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Implementing measures on the Alternative Investment Fund Managers Directive

Dear Madam or Sir,

The Association of Foreign Banks in Germany represents 220 foreign banks, investment firms and investment management companies active in the German market.

We appreciate the opportunity to comment on ESMA's Consultation Paper regarding implementing measures on the Alternative Investment Fund managers Directive (AIFMD). Our comments and statements represent a consolidated view of our members which operate under relevant business models in the German market.

A lot of our members operate their German business as a branch. Therefore, in our day-to-day Association work, we especially cover issues of home and host supervision in connection with organisational requirements and conduct of business rules for branches of foreign financial enterprises. Such home/host supervision issues arise in the area of the investment firm passport under MiFID and of the management company passport under the UCITS Directive. In the light of our experience gathered in this field over time, we think that it is necessary to provide some guidance on level 2, in addition to the wording of AIFMD, with regard to the rules applicable to branches of AIFM and the tasks of supervisors in this respect (Artt. 9, 10, 40a (2) AIFMD in the final version).

Our members also have a substantial market share as regards the global custodian business in Germany, because they act as depositary banks under the German Investment Act. We therefore like to share with you our views on the interpretation of Art. 21 and the way the respective implementing measures should be designed.

Our answers to the consultation paper are attached to this letter. In case of further queries, we will gladly answer any questions you may have.

Yours sincerely,

Dr. Oliver Wagner Wolfgang Vahldiek

Verband der Auslandsbanken
in Deutschland e.V.
Association of Foreign Banks in Germany

Position Paper
Implementing Measures for the AIFM Directive

Part I: General provisions, authorisation and operating conditions

Issue 3 – Article 12 General principles

Question 1

CESR is requested to advise the Commission on criteria to be used by the relevant competent authorities to assess whether AIFM comply with their obligations under Article 12(1).

Article 12 (1) of the draft AIFMD (which is Art. 9(1) AIFMD in the final version) poses particular issues when read in conjunction with Art. 40a (2) AIFMD, which confides some aspects of the supervision of branches to their respective host Member State authorities.

The wording of Art. 40a (2) AIFMD seems to be based on an overly simplified understanding of the value chain and/or the allocation of specific tasks to branch and head office in cases where the branch is involved in managing an AIF or distribution/marketing activities with regard to AIF fund units. In practise, the managing and/or marketing tasks will have to be split between branch and head office.

E. g., when a branch would be managing an AIF, it seems most likely and prudent that it would at least partly rely on management know-how, resources and procedures available at the head office.

It would be highly impracticable if the host state authorities were responsible to supervise, in such circumstances, according to Art. 12 (1) (c) of the draft AIFMD (= Art. 9 (1) (c) AIFMD in the final version), the resources and procedures at the head office which are used by the branch. Instead, the authorities of the state where the respective functions are performed and resources are held by the AIFM should be responsible for supervision.

For this reason, a clarification at level 2 should be introduced to make sure that the host Member State law's application is focussed and limited to the supervision of those activities that the branch carries out itself, and is not extended to cover also the activities of the head office which remains to be supervised according to home Member State law. Such clarification could be drafted in line with the first sub-paragraph of Art. 32 (7) MiFID:

"The competent authority of the Member State in which the branch is located shall assume responsibility for ensuring that the services provided by the branch within its territory comply with the obligations laid down in Articles 9 and 10 and in measures adopted pursuant thereto."

Issue 4 – Article 14 Conflicts of interest

Question 2

CESR is requested to advise the Commission on the reasonable steps an AIFM should be expected to take in terms of structures and organisational and administrative procedures in order to identify, prevent, manage, montitor and disclose conflicts of interest.

Article 14 (1) of the draft AIFMD (which is Art. 10(1) AIFMD in the final version) poses the same issues when read in conjunction with Art. 40a (2) AIFMD as Art. 12 (1) of the draft AIFMD, as regards the supervision of branches by their respective host Member State authorities:

The wording of Art. 40a (2) AIFMD does not reflect the fact that due to the organisational split of activities between head offices and branches the latter are not in danger of and subject to the same conflicts of interest as the AIFM as a whole. The circumstances of a branch will always be a result of the limited scope of services it performs. Therefore, its conflicts of interest are also limited in scope.

Consequently, host state authorities should focus on the supervision of the conflicts of interest management necessary with regard to those tasks and services the branch actually performs itself. Art. 14 (1) of the draft AIFMD should not be understood in a way that requires host Member State authorities of branches to supervise the conflicts of interest management of the whole AIFM (including its head office and, if applicable, other branches).

