

September 13th , 2011

ESMA Consultation Paper on Possible Implementing Measures under the AIFMD

BNP PARIBAS Contribution on depositary's functions

BNP PARIBAS welcomes the opportunity to contribute to the ESMA consultation on the Implementing Measures on the AIFM Directive.

As BNP PARIBAS SECURITIES SERVICES is a major European player in the depositary activity with a presence in most European markets, it can provide the European Regulators with a very constructive view on concrete and operational aspects that need to be taken into consideration when defining the depositary function. At the same time, one of BNP PARIBAS' key priorities is to make proposals which enhance the harmonisation of the depositary function at the European level and which consequently reinforce the level of investor protection within the EU.

In addition, BNP Paribas provides Prime Brokerage services and certain comments are made from the perspective of that business. Comments are ascribed to "BNP Paribas" unless a distinction between the operating entities is relevant.

BNP PARIBAS agrees with the aims of the ESMA advice:

- 1 to strike the appropriate balance between the Directive's objective of ensuring a high level of investor protection while refraining from placing the entire responsibility on depositaries and consequently increase in systemic risk;**
- 2 to propose measures that are not unduly costly compared to alternatives measures which would also ensure the achievements of the objectives of the directives**

I – Key points

When clarifying the duties and the definition of the liability regime applicable to the depositary BNP PARIBAS expects the implementing measures to take into account the following principles with regard to:

a) The scope of the custody

The scope of “assets held in custody” should be clearly defined. In this respect, BNP PARIBAS believes that financial instruments held in custody should be transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC. Furthermore these financial instruments should have the following characteristics:

1. they are registered in the name of the depositary or in the name of its sub-custodian acting on behalf the depositary;
2. They are settled in a settlement system which maintains the relevant issuer account; in order to promote and protect investments and financial stability in Europe, the European banking system should not be exposed and made liable for weaker or less regulated financial markets outside the EU. We therefore suggest to restrict the settlement systems to those designated in Directive 98/26/EC".
3. They have not been provided as collateral.

b) The definition of the liability regime applicable to the depositary

Depositaries cannot be made liable for events outside their sphere of control and influence. **In particular insolvency related events of a sub-custodian to the Depositary should be considered an “external event beyond the depositary’s reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary”.** It is beyond the possibility for a Depositary to foresee insolvency of a sub-custodian whatever the nature of the “due diligences” carried out by the depositary and in view of the fact that due to this insolvency acts or omissions of a sub-custodian may result in a loss which would not have been the case if the sub-custodian had not been insolvent. The bankruptcy of the sub-custodian, that overrules the agreement between the sub-custodian and the depositary, prevents the sub-custodian from returning the assets to the depositary as it would have not been the case, if the sub-custodian had not been insolvent. Indeed, according to the provisions laid down in the agreement entered into between the depositary and the sub-custodian the sub-custodian has to return the assets

Furthermore the depositary cannot be requested to compensate for, or substitute, local regulators /supervisors that are in charge of the sound functioning of the financial and banking system.

In case such a liability would be imposed on the Depositary, it could create grave systematic risks considering the large values that might be involved

Therefore, ESMA should further develop the concept of proportionality in the advice in order to avoid the situation where depositaries would be treated as insurers for the fund industry.

c) Cash monitoring and safekeeping related to other assets

BNP PARIBAS believes that the depositary should not act as a central hub and should neither mirror the transactions of the cash accounts opened at third party entities nor mirror the transactions on other assets, in particular trade on listed derivatives or trades on assets provided as collateral to a Prime broker. A depositary record would be onerous for AIF with large trading volume without providing any additional protection over the processes outlined. Mirroring these transactions would lead to major change in operating model and relationship with the fund manager, incremental costs for the depositary and consequently for the fund, but with little added value.

d) Oversight duties

BNP PARIBAS welcomes the consultation from ESMA and supports the **objectives of investor protection** and a **full harmonization** of the principles that govern the duties and liabilities of Depositaries under AIFMD in all EU Member States. Thus full harmonisation in this area must be the objective. Nevertheless **it should be acknowledged that for the time being there are different models which co-exist in the EU and within EU Member States depending on:**

- **the type of investment fund (UCITS like funds, Real estate fund, Private equity fund) and the national law applicable to them,**
- **the type of assets these funds invest in (listed/ non listed, in which way the underlying assets are regulated) ;**

The principles laid down at the level 2 text should remain generic enough to be applicable to these different types of funds. The full harmonisation of rules will require further levels of European text and cannot be achieved at the implementation measures level

Therefore BNP PARIBAS supports the proposal to introduce principle-based implementing measures with regard to oversight duties, which will result in an adequate harmonization of duties across the European Member States.

BNP PARIBAS supports this approach but would like to make the following observations and comments:

- i. The scope of the oversight duties should not include the review of the whole organization and processes of the AIFM/AIF but should be limited to the processes and procedures of the AIFM in relation to its obligations pursuant to article 21(9),

- ii. The Depositary oversight duties are to be performed by *ex post* controls.
- iii. No prevailing means of controls (samples, assessment of procedures, on site-visits ...) should be designated in the level 2 text,
- iv. The depositary should not perform first levels of control (operational & internal control) that are performed at AIF/AIFM level). The depositary performs secondary level controls.
- v. AIFM and UCITS requirements on oversight duties should be aligned.

II- Detailed contribution to the public consultation

1- Cash monitoring

1-1 Cash Monitoring – general information requirements-BNP PARIBAS analysis of Box 75 and proposed amendments to Box 75

With regard to Box 75 we believe that it should be specified that the depositary receives timely and accurate information .If the information is not timely or accurate, then the monitoring will be ineffective. We suggest the amendment as set out below:

Box 75-Cash Monitoring – general information requirements

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 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 **timely and accurate information**, the AIFM will have been deemed not to have satisfied the requirements of Article 21 of the directive.

