls within the definition.

Question 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?

We agree that where local legislation may not recognise the effects of segregation requirements, any loss should be considered as an external event.

Question 50

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

We refer you to the event types provided by DATA in ESMA's Call for Evidence in January 2011. These remain valid

Additionally, We are concerned as to the potential liability to the depositary relating to fraud taking place within a sub custodian when custody has been delegated by the depositary. The stand out section on this is paragraph 29 of the explanatory text. The final sentence implies that such fraud would be deemed internal and so the depositary would be liable. It is not clear what action the Depositary could take to prevent such fraud beyond the duties relating to diligence as per point 3 within Box 91, and so provided the Depositary has properly satisfied its diligence obligations we are strongly of the view that fraud within the delegated entity should result in the consequential loss being borne by that entity.

Question 51

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?

Please see our comments on Box 91 in the Appendix.

Question 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?

Option 2 is preferred, however this concept of contractual discharge would be difficult to implement in practice.

Question 53

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?

No comment

Question 54

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?

Further tailoring may be required to take into account certain types of fund such as closed end funds, including investment trusts.

Appendix

Box 74

We welcome the clarification that an agreement should specify the details whereby the AIFM should supply information to enable a depositary to carry out its duties. We believe however there is too much detail within the Box for a secondary directive. Essentially the majority of information to be contained within a depositary agreement should be left to individual depositaries, who should have standard agreements for their existing business, both UCITS and non UCITS.

Box 75

- We request clarification that the requirements do not extend to dealing accounts operated by the AIFM, i.e. subscriptions and redemption accounts.
- The third bullet states *'the depositary is provided with all information...directly from those third parties in order for the depositary to have access to all information'*. This is in excess of requirements within Article 21 and we feel the AIFM should be responsible for any information the depositary may require relating to cash accounts it opens.

Box 76

- Option 2 is preferred however a question remains around how much liability this gives depositaries. This is particularly relevant regarding the requirements in point 5 within option 2, concerning escalation processes. Option 1 would mean depositaries would incur significantly increased costs.
- Point 2 within option 2: Please clarify the reconciliation requirement is on the AIFM.
- Regarding option 2, there is significant detail in section 9 of the explanatory text. If this is what is expected then perhaps more detail should be inserted in the text box, however we feel section 9 is too prescriptive and inconsistent with the sentiment expressed within the Box.

Box 77

Carries over MiFID requirements but does not take into account different fund types eg common investment funds and investment trusts. The rule should draw a distinction between the operating differences of fund types.

Box 80

The reference in the last sentence should be to Box 89

Box 81

Option 1 is preferable. It is unclear as to exactly what is meant by 'mirroring' in option 2, however if this amounts to replicating the AIF's records on a separate system based on daily trade activity, then this would amount to re-doing the AIF activity so would be too costly for depositaries and consequently investors.

Box 82

- The scope is widely drawn. It should be clarified that the depositary is not required to conduct oversight of the AIF's governance.
- Paragraph 3 talks about 'potential irregularities'. This is too open ended and should be more specific, perhaps in Level 3 guidance.
- In the explanatory text, paragraph 48 suggests the depositary should apply a risk assessment in establishing the scope and extent of its oversight of the AIFM.

However, paragraphs 49, 50 and 51 appear to be specific about what these controls should entail, therefore the advice is inconsistent.

Box 83

The wording in the Box appears to suggest super equivalence to Article 21.9(a) as the article restricts itself to the transactional aspects of issues, cancellations, subscriptions and redemptions. However section 1 in the box, along with paragraph 53 of the explanatory text, imposes a standard of reconciliation with subscription and redemption proceeds. The subscription / redemption accounts are generally operated by the manager separately to the AIF with the depositary having no direct involvement and so the standards applied to depositary oversight of cash accounts within AIFMD should take account of this.

Box 84

- We welcome ESMA's position that the depositary is not responsible for the valuation process, and accordingly will assess the AIFM's operation to design the frequency and extent of its monitoring.
- Paragraph 5 in the box is super equivalent to the wording in Article 21.9(b), which only refers to the calculation of the value of units and not the appointment of the external valuer. We therefore we request that this paragraph is deleted.

Box 85

The box text is reasonable however paragraph 62 in the explanatory notes imposes a duty on depositaries to check the AIF's 'investment strategy'. We believe this is in excess of requirements in Article 21 and could mean depositaries are involved in the investment management process.

Box 87

Requirement 2 refers to 'appropriate measures' to be taken by the AIFM in case of reserves on the financial statements. We request clarification on the type of appropriate measures envisaged and that these should be agreed only between the auditor and AIFM.

Box 88

- 1(a)(i): Requires the depositary to 'determine the potential implication of the insolvency of the custodian'. Further in section 7 of the explanatory text, the depositary is requested to 'analyse the legal & regulatory framework of the relevant country'. It would be useful here to gain clarification that a depositary that delegates to a global custodian can make enquiries into the relevant diligence of that custodian in relation to assets delegated further to sub custodians, and, if satisfied with these enquiries, is not required to conduct diligence of those sub custodians down the 'chain'..
- 1(b)(ii): Reference should be to Box 89.

Box 91

- We are concerned that the definition of 'external events beyond the depositary's reasonable control' does not include events within a sub-custodian which contribute to loss. This is despite the fact that the standards of diligence imposed on the depositary (Box 88) may have been met.
- We are concerned as to the potential liability of the depositary in relation to fraud taking place within a sub custodian when custody has been delegated by the depositary. The stand out section on this is paragraph 29 of the explanatory text. The final sentence implies that such fraud would be deemed internal and so the

depository would be liable. Once the depository has performed its duties as per point 3 within Box 91, then fraud within the delegated entity should not mean the consequential loss is to be borne by that depository.

- Paragraph 31, page 185. Please clarify the meaning within (iii) of 'the disruption in the entity's activity in relation to its default'? Note that (iii) is given as one of the insolvency aspects which incur depository liability.
- Paragraph 39 of the explanatory text presents further concerns. This suggests that in terms of appropriate action, if a depository has advised the AIFM that continued investment in certain financial instruments represents significant custody risk, then its ultimate sanction is to terminate the agreement with the AIFM and find another depository. This is impractical as it is unlikely another depository will accept the risk once identified. We propose that the depository's final sanction should be to notify the competent authority and at this point its liability is discharged.