In this regard, we propose the same clarification at level 2 in line with Art. 32 (7) MiFID as set out above, to make sure that the host Member State law's application is focussed and limited to the supervision of those activities that the branch carries out itself, and is not extended to cover also the activities of the head office which remains to be supervised according to home Member State law:

"The competent authority of the Member State in which the branch is located shall assume responsibility for ensuring that the services provided by the branch within its territory comply with the obligations laid down in Articles 9 and 10 and in measures adopted pursuant thereto."

Issue 9 – Article 19 Valuation

As an introduction to all questions related to the valuation function, we are of the opinion that implementing measures should indicate very clearly that the valuation of the assets of the fund and the calculation of the net asset value per share or unit are two different tasks that can be performed by two different entities. The expertise and means required to perform these tasks are of different natures, so they may justify in many cases the intervention of different actors.

Question 1:
The criteria concerning the procedures for the proper valuation of the assets and the calculation of the net asset value per share or unit to be used by competent authorities in assessing whether an AIFM complies with its obligation under Article 19.1 and Article 19.3

It is important to note that there is a huge diversity of assets that can be held within the portfolio of an AIF. According to the nature and level of complexity of the assets, the methodology to value the underlying assets and to calculate the net asset value (NAV) may vary significantly from one fund to another.

Under these conditions, it would be difficult to establish very detailed rules and procedures through implementing measures that would reflect the diverse characteristics of the assets in which an AIF may invest. We rather recommend identifying general principles at EU level that should be applied by any valuer when carrying out the valuation function whatever the type of AIF. As national rules are to prevail for valuation, these principles could be further detailed at national level in compliance with national accounting standards.

We believe that the standards should at least be in accordance with the following rules:

- have a data management adapted to the assets used by the the AIFM,
- use the data management according to the rules defined by the AIFM and in compliance with national accounting rules,
- where required, have the adequate expertise to value complex products,
- be sure that the accounting rules applicable to the NAV calculation are always compliant with the agreement signed with the AIFM (as reflected in the fund prospectus),
- have permanent and reliable resources in order to identify and to enter the corporate actions in the NAV calculation,
- have an internal control process to check the quality of the valuation process.

Whatever the rules and procedures applied by the valuer, it must be clearly specified that the AIFM remains responsible for the proper valuation of the assets and the NAV calculation. To that end, the AIFM has to set out the appropriate controls to check that the external valuer fulfils its obligations.

Question 2:
The types of specific professional guarantees an external valuer should be required to provide so as to allow the AIFM to fulfil its obligation under Article 19.5. CESR is asked to consider the impact of the required guarantees on the availbility of external valuers to the AIFM industry.

Once again only generic principles can be applied to define which types of entities can act as a valuer. The key objective of the corresponding professional guarantees should be to ensure that the valuer has the appropriate expertise to carry out the valuation function according to the types of assets invested in by the fund and that appropriate procedures are in place to ensure transparency, traceability and continuity of the methods applied by the valuer.

To that end, the valuer should have procedures/processes that ensure that:
- it relies on permanent and sustainable material and technical means and resources adapted to the assets invested in by the AIF,
- it relies on qualified staff benefiting from the adequate level of expertise,
- it has internal control procedures in line with the types of assets invested in the AIF,
- it has appropriate reporting systems to communicate the proper information to the AIFM.

In addition, the quality and the adequacy of the valuer can be reinforced with the application of the following conditions:
- it is member of a professional body / association which recognises the application of common standards as referred to above,
- it is audited at least once year by a regulated external auditor which certifies the application of national rules,
- it publishes a certificate testifying the quality of the procedures applied (e.g. SAS 70 report).

Where specific assets require the intervention of valuation experts for the proper valuation of the assets of the fund (e.g. for real estate, private equity, illiquid instruments, OTC derivatives, …), the AIFM should be authorised to appoint such experts that would establish the princing for the corresponding aspects. This pricing should be communicated to the valuer by the AIFM after validation and under its sole responsiblity.
In adition valuation experts should comply with the same obligations as those imposed to the valuer.

Question 3:
The frequency of valuation carried out by open-ended funds that can be considered appropriate to the assets held by the fund and its issuance and redemption frequency. In particular, CESR is invited to consider how the appropriate frequency of valuation should be assessed for funds investing in different types of assets and with different and redemption frequencies, taking into account different (and varying) degrees of market liquidity. CESR is invited to take account of the fact that such valuations shall in any case be performed once a year.