1-2 Cash Monitoring – ensuring the cash is properly booked -BNP PARIBAS analysis and proposed amendments to Box 77 – answer to Q25, Q26, Q 27, Q28

With regard to Box 77 and its first requirement it should be clarified that the depositary should not have to look through to the underlying 'correspondent bank' cash accounts held by the third party in its network

We suggest the following amendment.

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

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 **opened at the third party** 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

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?

As the Level 1 Directive expressly retains the possibility that cash accounts can be opened with entities different from the depositary and consequently the measures of implementation should not impose the restriction that cash accounts be opened at the depositary. This requirement would raise major operational difficulties. It could have a damaging impact on distribution channels and would therefore increase costs. In our opinion, the current arrangements enable the AIF accounts to be promptly credited with subscriptions monies. We therefore do not see any added value in disrupting administrative channels that best suit the distribution procedures.

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?

In practice the fund's accountant reconciles all cash flow movements at least at every NAV calculation. This frequency doesn't depend on the type of assets. The reconciliation of cash flows is performed at each calculation of the NAV by the AIF as the administrator/valuer. On a periodic basis in accordance with its own risk analysis the depositary has to verify the reconciliation performed by the administrator/valuer .

There is no distinction to be made depending on the type of assets in which the AIF invests.

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

Currently cash accounts may be opened in the name of the AIF with clearers or prime brokers that neither are nor bank neither credit institution.

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

This requirement appears to increase the safety of cash deposit and consequently be in the interest of the investors. Yet it should not necessary be in the interest of the hedge fund industry.

It should be clarified how the Prime brokers, acting not as bank but as broker dealer, will have to operate to fulfil this requirement.

Furthermore it should be clarified that before entering in an agreement with a third party to open a cash account on behalf of the fund, the fund manager will have to check the third party fulfils the requirement referring to Article 18 and will have to transmit the outcome of its checking to the depositary.

1-3 Cash Monitoring – Proper monitoring of all AIF's cash flows - BNP PARIBAS analysis of Option 1 and 2 and proposed amendments to Box 76 –answers to Q29,Q30,Q31

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

1. **BNP PARIBAS does not support Option 1** as it would lead to a complete change of operating model and to very high additional costs but with no real added value. Meeting the requirements of option 1 would lead the depositary to:
 - i. duplicate part of the middle office function and of the valuation function,
 - ii. modify the relationship with fund manager,
 - iii. implement a new system architecture and to increase the number of depositary staff,
 - iv. Additional running costs potentially over 100% of the current cost for AIFS with a high number of cash movements.

2. Option2, with some amendments, is preferable.

Mirroring all transactions on a depositary record would be onerous for AIFs with large trading volumes and such mirroring would be prone to error and require additional reconciliation, without providing any additional protection over the processes outlined in option 2. Point 8 of the explanatory text associated with option 1 notes that: 'the depositary could intervene immediately if it considers the cash flows inappropriate.' This would require the depositary to complete real time monitoring of all cash transactions, and also reviewing the reason for the transaction (supporting a trade, deposit with credit institution, expense payment or potentially free cash transfer) to determine if the transaction were potentially inappropriate. Consequently the depositary would perform a part of the Fund manager's middle-office tasks. The cost in terms of infrastructure and resources to meet this requirement would be very high, as stated in the ESMA's impact assessment (page 308), and similar to the cost of an ex-ante authorization regime by the depositary..

Reconciling the cash movements with the information stemming from the accounting system would mean that the depositary uses the same data and duplicates the process of reconciliation already performed by the fund accountant. This duplication would not provide any real added value as it is unlikely that it would allow the detection of any actual discrepancies.

Option 2 is the preferred option. However:

- When the depositary carries out the task associated with the custody, the market practice is that a general account is opened in the books of the depositary. Carrying out custodial tasks such as the processing of settlement and of corporate actions for the AIF's assets requires the opening by the AIF of a cash account on the custodian's books. In this case where cash accounts are opened in the name of the AIF with a third party, the global proceeds are credited in the account opened in the custodian's book.
- The notion of "full review of the reconciliation process" appears to be unclear. We are of the opinion that the depositary's duty is to check that appropriate procedures are implemented in order to perform cash reconciliation. The scope of the review includes the administrator and the third parties' positions.
- Point 9 of the explanatory text suggests that if the reconciliations are performed daily, then the depositary would be expected to perform its verifications on a weekly basis. The suggested verification frequency does not take into account the nature, scale and complexity of the AIF, or the volume of transactions. Normally, the fund administrator would complete daily reconciliations for a daily valued fund, but the transactions may be minimal, and thus weekly verification by the depositary would not be cost effective.

Therefore BNP PARIBAS suggests the following amendments:

Box 76

Proper monitoring of all AIF's cash flows

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 the cash belonging to the AIF is booked in an account opened at the depositary when it carries out the custody of financial instruments; and

2. 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);

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

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

5. review periodically the adequacy of those procedures and in particular check that the relevant cash accounts opened in the name of the AIF are included in including through a full review of the reconciliation process at least once a year; procedures

6. 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.

The depositary's monitoring should take into account the nature, scale and complexity of the AIF, and the volume of transactions.

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

Set –up costs

Option 1: high systems related costs to hold/store records

Option 2: no additional costs

Running costs

Option 1: Estimate from +30% to widely above 100 % (in the cases of high trading volumes): additional headcount to record, reconcile mirror records.

Option 2: If verification required on a more regular basis, then it would require depositary headcount. – Approx +10% over current cost.

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

See answer to Q 30

2 - Safe-keeping duties

2-1 Definition of financial instruments to be held in custody - BNP PARIBAS analysis and proposed amendments to Box 78 – answer to Q 32,Q33

Q32: Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view. Although option 1 provides an important element that should be taken into account, option 2 is preferable with some amendments.