We consider that key parameters to be taken into account to assess the appropriate frequency of valuation are:

- the frequency of valuation of the underlying assets of the fund, i.e. the availability of pricing for the majority of the assets,
- the frequency of subscriptions and redemptions for the fund (it must ensured that a net asset value is available as soon as fund units or shares can be subscribed or redeemed),
- the number and types of investors in the AIF:
    - If the AIF is an institutional fund where the units or shares are held by only one institutional investor or a group of investors having a contractual relationship or belonging to the same group, the frequency should be defined by the AIFM in the contract of this fund. The fund doesn't need to be liquid (subscriptions and redemptions can be done with an ad-hoc NAV calculation).
    - Retail funds should be valuated at a higher frequency because the fund needs to be liquid.

Part II – Depositary (Article 21)

Issue 11 – Contract evidencing appointment of the depositary

We consider it not necessary to provide a draft model agreement by the legislator since the potential depositaries essentially differ in their set-up.

Since the depositary functions do not essentially differ, the basic content of the agreement should be similar for all types of funds under the AIFM and UCITS Directives, in particular with regard to:

1. exchange of information between the depositary and the AIF (or the AIFM acting on behalf of the AIF) regarding the performance of the respective duties, in particular
    - how the depositary performs the safe-keeping function for each type of AIF entrusted to the depositary;
    - whether the AIFM envisages a modification of the fund rules or prospectus of the AIF, esp. where prior agreement of the depositary is needed to proceed with the modification;
    - how and when the depositary shall forward information that the management company needs to perform its duties, including the exercise of any rights attached to financial instruments;
    - how depositary will have access to all relevant information/accounts it needs to perform its duties;
    - how the depositary can inquire on the conduct of the AIFM and assess the quality of information transmitted, including by way of on-site visits;
    - the types of information that need to be exchanged between the AIF, the AIFM and the depositary regarding subscription, redemption, issue, cancellation and repurchase of units of the AIF.
2. confidentiality and money-laundering;
3. appointment of third parties, in particular
    - criteria for selecting the third party and the steps taken to monitor its activities;
    - a statement on depositary's liability, as referred to in Article 21
    - potential amendments and termination of the agreement:
    - the period of validity of the agreement;
    - the conditions for amendments or termination,
    - the conditions which are necessary to facilitate transition to another depositary and, in case of such transition the procedure by which the depositary shall send all relevant information to the other depositary.
4. the applicable law (preferably of the AIF’s home Member State).

Issue 12 – General criteria for assessing equivalence of the effective prudential regulation and supervision of third countries

Question 1: Prudential regulation applicable to a depositary established in a third country

The criteria proposed in the CP are essential to ensure investor protection. In addition, the following points should be considered:

- A depositary shall first be authorised by the competent authority to perform this function;
- supervision on an ongoing basis should be performed by the competent authority of the third country where the fund is domiciled and also by an external auditor on an annual basis;
- equivalence should primarily be measured by the definition of functions performed by the depositary and by the level of liability in case of loss, as defined in Article 21 of the AIFM Directive.

Issue 13.1 – Depositary functions pursuant to paragraph 6

It seems appropriate to distinguish between cash flows resulting from the functioning of the fund (i.e. associated with the fund's transactions and fund's incomes) and cash deposits resulting from investment decisions made by the AIF (or the AIFM acting on behalf of the AIF) relevant to the fund's assets. Such cash deposits should be considered as "other assets" as defined under Issue 13.2 below.

Question 1:

1. Monitoring of cash flows

Regarding the depositary's duty to monitor cash flows, a distinction should be made between cash accounts held by the depositary and cash accounts with third parties.

In the first case, the depositary ensures the cash account keeping function as required by national law. Segregated cash accounts are used in the books of the depositary to separate the monies held by each AIF from the monies held by the depositary on its own account.

In the second case, the opening of a cash account with a third party should depend on the depositary's prior approval without the obligation to perform a due diligence of that third party, since the depositary's function is limited to ex post supervision. The third party should be contractually obliged to inform the depositary about the cash accounts movements and balances. Such contract should specify that the AIF has a credit right on the cash held with the third party and that the depositary is not liable for cash held by such third party.

In addition, where the depositary receives instructions from the AIF or the AIFM on behalf of the AIF to transfer cash amounts to external cash accounts, the depositary performs a number of verifications to handle instructions sent by the AIF or the AIFM on behalf of the AIF:

- After receipt of the instructions sent by the AIF or the AIFM on behalf of the AIF, the depositary checks that the latter are effectively sent by the AIF or by the AIFM on behalf of the AIF.
- Where instructions have been executed, the depositary verifies whether the AIF or the AIFM on behalf of the AIF has performed the appropriate reconciliations to make sure that cash flows have been recorded on the right cash account. However, the depositary shall not be obliged to perform the reconciliations.