BNP PARIBAS believes that financial instruments held in custody should be

transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC . Furthermore these financial instruments should have the following characteristics:

4. they are registered in the name of the depositary or in the name of its sub-custodian acting on behalf the depositary;
 5. they are settled in an settlement system which maintains the relevant issuer account;
 6. they have not been provided as collateral.
- Firstly, when the financial instruments are registered in the name of the AIF, or in the depositary's name on behalf of the AIF, directly or even through a register maintained by a settlement system, the AIF is clearly identified by the issuer as the owner of the assets. Consequently these assets should not be subject to custody but to record keeping. Therefore for assets to be considered as held in custody **the depositary or its delegate should be the registered owner of the financial instruments or the depositary or its delegate should be the only registered owner of the assets on behalf of a group of one or more unidentified clients.**
 - Secondly, **the maintenance of the register relative to the issuance of the financial instrument should be entrusted by the issuer to a settlement system designated by Directive 98/26/EC.** Financial instruments only registered with an issuer or a registrar cannot be considered as assets coming under the scope of the custody duties :
 - o the depositary does not select the issuer or the registrar of the financial instruments, which consequently cannot be considered as a sub-custodian,
 - o the depositary is a mere intermediary acting on behalf of the fund for the transmission of subscription/redemption orders even in the cases where the issuer/register selected by the AIF does not allow the registration on behalf of the name of another entity other than the transmitter of the order (i.e. the depositary),
 - o the issuer or the registrar is not systematically a regulated entity and has not always implemented central regulated procedures to validate that the number of issued shares or units is similar to the number of shares or units in circulation. As a result there is a risk of loss of these financial instruments resulting from the improper performance of the issuer record keeping although in some countries some regulatory provisions exist to prevent such a risk,
 - o in order to promote and protect investments and financial stability in Europe, the European banking system should not be exposed and made liable for weaker or less regulated financial markets outside the EU. We therefore suggest to restrict the settlement systems to those designated in

Directive 98/26/EC". Furthermore it is hard to define what is a non European settlement system deemed equivalent to a settlement system designated by Directive 98/26/EC

- Thirdly, financial instruments that have been provided as collateral should not be in custody except in the following case (which we believe is likely to be very rare, since collateral takers will typically want to ensure their own control or “perfection” of the collateral interest):
 - they have not been transferred out of the depositary’s book, (and remain with the depositary for the AIF in question),and
 - their ownership right has not been transferred to a third party, and
 - they cannot be re-used by a third party which is not the depositary.

Additionally, financial instruments which are **physically delivered** to the depositary should be held in custody. Some financial instruments can be held either in dematerialised form or by physical certificate. The text should not lead the fund manager to prefer using physical certificates, which would not be standard market practice as it is less efficient for trading and settlement.

Therefore BNP PARIBAS suggests the following amendments:

Box 78

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

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 **and the depositary or its sub custodian is the registered holder of the financial instruments or the depositary or its sub custodian is the only registered holder of the assets whether on a client by client basis or according to an “omnibus “account scheme).**
2. they are not provided as collateral in accordance with the provisions set out in Box 79 (option 3); and

Option 1

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

Option 2

3. they are financial instruments with respect to which the depositary may itself or through its sub-custodian instruct the transfer of title or an interest therein by means of a book-entry on a register **subject to regulated central reconciliation procedures and maintained by a settlement system which acts directly for the issuer or its agent. This settlement system is one of the European settlement systems** as designated by Directive 98/26/EC or ~~similar non-European securities settlement system which acts directly for the issuer or its agent.~~

Additionally, financial instruments which ~~can be~~ **are** 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 ~~are can be~~ physically delivered to the depositary. Further, financial instruments which comply with the definition set out above will remain in custody when the depositary is entitled to re-use them whether that right has been exercised or not. 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.

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?

These financial instruments are transferable securities, money market instruments or units of collective investment undertakings in bearer form, as listed in Annex I, section C of Directive 2004/39/EC (derivatives excluded) .

These financial instruments, in bearer form, are subject to mandatory registration in a regulated CSD and registered with an account opened in the name of the depositary itself. This is therefore consistency with the proposal for a definition, as amended in Box 78.

2-2 Treatment of collateral -BNP PARIBAS analysis of Option 2 Box 79 and proposed amendments to Box 79- answer to Q34

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?

We think it is safe to say that it is easy to distinguish between title transfer and security financial collateral arrangements given the differences identified in the Collateral directive; and also that the financial markets are well versed in the differences between title transfer and security arrangements, not least because of the differences in “perfection” and different duties and consequences in relation to the underlying collateral assets (not least, the right of use and method of enforcement) under these respective collateral structures. Nevertheless, if it is felt that these are not adequately clear, then we would respectfully suggest that this is more an issue impacting the taking of collateral in the financial markets generally, as opposed to limited to the AIFM parameter and hence any changes should be considered in the context of a recasting of that Collateral directive.

More generally, we note the identification of three potential options as to the collateral structures for the purposes of distinguishing “collateral” assets from “custody” assets. Whilst the paper does not ask for input on this point, **we respectfully suggest that Option 3 would be the most appropriate so as not to require the market to change its approach as to collateral structures which have been diligenced as to enforceability and acceptability, particularly bearing in mind that certain local assets may be subject to collateral structures not falling within Options 1 or 2.**

The liability for the custodian could only be stated if the financial instruments being held at the depository are free of pledge or other control/possession possibility or right of any third party. So if there is still a possession or any control possibility over the financial instrument by a third person, these instruments should not be held in custody

In practice in the BNP PARIBAS SECURITIES SERVICES ‘books:

- Where the collateral arrangement is a title transfer financial collateral arrangement the assets received in collateral are booked in a collateral account opened in the name of the collateral taker,
- Where the collateral arrangement is a security transfer the assets received in collateral are booked in a specific account opened in the name of the collateral provider mentioning the collateral taker.