2. Payments made upon the subscription of units or shares

The depositary shall ensure that the AIFM has set up a procedure for reconciliation between the number of shares issued (or redeemed) and the amount credited (debited) on the cash account of the fund.

The corresponding verifications can only be performed ex post for the total amount of subscriptions recorded on a certain date rather than for each subscription, since the amount of subscriptions received in one date may be quite high. Such verifications should be processed on a periodical basis, since the objective of controls is to validate that the booking of subscriptions on the AIF's cash accounts is correctly executed by the transfer agent of the AIF.

3. Cash accounts opened in the name of the depositary

The obligation imposed by the Directive is not feasible since cash is a fungible asset. If cash is held on an account opened in the name of the depositary, it will not be possible in case of the depositary's failure to make a distinction between cash belonging to the depositary and cash belonging to the fund because cash held in an account opened in the name of the depositary will be considered as belonging to the depositary.

The segregation between cash held by the fund and cash held by the depositary on its own account is actually ensured by the internal follow-up-system as applied by the depositary in its own accounting structure.

4. Type of funds

It is not appropriate to apply distinctions according to the legal nature of the AIF (esp. closed-ended or open-ended) because the depositary's duties are similar in all cases except that in the case of a closed-ended fund, subscriptions and redemptions can only take place during specific periods clearly specified in the AIF's fund rules.

Question 2:

At least the following conditions should be applied:

- the entity is subject to local prudential regulation and supervision that is enforced by the competent authority of the country where it is established,
- the entity complies with international rules which are also transposed at the European level (e.g. Basel III for rules relating to capital requirements),
- the entity is able to produce a reporting indicating for the cash accounts opened in its books the balance and the movements of these accounts on a regular basis and at any request by the depositary. In addition, as indicated above, there should be an agreement in place between the entity and the AIF or the AIFM acting on behalf of the AIF specifying that the owner of the account has a credit right on this entity for the cash accounts opened in its books.

Question 3: Cash accounts may be required in non-EU markets in the following cases

- For non-EU AIFs which are marketed in the EU, a cash account may be required by law in the country where the fund is domiciled;
- For EU AIFs, which are marketed in non-EU markets, a cash account may have to be opened in those countries, e.g. in order to receive payments made upon the subscription of units or shares or to pay the redemption of units or shares;
- When an AIF is investing in non-EU assets, the processing of corporate actions may require the opening of a cash account in a non-EU country, e.g. to collect dividends;
- When the AIF enters into a financing transaction with a financial intermediary, a cash account may be opened with this financial intermediary, who may be domiciled outside the EU.

Given the large variety of situations where cash accounts may be required, it would be helpful for market participants if the regulators issue a list of relevant markets which comply with the criteria of equivalence.

Issue 13.2 – Depositary functions pursuant to paragraph 7

Question 1:

1. Types of financial instruments to be included in the scope of the custody duties

It is necessary to restrict the scope to financial instruments which

- can be registered in financial accounts, AND
- whose existence and location can be verified along the holding chain in order to retrieve them at any time through effective operational processes and controls.

These conditions are the minimum requirements to enable the depositary to retrieve the assets in case of loss, as required under the Directive.

Only those financial instruments can be held in custody for which the issuer has registered the relevant securities with a Central Securities Depositary (CSD). It thus seems vital to establish regulation that ensures that

- the collapse of a CSD or of the CSD's participants will not result in a loss of the assets entrusted to them by a third party;
- the assets entrusted with the CSD are segregated from their own assets and from the assets of other CSD's participants;
- the assets are not re-hypothecated by CSD or of CSD's members unless with the prior consent of the assets' owner and according to the terms of the agreed contract.

The custody function for a depository can be described as follows:

As already mentioned in the Level 1 text, financial instruments shall be registered in financial instruments accounts opened in the books of the depositary in the name of the AIF. This implies that the depositary should able to perform the following tasks:

- maintain the financial instruments accounts in its books by applying accounting principles which exclude any inflation of financial instruments and a strict reconciliation with the upper level through the chain of intermediaries;
- carry out instructions of the AIF or of the AIFM acting on behalf of the AIF,
- process corporate actions;
- report on financial instruments movements;
- apply the appropriate controls (including continuously reconciling the fund assets with the assets held by the depositary in the books of the sub-custodians).

The following conditions are crucial to ensure that the depositary has the capacity to validate the existence or retrieve the assets of the AIF and effectively ensure the rights granted to the investors:

- sub-custodians acting as intermediaries in the holding chain, who are domiciled abroad, are selected by the depositary (rather than by the AIF or the AIFM on behalf of the AIFM) by performing a due diligence as required under the Directive and periodic reviews on these third parties to ensure that they continuously comply with the criteria of selection;
- at any stage of the holding chain, the fund's assets are segregated from the depositary's own assets;

- financial instruments held by the AIF remain in the books of the depositary (no transfer of ownership to a third party) and are not transferred to a counterparty for a potential re-use.

Accordingly, the following types of financial instruments shall be excluded from the scope of custody:

- Physical securities not held by the depositary. Physical securities can be held in custody only if the depositary is holding them directly in its safe as otherwise it will not be able to ensure the appropriate controls and potential restitution.
- Derivatives: Because these instruments are financial contracts and not securities, the depositary cannot restitute the contracts and can't substitute the party in default. Those financial instruments represent obligatory claims rather than *in rem* securities and are generally kept by the AIF or the AIFM.
- Units and shares of funds issued in the nominative form or held with a registrar. Registrars are not selected by the depositary but by the issuer of the fund who determines whether the shares or units will be circulated through a CSD or through a registrar. Moreover, in most cases, registrars are no regulated entities which do not comply with all the requirements stipulated in paragraph 10 of Article 21.
- For the same reasons, all financial instruments issued in a nominative form or registered with an issuer or a registrar should also be excluded.
- All financial instruments associated with the use of collateral, where the collateral is not held in the books of the depositary (see issue 13.2, question 4). Where collateral implies a transfer of ownership of the securities, financial instruments are no longer part of the fund portfolio and thus cannot be held in custody by the depositary. Where collateral only implies a security interest, the financial instruments remain in the fund portfolio. However, if the collateral is transferred in the books of a third party (i.e. in most cases, the beneficiary of the security interest) the depositary has not selected this counterparty and has no means to verify where these assets are and how they are re-used by the counterparty. The holding chain cannot provide that the depositary can retrieve the securities at any time.

Hence, financial instruments which can be held in custody are primarily those which are registered with a CSD, either directly or through a chain of intermediaries, as this is the only case where the above mentioned criteria are met, notably:

- the CSD and the various intermediaries are all regulated entities which have to comply with a specific number of conditions which are imposed by their local regulator and the collapse of the CSD or its members will not result in a loss of the assets entrusted to them by a third party;
- the depositary is usually able to choose the intermediaries who shall hold the financial instruments according to stringent criteria ensuring sufficient expertise and capital;
- the depositary carries out periodic reviews on the sub-custodian network to verify that they keep to apply these criteria on an ongoing basis.

2. Physical instruments

Financial instruments that can be physically delivered to the depositary are those that may be transferred by their owner in a physical (hardcopy) form only. These instruments which are not de-materialized are safe kept in a vault only and all relating acquisitions and disposals cannot be registered by debits and credits in financial instrument accounts as such. The depositary will maintain a record on ownership and potential acquisitions and disposals. However, if such physical instruments are held directly by the depositary in its vaults, the depositary can provide a service similar to custody and ensure the same level of responsibility.

3. Conditions applicable to the depositary when exercising its custody duties

The main conditions applicable are the ones that enable the depositary throughout the holding chain to verify the existence and the location of the financial instruments and to get them back at any time through effective operational processes and controls.

One of these criteria consists of the rules applied for the *segregation of financial instruments* held by the fund along the chain. The objective of segregation rules is to identify at all times the belongings of each investor, including in case of events that may cause the loss of financial instruments. Appropriate segregation of assets can be ensured by the following conditions:

- One securities account and one cash account are opened for each AIF in the name of the AIF in the books of the depositary to register the AIF's assets and separate them from assets held by the depositary for its own account or for other investors.
- Where a depositary uses a sub-custodian, the segregation of the assets is ensured when the depositary's own assets are segregated from the ones of its clients. In the books of the sub-custodian, the depositary will open one account where the assets held by the depositary for its own account are recorded and one or several other accounts where the assets of the depositary's clients are registered. One account per AIF in the books of the sub-custodian would not be necessary.
- This principle is to be applied throughout the chain of intermediaries and for the accounts opened in the CSD's books where the assets are ultimately registered.

Question 2: Scope of Other assets

Other assets include:

1) financial instruments which are not held in custody

2) assets which are no financial instruments

1. Financial instruments which are not held in custody

As outlined above, financial instruments which cannot be held is custody are:

- physical securities not held by the depositary directly,
- derivatives,
- fund units or shares held by a registrar and more globally all financial instruments held with the issuer or a registrar,
- financial instruments subject to a security collateral arrangement not held by the depositary (see Issue 13.2, question 4).