Therefore BNP PARIBAS suggests amending Box 79 as follows:

Box 79
Treatment of collateral – Article 21 (8) (a)

Financial instruments provided as collateral 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

2-3 Safekeeping duties related to financial instruments that can be held in custody and proposed amendments to Box 80

BNP PARIBAS is of the considerate opinion that under point 1 (c), the depositary cannot "... assess and monitor all relevant custody risks...", and especially not those custody risks "...related to settlement systems and inform the AIFM of any material risk identified." BNP PARIBAS recommends amending point 1 (c) For risk mitigation purposes and asset and investor protection, the depositary shall inform the AIF or the AIFM acting on behalf of the AIF of any material change in those markets where it holds the AIF's assets in custody.

Therefore BNP PARIBAS suggests amending Box 80 as follows:

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

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 booked 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. In particular, depositaries should be required to assess the custody risks related to settlement systems and inform the AIFM **of any material change in the market practices.**

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-custodian²³') complies with §1 (b) as well as with the segregation obligations set out in Box 16.

2-4 Safekeeping duties – Conditions applicable to the depositary when performing its safekeeping duties on each category of assets –Answers to Q35,Q36,Q37

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

The safekeeping tasks related to 'other assets' are generally not delegated. Nevertheless the requirement to mirror all transactions in a position keeping record (and in particular trades on listed derivatives or trades on assets provided as collateral) would force the depositary to delegate this task to the clearer or the prime broker

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?

We assume that the question relates to transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC.

When the assets are registered either in the name of the 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, information related to these assets is directly transmitted to the depositary by the register. The depositary does not depend on the AIF to receive the necessary information with its controls.

Where the assets are registered in the name of the AIF directly, the depositary depends on the AIF to receive this information.

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

Where the rules applying to the AIF specifies a re-hypothecation limit it is needed to allow the depositary to perform its oversight duties

Prime brokers should be in a position to provide daily reports. However, this may not be the case for other counterparties/clearers e.g. derivatives.

In addition, whilst at a conceptual level, there should be no issue with prime brokers providing daily reports as to the location of assets and the current level of rehypothecation as this is current market practice, we would propose that this requirement be drafted separately to address specific concerns as opposed to a simple transposition of the FSA regulation. CASS 9.2.1 has been the subject of further discussion between the prime brokerage community and the FSA due to the lack of clarity of some of the provisions therein. The FSA has itself recognised that its prime brokerage rules are “super-equivalent” to those under MiFID and we believe it would be premature to seek to replicate them at a European level, particularly with reference to the ongoing drive towards a Single European Rulebook.

2-5 Safekeeping duties related to ‘other assets’ – Ownership verification and record keeping - BNP PARIBAS analysis and proposed amendments to Box 81- Answers to Q38, Q39

Q38: What would be the estimated costs related to the implementation of option 1 or option2 of Box 81? 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?

BNP PARIBAS SECURITIES SERVICES doesn’t support option 2 which would lead to a complete change of operating model and to very high additional costs but no real added value. Meeting the requirements of option 2 would lead the depositary:

- i. to duplicate part of the clearer or of the prime broker activity ,
- ii. to modify the relationship with fund manager,
- iii. to implement a new system architecture and to increase the number of depositary staff,
- iv. To an additional running cost widely over than 100% of the current cost for AIFs with large trading volume on listed derivatives or on assets provided as collateral.

2. Option1, with some amendments, is preferable.

Mirroring all transactions with option 2 , in particular trade on listed derivatives or trades on assets provided as collateral to a Prime broker, on a depositary record would be onerous for AIF with large trading volume and such mirroring would be prone to error and require additional reconciliations, without providing any additional protection over the processes outlined in option 1.

To allow the depositary to comply, at a reasonable cost, with its obligation to provide at any time a comprehensive and up to date inventory of the AIF's assets, it should be clarified that for listed derivatives, for transactions related to assets provided in collateral, **the depositary can discharge its assets monitoring duties by receiving and storing the clearing broker statement mentioning the transactions and positions.**

Therefore BNP PARIBAS SECURITIES SERVICES suggests the following amendments:

Box 81

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

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, or

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; or

(iii) **receive and store electronic data flow 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 **or relevant electronic data flows** 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.

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

As a matter of principle the depositary has not to verify the ownership of the underlying assets. The control of ownership of the underlying assets has to be performed by the AIF/AIFM in case it holds non listed assets. It is the responsibility of the AIF/AIFM to value the assets but it is not part of the asset monitoring duties

The depositary may check that in case of non listed assets the AIF's investment procedure and the AIF's valuation procedures establish that the AIF has to verify the ownership of the underlying assets.

3- Oversight duties

3-1 Oversight duties – general requirements - BNP PARIBAS analysis and proposed amendments to Box 82 - Answer to Q 40

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?

BNP PARIBAS supports the proposal to introduce principle-based implementing measures with regard to oversight duties, which will result in an adequate harmonization of duties across the European Member States. The proposed advice will create benefits for the reason that it enhances the orderly harmonized cooperation between the depositary and the AIFM or the AIF in relation to clearly establishing all the relevant information / communications flows, which is essential for an adequate investors' protection.

BNP PARIBAS supports this approach but would like to make the following observations and comments:

- vi. The scope of the oversight duties should not include the review of the whole organization and processes of the AIFM/AIF but should be limited to the processes and procedures of the AIFM in relation to its obligations pursuant to article 21(9),
- vii. The Depositary oversight duties are to be performed by *ex post* controls.
- viii. No prevailing means of controls (samples, assessment of procedures, on site-visits ...) should be designated in the level 2 text, in order to allow the use of the best appropriate. In particular the depositary should perform on-site visits only when it estimates it is necessary.
- ix. Level 1 does not impose the obligation on the depositary to undertake primary verification of every matter described in Article 21 (9). The depositary should not perform first levels of control (operational & internal control) that are performed at AIF/AIFM level). The depositary performs secondary level controls. Therefore the depositary should neither substitute nor replicate the controls performed internally by the AIF/AIFM.
- x. Alignment with UCITS regulation.

Provided the principles listed above are followed BNP PARIBAS does not believe that the advice on oversight duties will materially impact the depositary's relationships with AIFMs, AIF and third party providers.