Such assets cannot be held in custody as the depositary is not able to ensure effective control over them.

Financial instruments issued in a nominative form or registered with an issuer or a registrar cannot be held in custody because

- the decision to issue a financial instrument in the nominative form is made by the issuer of the fund, not by the depositary;
- the registrar is selected by the issuer of the fund. So the depositary cannot perform a due diligence according to its own criteria as for the selection of a sub-custodian;
- the registrar is not always a regulated entity which has to be compliant with all criteria listed in the Directive under paragraph 10 of Article 21.

Under these conditions, the level of control of the depositary over the assets of the fund is not sufficient to ensure restitution in case of failure of the registrar.

2. Assets which are no financial instruments

The main categories of those assets are:

- receivables (e.g. from assets that were not securitised);
- commodities;
- real estate;
- fine art;
- other material goods.

Such assets, which are not dematerialised, cannot be transferred as such between intermediaries through debits and credits of accounts. They are not subject to a global framework with specific rules as it exists for financial instruments and are exchanged according to bilateral agreements. Furthermore, in order to receive the proceeds from such assets (e.g. rent, interests from receivables), the legal documentation is usually kept by the AIF or the AIFM, acting on behalf of the AIF or by a third party entrusted by the AIF or the AIFM acting on behalf of the AIF.

Question 3: Conditions upon which the depositary shall verify the ownership

The options to control ownership depend on the specific type of asset. In particular, a distinction needs to be made between derivatives and other types of assets.

For derivatives, the depositary cannot control ownership but the existence of a contract between the AIF, or the AIFM acting on behalf of the AIF, and a counterparty. For this purpose, the depositary needs copies of the signed trade confirmation for OTC-derivatives and the clearing broker statement showing the respective position for listed derivatives, which identifies the transactions and their specific characteristics, and, if necessary, additional relevant documents, esp. the master agreement.

For other assets that are no derivatives, ownership rights can usually be verified by copies of documents evidencing the purchase of an asset, in compliance with the law and regulation enforced in the purchase deed, when the assets are acquired by the AIF or the AIFM, acting on behalf of the AIF.

In both cases, the depositary will be able to perform its duties only if the AIF, or the AIFM acting on behalf of the AIF, informs the depositary about the acquisition and provides adequate documentation including external evidence.

After the acquisition of the assets, the depositary must also be informed by the AIF, or the AIFM acting on behalf of the AIF, about any amendments relating to the assets held by the fund.

The obligation to provide the depositary with such information has to be included in the agreement between the depositary and the AIF, or the AIFM acting on behalf of the AIF. The information flows need to be described appropriately by specifying their nature (internal documentation and external evidence), their way of transmission and in which circumstances they need to be transmitted to the depositary. Therefore, the AIF or the AIFM acting on behalf of the AIF, should provide the depositary with information about the characteristics and events affecting the assets and, periodically for registered financial instruments, certifications of the issuer.

Furthermore, the depositary shall perform a reconciliation between the AIF's position recorded by the depository and the AIF's accounting inventory to verify the matching of the main characteristics of the asset in terms of value, quantity, date of acquisition, etc.

These verifications are sufficient to determine ownership of the assets. It is thus not necessary that the depositary performs physical controls by onsite visits.

In addition, the depositary can send requests to the AIF and make sure that the record of assets is regularly updated. The respective frequency can be specified in the main agreement between the depositary and the AIF. The AIF should be obliged to respond to these requests. Otherwise, the depositary cannot be held liable for keeping incorrect records.

Question 4:

1. Assets subject to lending or repurchase arrangements

In principle, the Depositary should not be responsible for the loss of any assets given by the AIF to a counterparty as collateral, unless the assets remain with the depositary. Further, it should be clarified that a counterparty (such as a prime broker), who is a collateral taker, may directly hold assets subject to a collateral arrangement, without qualifying as "depositary" or undertaking depositary functions in respect of such assets, as such assets are held as security for the performance of obligations owed by an AIF to such secured counterparty.

There are a number of cases where an AIF provides collateral to a third party. For example, if an AIF wants to leverage its portfolio by debt capital, the entity providing this capital will require collateral. Similarly, where an AIF enters into transactions cleared through a CCP, its General Clearing Member, representing the AIF at the CCP, will also request collateral and regularly reassess this collateral to protect itself against the default of the AIF.

There are different forms of legal arrangements, adopted in relation to collateral, which broadly fall into two categories (a) title transfer arrangements and (b) security arrangements. The liabilities of the parties regarding collateral are specified in the applicable legal arrangements.

2. Title Transfer Arrangements

In the case of a collateral arrangement involving the transfer of title of the AIF's assets to its counterparty, ownership of such assets is transferred from the AIF to the counterparty. As the assets do no longer belong to the AIF, the AIFM Directive clearly states that the depositary should have no safekeeping duties for such assets. The counterparty is able to use such assets as its own, subject to a contractual obligation to re-deliver equivalent assets when the collateral requirement is reduced (or to account for the value thereof in the context of a close-out).

3. Security Arrangements

Where the AIF's assets constituting collateral in favour of the AIF's counterparty are not subject to a title transfer arrangement but rather a security interest, it is unclear under the AIFM Directive whether such assets may be held by the counterparty directly, or whether they shall remain with the Depositary. In addition, under the Collateral Directive, the counterparty can re-use the assets, also in case of a security arrangement. The role and responsibilities of the depositary need to be clarified since it is yet unclear whether holding assets subject to a security interest is a depositary function or not.

In the case of a security arrangement, the assets remain part of the portfolio of the fund. The depositary will therefore be able to continue to perform safekeeping duties regarding those assets. If the assets are held in the books of the depositary, the depositary is able to perform the custody function. However, if they are held outside the depositary's book, the depositary cannot perform custody functions but only the safekeeping function (as for assets not held in custody (see issue 13.2, question 2), as the depositary will not be able to control where the assets are and how they are used by the counterparty, unless the role of the depositary is performed by a prime broker.

Generally speaking, if an AIFM, on behalf of an AIF, enters into security collateral arrangements, it may require active collateral management to allow for example substitution of collateral and hence avoid restrictions on its investment strategy.

If assets subject to a security interest must remain with the depositary in a security collateral arrangement, this would create a new role for the depositary which is not covered in the AIFM Directive, namely the management of collateral on behalf of (i) the AIF and (ii) any counterparty which has entered into a transaction with the AIF (including financing or leverage transactions).

In addition, requiring that the collateral be held only with the depositary will raise additional concerns from counterparties where there is a collateral security arrangement. Counterparties will have to face additional risks (e.g. counterparty risk, liquidity risk) associated with the depositary which may limit their capacity to contract with the AIFM or increase the costs of financing.

On the other hand, the depositary will not be able to fulfil its custody duties if the assets subject to security interest are not held in its books as it will not be able to control where the assets are and how they are used by the counterparty. This cannot be considered as a delegation of the custody function from the depositary to the counterparty as the counterparty or the collateral manager is chosen by the AIFM and not by the depositary.

Therefore, if the assets, subject to a security interest, are held by a third party, the depositary should not be liable based on a restitution obligation.

In any case, in order for the depositary to fulfil its duties with regard to its supervisory function, the depositary will require information flows from the counterparty or the collateral manager holding the assets. The AIFM shall ensure that its counterparty or collateral manager is willing and able to provide the required information to the depositary. Those information flows need to be specified in the contract between the depositary and the AIFM.

Issue 13.3 – Depositary functions pursuant to paragraph 8

It should be acknowledged that, for the time being, there are different models which co-exist in the EU for the application of the depositary's supervisory functions. As indicated in the level 1 text, the depositary will have to perform these functions in accordance with "the applicable national law" and with local professional guidelines when they exist. The implementing measures should hence not impose new measures that would compel some EU Member States to significantly modify their existing national regimes.

The implementing measures should consider the following general principles:

- A risk-based approach that implies proportionality when fulfilling the duties;
- An efficiency approach that implies that:
    - the depositary is not obliged to replicate works and processes done by others. In particular, the depositary should not be required to "recalculate" the Net Asset Values where the applicable national legislation does not require the depositary to process the calculation of the fund's NAV. The depositary should only perform some ex-post controls and to review the NAV calculation procedure. Where, according to national law, the depositary is officially calculating the NAV appointed by the AIF / AIFM as one of its depository functions, the level of ex-post controls should be adapted and proportionate taken this element into account.
- The supervisory functions should always be performed on a *posteriori* basis as they are always carried out by the depositary in addition to the controls already performed by the AIF itself or the AIFM acting on behalf of the AIF, including the verification of compliance of the AIF with its investment rules. The depository has neither sufficient time nor sufficient information (the AIF real time front–office position would be needed) to verify that respective instructions are compliant with the investment policy of the AIF.