Therefore BNP PARIBAS suggests the following amendments:

Box 82

Oversight duties – general requirements

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 **in relation to its obligations pursuant to article 21(9)** 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 on a regular basis.

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) the **outcome of the AIF/AIFM's monitoring on the actual and ongoing performance of the processes and procedures including** by third parties and particularly:

- **that the depositary receives the risk management procedures describing how the AIF/AIFM will exercise its supervision duties in that regards ,the information made by the independent assessment of the AIF/AIFM and its service provider on their control environment, the reserves on the AIF's auditor expressed on the annual financial statements, the outcome of the controls and calculation performed by the AIF/AIFM 's internal control and risk management function**
- that the depositary, **when it estimates it is necessary**, 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,

3-2 Oversight duties – Duties related to subscriptions / redemptions - BNP PARIBAS analysis and proposed amendments to Box 83 - Answers to Q 41 , Q42, Q43

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

As a general duty, the depositary is required to have an organisation that identifies and mitigates all potential conflicts of interest (operational, functional and hierarchical segregation of functions).

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 or the AIFM on behalf of the AIF or the appointed service provider (e.g. fund administrator) has an appropriate procedure to reconcile units / shares created with the subscription proceeds received by the AIF, **The frequency of the controls conducted by the depositary should be based on the nature,**

scale and complexity of the AIF and on the frequency of the AIF's calculation of the units or shares of the AIF.

- verifies that the procedure is reviewed on a regular basis ,

.The depositary does not perform cash reconciliations for the collection accounts, which could lead to additional cost but no added value

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?

Paragraph 2 of Box 83 should be clarified. Indeed, the oversight duties of the depositary cannot include “secondary” market transactions (i.e. sale or repurchase of shares and units) the oversight duties should apply to the compliance of the procedures at the level of AIF, AIFM or the designated entity only. The depositary has no view and access to the distribution channels. Furthermore it is impossible to satisfy this requirement when the units/share are not issued in a nominative form.

Therefore BNP PARIBAS suggests the following amendments

Box 83

Clarifications of the depositary's oversight duties

Duties related to subscriptions / redemptions

The oversight duties of the depositary do not include “secondary” market transactions (i.e. sale or repurchase of shares and units).

(a) 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. **The frequency of the controls conducted by the depositary should be based on the nature, scale and complexity of the AIF and on the frequency of the AIF's calculation of the units or shares of the AIF.**

2 .ensure and regularly check the compliance of the procedures regarding the 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.~~

3-3 Oversight Duties related to the valuation of shares / units - BNP PARIBAS analysis and proposed amendments to Box 84

With respect to Box 84, BNP PARIBAS considers that ESMA's advice and explanatory text impose more duties on the depositary than laid down in the Level 1 text. The Level 1 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...". This does not require the depositary to directly oversee the valuation of assets. Accordingly, BNP PARIBAS believes that item 1 of Box 84 should be deleted.

For the avoidance of confusion, BNP PARIBAS also proposes to amend:

1. 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."
2. 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**". **Furthermore it should be clarified that the frequency of the controls conducted by the depositary should be based on the nature, scale and complexity of the AIF and on the frequency of the AIF's calculation of the units or shares of the AIF:**

Therefore BNP PARIBAS suggests the following amendments

Box 84**Clarifications of the depositary's oversight duties
Duties related to the valuation of shares / units (b)**

1. ~~The depositary should verify on an 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.~~
2. 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 effectively implemented and periodically reviewed.
3. The depositary's procedures should be proportionate to of the AIF and conducted at a frequency consistent with **the nature, scale and complexity and** the frequency of the AIF's valuation policy-**"policy for the calculation of the value of the units or shares of the AIF"**, as defined in Article 19 and its implementing measures.
4. 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.

3-4 Oversight Duties related to the valuation of shares / units - BNP PARIBAS analysis and proposed amendments to Box 85 - Answer to Q 44

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.

Regarding box 85 it is the understanding of BNP PARIBAS that investment restrictions are defined by the Level 1 text which refers to the incorporation document (not offering documents that may change without the depositary being informed). Furthermore in that regards, the reference to laws and regulations goes a little bit further than the Directive which refers to "national law", the difference may be tiny, but legally speaking it may not be the same..

The explanatory note 62: 'The depositary should also monitor the AIF's transactions and investigate any 'unusual' transaction it has identified in conjunction with its cash monitoring duties.' should not imply a review of all cash transactions by the depositary. This would mean that the depositary duplicates the process of reconciliation already performed by the fund accountant and this would lead to a significant additional cost.

Therefore BNP PARIBAS suggests the following amendments:

Box 85

**Clarifications of the depositary's oversight duties
Duties related to the carrying out of the AIFM's instructions (c)**

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 **regarding investment restrictions and leverage limits** with applicable national 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.

3-5 Oversight Duties related to the timely settlement of transactions - BNP PARIBAS answer to Q 45

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

Option 1 is preferable. Although in regards to assets held in custody option 2 is current practice, where the assets are not in custody (derivatives, real estate, private equity...), and due to the non-standard nature of those transactions, BNP PARIBAS believes that the responsibility of assessing the usual time limits should not be transferred over to the depositary and should remain with the contracting parties of the transaction. The documents supporting the individual transaction signed by the parties should clearly indicate a settlement date to be used as a reference for defining if the assets have been remitted within the usual time limits.

There would be additional processes required, with significant additional cost, to receive relevant settlement details from the third party, and to review them.

3-6 Oversight Duties related to the AIF's income distribution - BNP PARIBAS analysis and proposed amendments to Box 87

Regarding box 87 BNP PARIBAS 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, once a decision has been made by the AIFM to distribute.

Distributions take many forms and are usually declared after the AIFM has decided on their working capital requirements and other strategic issues. Reasons for distributions may include, for example, income, capital gains, and a return of capital or repayment of a shareholder loan.

Under Box 87 (1) calculation of the net income or dividends or carried interests 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.

Paragraph 3: It is our opinion that the requirement set out in this sub-section, are part of the external auditor duties and obligations. Indeed, it appears that many of the oversight functions as further described herein overlap considerably with the functions already performed by auditors to the funds. Some clarification as to the degree to which oversight may be delegated to auditors would be beneficial.

Therefore BNP PARIBAS suggests the following amendments

Box 87

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

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

1. Ensure the net income and dividend payments 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. ~~Check the completeness and accuracy of dividend payments and where relevant of the carried interest~~

4 Due Diligence Requirements – BNP PARIBAS analysis of Box 88 and proposed amendments to Box 88

BN PARIBAS regrets that ESMA does not support the development of a comprehensive template of evaluation.

Indeed, parameters, topics to be checked on sub custodians and guidelines that appear to be pretty standard practice could be useful. Although this would be further adapted by all depositaries, this would encourage best professional practices and limit room for interpretations when assessing the relevance, or the absence of due diligence task

We support the distinction made in ESMA's advice between delegations of custody of financial instruments in respect of which the custody obligation applies (i.e. on the delegates selected by the depositary only) and safe-keeping of other assets.

Hereafter our comments in relation to Box 88:

- Paragraph 1(a) (I): it may be not possible to assess the potential implication of the insolvency of a sub-custodian. This requirement should be beyond the ability of the depositary and should be deleted Local legislation and local court decisions prevail in all disputes, no third party such as the depositary can be requested to ensure that the effect of the segregation or any other measures is such that the assets held by a sub custodian for the benefits of its customers are fully protected from an insolvency of the sub custodian
- Paragraph 1 (b) (ii): Cross-reference to Box 16 should not apply in this context. Indeed, financial instruments are not registered in the account of the AIFs at the sub custodian's level. Such a requirement would cause a major additional costs and operational burden and will not bring any further protection (please refer to Box 89 on segregation and section "Delegation").the sub-custodian should operate a segregation between its assets and the assets of its clients 2) the assets held by the depositary for its own account and the assets held for the depositary's clients.
- Paragraph 1 (b) (iii): the depositary's obligation under paragraph (b) (iii) should essentially be to revisit the assessments carried out under (a) (i) and (a) (iii). Conversely, the requirement to notify any change of the custody risk to the AIF/AIFM appears to be not advisable and possibly unlawful. Any change identified by the depositary should be assessed and may lead to decisions made by the depositary with respect to its relation with the sub-custodian. The AIF/AIFM may be informed of these decisions but this information should in no case be mandatory since the dissemination of information or decision to third parties with regards to custody risk of a given market/given entity may qualify as a breach of a confidentiality obligation and market abuse regulation and may stark systemic consequences.

Paragraph 3: The termination of sub-custody agreement should not be mandatory. Indeed this may not in every case, when practicable, be in the AIF/AIFM's best interests. As an alternative, we would suggest that the depositary be required to "take such measures, including terminating the contract, as are in the best interest of the AIF and its investors provided that:

- the sub-custodian no longer complies with the requirements and
- this situation cannot be cured in a reasonable period of time".

Therefore BNP PARIBAS suggests the following amendments

Box 88

Due Diligence Requirements

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, 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- between 1) its assets and the assets of its clients 2) the assets held by the depositary for its own account and the assets of the depositary's clients.

(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.~~ take such measures, including terminating the contract, as are in the best interest of the AIF and its investors provided that: the sub custodian no longer complies with the requirements and this situation cannot be cured in a reasonable period of time".

5- Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions-BNP PARIBAS analysis and proposed amendments to Box 89 - Answer to Q 46

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.

In our network, to the best of our knowledge, we are not aware of any country where effects of segregation are not recognized. Thus, we didn't put in place any alternative or additional measures to segregation

BNP PARIBAS SECURITIES SERVICES finds that the segregation criteria proposed in Box 89 seems to be adequate and reasonable. It would however make the following comments:

- 1- It is favourably noted that there is no requirement to segregate assets on a fund by fund basis, and that the proposed wording allows the use of omnibus accounts for depositary clients' assets by sub-custodians as per current prevailing market practice in most jurisdictions. With respect to paragraph a) we suggest amending the proposed wording in order to clarify the conditions for segregation: in this respect "to distinguish assets between 1) its own assets and the assets of its clients and between 2) the assets held by their clients for their own account and for their own clients".
- 2- Similarly, and corresponding to overall market practice, segregation of cash is limited to segregation from cash of third parties or the sub-delegate of the depositary. With respect to cash, it is important to note that further segregation requirements at sub-delegate level would not add protection to cash holdings in case of an insolvency of the sub-delegate, and would thus offer no further investor protection (neither in the EU neither outside of the EU). With respect to paragraph 1 e) we are of the opinion that e) should be deleted.. Such a requirement would cause a major change in the operational additional costs and operational burden, whilst the cash assets represent the slightest portion of the assets of the AIF.
- 3- Item 1.e and Paragraph 2 should be deleted.. Protection of the financial instruments from the event of insolvency of the sub custodian is subject to the local law recognising the full effects of the segregation.). Indeed, Segregation procedures should be viewed as a presumption of protection of the assets held in custody and deemed to be sufficient in this context. In addition, it should be recognized that not all national legislations provide for segregation obligations and any segregation at the 3rd party level (as provided for in Level 1) may not have any legal effects with regard of the protection of assets.
- 4- With respect to explanatory text paragraph 5, we are of the opinion that segregation obligations CANNOT apply to assets in recordkeeping. By definition assets held in recordkeeping are either assets held with a third party custodian that is not a sub-contractor of the depositary, or assets held directly with the issuer or its agent, none of which having been selected by the depositary. Consequently, no due diligence duty should bear on the depositary as per the internal organisation and quality of such third party. BNP PARIBAS strongly rejects the concept of any duty to monitor the eligibility, whatever the circumstances, of such party. It is our view that this issue is a perfect illustration of what could be a "non custodial" component of the custody risk. Nevertheless, we recognise that the depositary has an obligation to ensure that the AIF/AIFM has put in place the necessary due diligences procedures with respect to such third party as regards their own sub custodians, where applicable (e.g. prime brokers, selected by the AIFM, with arrangements of delegation), In addition, it should be recognised that in some circumstances, these third parties (e.g. prime brokers) may not be in the position to comply with the segregation obligations. Should these circumstances exist the AIF/AIFM should have an obligation to report and disclose this situation in the documentation available to the investors.

Therefore BNP PARIBAS suggests the following amendments

Box 89

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

1. Where ~~safekeeping~~ **custody** 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 safe kept for the depositary on behalf of its clients from **(1) its own assets and the assets of its clients (2) the assets held by the depositary for its own account and the assets held for the depositary's clients 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 safe kept 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 safe kept;
- ~~(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).

6- The depositary's liability regime -BNP PARIBAS analysis and proposed amendments to Box 91 – Answers from Q 47 to Q54,

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

depository's liability regime with regard to prudential regulation, in particular capital charges?

BNP PARIBAS would like to make the following comments regarding:

- the definition of external events ,
- the due diligences to be performed by the depository

“External event”

ESMA has identified three types of events:

- Acts of State or Acts of God,
- Events related to the insolvency of a sub-custodian,
- Other events including operational failures, fraud at the level of Central Security Depository, Settlement System, Market (issuers, sellers,)

BNP PARIBAS agrees with ESMA that the first and the third types of event should be considered as “external” event and welcomes the fact that ESMA considers that the depository does not have to return the assets in case a depository has gone bankrupt and the national insolvency laws do not recognize the effects of the segregation of the assets. However, BNP PARIBAS strongly disagrees that the other event resulting in a loss of the AIF's assets that are related to the insolvency of a sub-custodian should be considered as an «internal” event:

- despite appropriate due diligences performed by the depository insolvency cannot be predicted sufficiently in advance in order for the depository to take appropriate action; and
- insolvency laws overrule any contractual arrangements that would link a depository and its sub-custodian.

“External” should be interpreted in a strict way, as everything that is not related to the depository or any of its affiliates.

Following this rationale, the insolvency of a sub-custodian is an external event by nature which may prevent a depository getting back the assets entrusted to a sub-custodian despite rigorous due diligence performed by the depository in order to check the segregation of the AIF's assets.

Furthermore:

- Experience has shown that client's assets may have been used before insolvency in a desperate attempt to avoid bankruptcy and inaccurate securities statements (fakes) may have been provided to the depository.
- The bankruptcy of the sub-custodian, that overrules the agreement between the sub-custodian and the depository, prevents the sub-custodian from returning the assets to the depository as it would have not been the case, if the sub-custodian had not been insolvent. Indeed, according to the provisions laid down in the

agreement entered into between the depositary and the sub-custodian the sub-custodian has to return the assets.

- A loss of assets is not the result of the sole fraud of the sub-custodian but is the result of both the fraud (or negligence) and of the insolvency of the sub-custodian therefore, in this case, the loss of asset should be considered as an **'external event beyond the depositary's reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary'**

Nevertheless BNP PARIBAS agrees that the depositary should have the obligation to ensure proper representation of its clients' interests in the insolvency procedure. Should insolvency of sub-custodians not qualify as "external event" the level of liability that depositaries would have to assume would be beyond their financial capacity.

Indeed the amounts of assets involved are significant. Although the total amount of assets entrusted by a depositary to external sub-custodians may represent a small percentage of the total assets of the funds entrusted to it as a depositary, it may represent an amount of assets in excess of several billion Euro .

In a worst case scenario and given the amount of assets to return, even if split between several sub-custodians, any increase in the regular capital requirements, of which the amount depends on the frequency of occurrence of such event (very hard to determine) , would not be sufficient to avoid a major financial impact on a depositary and would consequently increase systemic risk.

Assuming in all cases that an event should be deemed 'internal' if it did occur as the result of an act or an omission of the sub-custodians of the depositary:

- **It would not be neither in the interest of the fund industry nor in the depositary's other clients interest ,**
- **It would lead to a concentration of the activity and of the systemic risk within a small number of global custodians that are direct members of CSD/ICSD.**

BNP PARIBAS is of the opinion that, as long as it has fulfilled its duties, a depositary should never have to assume, directly or indirectly, the financial consequences of an investment decision taken by an AIFM. Qualifying events related to a sub-custodian as internal would go against such a principle.

As an example, we could think of a situation where a sub-custodian becomes insolvent following a fraud. In such a situation the depositary would have to face financial consequences since it would have to return the financial instruments which have been lost, but may not have any recourse to the sub-custodian since the latter is insolvent.

Finally, BNP PARIBAS is concerned that AIFMs may choose to invest in countries with less secure internal infrastructure, safe in the knowledge that the depositary will be liable for any losses. BNP PARIBAS does not believe that the burden of such risks should be placed on depositaries.

Definition of the due diligence to be performed by the depositary

The proposed advice should not bring about circumstances whereby the depositary would have to carry out acts or take decisions that fall into the AIF/AIFM scope of duties/liability. In addition, the advice should recognise that sub-custodians are regulated entities in their jurisdictions. In this respect a third party such as the depositary cannot be requested to supplement supervisory duties, and made liable as a result.

Furthermore BNP PARIBAS believes that imposing a requirement of "rigorous and comprehensive due diligence" does not reflect the Level 1 text and could be read as requesting the depositary to go far beyond "reasonable efforts". The words "comprehensive" and "potential", in particular, could be understood as imposing to the depositary to do all-encompassing due diligence, covering as wide a range of theoretical possibilities as may be conceived, regardless of how reasonable it might be to do so. BNP PARIBAS does not support the rationale (following the third condition) whereby the depositary could be regarded as having made reasonable efforts to avoid a loss. Indeed, the requirements set out in a), b) and c) go far beyond the role and mission of the depositary.

Therefore BNP PARIBAS suggests the following amendments:

Proposed Alternative to 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'
Should be presumed as external any event that is not related to the depositary or any of its affiliates. A non-exhaustive list of these events should include : • Acts of god or Acts of states • Events related to the insolvency of a sub-custodian, • Other events including operational failures, fraud at the level of Central Security depositary, Settlement System, Market (issuers, sellers,...):
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 all the following conditions are met:
<u>1-The depositary has performed rigorous due diligences and the event which led to the loss did not occur as a result of an act or omission of the depositary to meet its obligations</u>
<u>21. The event which led to the loss did not occur as a result of an act or omission of the depositary or one of its sub-custodians to meet its obligations</u>

32. The event which led to the loss was and directly linked to the custodial functions and was beyond its reasonable control (i.e. it could not have prevented its occurrence by reasonable efforts)

43. ~~Despite rigorous and comprehensive due diligences in accordance with the national regulations and contractual arrangements with sub-custodians,~~ it could not have prevented the loss.

Conditions 2, 3, 4 are deemed to be met in case of insolvency of a sub custodian

~~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 external events 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

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

A list of such events should include:

- Act of god/ Act of states ,
- Act or omission of a sub-custodian which is found out after the sub-custodian became insolvent ,
- Other events including operational failures, fraud at the level of Central Security Depositary, Settlement System, Market (issuers, sellers,)

A typology can only be a non-exhaustive list.

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?

BNP PARIBAS SECURITES SERVICES does not see particular difficulties, strongly supports this proposal and considers that matters relating to local legislation are inherently "external". Local law and local courts decisions are, by definition, entirely outside the control or influence of the depositary. Further, changes in local legislation are also inherently unpredictable. BNP PARIBAS SECURITES SERVICES cannot see any justification for any matter pertaining to local law/court decisions being treated as an "internal" event.

The due diligence requirements are set forth as an obligation of means and not as an obligation of results. This applies not only with respect to the assessment of foreign laws and regulations but as well as with respect to the assessment of effective implementation of segregation at sub-custody level.

In addition and independently of the above, BNP PARIBAS SECURITES SERVICES is not certain why "the small percentage of the assets [that] may be lost due to the disruption in the entity's activities in relation to its default" are not "external events". BNP PARIBAS SECURITES SERVICES very much believes the contrary.

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

'External' should be interpreted in a strict way, as everything that is not related to the depositary or any of its affiliates.

Set out below is a non-exhaustive list of examples of other events which should be presumed 'external':

- Any event, the occurrence of which might reasonably be considered to be part of the general risk of investing].

- Liquidation, dissolution or winding up of issuer.

- National or international embargoes.

- Nationalization, strikes, devaluations or fluctuations, seizure, expropriation or other government actions, or other similar action by any governmental authority, de facto or de jure; or enactment, promulgation, imposition or enforcement by any such governmental authority of currency restrictions, exchange controls, levies or other charges affecting the financial instruments.

- Breakdown, failure, malfunction, error or interruption in the transmission of information caused by any machines, utilities or telecommunications systems.

Errors, Failures and event of insolvency of a register maintained by a settlement system as designated by Directive 98/26/EC, or a similar non European securities settlement subsystem which acts directly for the issuer or its agent

Any order or regulation of any banking or securities industry including changes in market rules and market conditions affecting the orderly execution or settlement of financial instruments transactions or affecting the value of financial instruments.

Acts of war, terrorism, insurrection or revolution.

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?

We make reference to our comments in response to Q 48 regarding the sphere of influence and the need to clarify that the relevant due diligence and similar obligations are obligations of means.

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?

It is not possible to assume that sub-custodians, in particular when they are not affiliates of the depositary, will be willing to accept a transfer of liability. Such entities already argue that contractual arrangements are entered into with the depositary and not with the underlying clients of the depositary and under such grounds they are not willing to directly handle claims from AIMF in case of loss of financial instruments.

This approach (where the sub-custodian is a Prime Broker) may be driven by the position it finds itself in, in relation to its own third party sub-custodians. Given that these sub-custodians hold multiple accounts of underlying AIFs (both subject to this Directive and outside the scope thereof) under an omnibus structure, they will not be willing to agree to the transfer of liability from a Prime Broker to themselves via a direct contractual relationship with the AIF or the AIFM acting on behalf of the AIF (particularly where segregation is not recognised in the local jurisdiction). It is also noted that in many jurisdictions, the custody market may be dominated by only one or two sub-custodians, with the result that the Prime Broker (and the same applies in relation to a Depositary dealing directly with such sub-custodian) will have little or no negotiating power to influence the way in which the subcustody services are administered and/or the terms on which they are provided. Hence, the Prime Broker would be in the position of not being able to discharge itself of liability as the Depositary has, where the Depositary has required the Prime Broker to agree to take on such liability. This may have an impact on the availability or cost of Prime Brokerage services to AIF and AIFM falling within the scope of this Directive.

BNP PARIBAS is of the opinion that this transfer is difficult to be implemented in practice because it is not cost effective for the sub custodian concerned by the transfer; the risk-benefit balance is not advantageous for the sub custodian.

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?

BNP PARIBAS considers that the framework set out in the draft advice must be implemented in non-bank depositaries. It is important to ensure a level playing field in the EU and for the third countries between all the depositaries.

While, having regard to the fact that the sort of assets concerned, namely certain types of financial instruments, are the same, regardless of whether the AIF is a private equity or real estate fund, BNP PARIBAS does not see good reasons for justifying amendments.

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?

For the time being there are different models which co-exist in the EU and within EU Member States depending on:

- the type of investment fund (UCITS like funds, Real estate fund, Private equity fund) and the national law applicable to them,
- the type of assets these funds invest in (listed/ non listed, in which way the underlying assets are regulated) ;

The principles laid down at the level 2 text should remain generic enough to be applicable to these different types of funds. The full harmonisation of rules will require further levels of European text and cannot be achieved at the implementation measures level.