Issue 14 – Due diligence

Question 1: Duties the depositary has to carry out in exercising its due diligence

It should be clarified that the due diligence requirements only apply to third parties selected by the depository excluding:

- the counterparties who are selected by the AIF or by the AIFM acting on behalf the AIF for cash or securities holding.
- the CSD or registrar who are selected by the issuer of the financial instruments.

The depositary should establish, implement and maintain internal procedures referring to:

1. the selection and appointment of a sub-custodian,
2. periodic reviews and ongoing monitoring of the sub-custodian.

The description of the due diligence duties to be performed by the depositary as described in the level 1 text of the Directive (Art 21.10.d) is already sufficiently detailed. It covers the main aspects to be reviewed by the depositary when performing the due diligence and is appropriate to ensure a high level of investor protection.

In these conditions, there is no need to introducing additional due diligence requirements in the level 2 text, as the corresponding procedures provide for:

- regular market reviews,
- the verification of:
    - the existence of contractual arrangements for assets in custody with the third party, and in particular, arrangements applicable to the obligation of segregation of assets,
    - all other dispositions provided for in Art. 21.10 (d)
- the appraisal of:
    - the means and organisation of the third party to perform the delegated tasks, including its internal reconciliation procedures,
    - the sufficient good repute and experience of the third party.

Question 2: Template of evaluation, selection, review and monitoring criteria

Any regulatory template should be limited to the main “headlines” given the diversity of countries that may be covered with the sub-custodian network of the depositary and the local specificities that need to be taken into account when assessing the quality of service and the associated risk with this service provider.

Such a template should be permanently kept updated and adapted to the specificities of the relationship with the third party. The template should also comply with the proportionality principle.

Issue 15 – The segregation obligation

The segregation obligation imposed on third parties should ensure that financial instruments deposited with that third party are separately identifiable from the financial instruments belonging to that third party. In our opinion there is no need to segregate assets by individual funds since the principles described above (see Issue 13.2) seem sufficient.

In the event that the local legal framework does not recognise that the segregation prevails in insolvency proceedings, however, the segregation of assets may not be sufficient to protect the assets in custody in case of the sub-custodian's default. Therefore, the contract signed between the depositary and the third party should include this segregation obligation and the sub-custodian should confirm to the depositary that:

- the assets entrusted to the sub-custodian are kept separately from its own assets and the sub-custodian's own assets are held separately from those of the next sub-custodian in the holding chain;
- the assets will not be re-hypothecated by the sub-custodian or subsequent sub-custodians employed by the primary sub-custodian, except in accordance with the agreed terms of a contract between the AIFM and the sub-custodian.

In the event that the laws of the jurisdiction where the sub-custodian is domiciled do not provide for segregation of assets in insolvency proceedings, the depositary cannot claim an effective warranty from the sub-custodian that the segregation will be guaranteed. To give investors the opportunity to benefit from investments in such markets, the obligations of the depositary shall be deemed fulfilled if it has ensured that the sub-custodian has taken all possible measures to protect the funds assets from loss. This seems definitely appropriate with regard to the elevated market potential of emerging markets and the fact that institutional investors are clearly aware of the specific country-risks of the markets where they invest via AIFs.

In order to allow for an ongoing survey, the contract should provide for the appropriate information to the depositary by the third party, in particular on any change of internal procedures or local regulation applicable to segregation and custody arrangements.

Issue 16 – Loss of financial instruments

Question 1: Circumstances under which financial instruments shall be considered "lost"

The loss of a financial instrument should only be assumed where the assets of the AIF are permanently unavailable for the investors. Accordingly, a financial instrument should be considered as permanently lost only where at least one of the following conditions is met:

- the financial instrument does no longer exist;
- the rights in the financial instrument were terminated.

On the contrary, a financial instrument cannot be deemed lost if it is temporarily unavailable as a result of legal and/or administrative proceedings. This is a typical scenario during a sub-custodian's insolvency. Provided that the assets were correctly segregated before, the depositary will entirely retrieve them after the insolvency procedure was completed;

In any case, the loss should be confirmed by a judicial authority who acknowledges that the financial instrument was irretrievably lost. In the event that no official authority is competent or available for that purpose, the loss should alternatively be confirmed by an external legal opinion.

Question 2: Distinction between permanently "lost" and temporarily "unavailable"

As outlined above, there is no loss of a financial instrument where the financial instrument is temporarily "unavailable" as explained above.

We therefore consider that none of the circumstances listed above qualify as a loss of financial instruments per se.

The above events may be considered as a case of loss only if these circumstances lead to the disappearance of the assets. Otherwise the financial instruments are not definitively lost and will continue to be part of the fund's assets.

In addition, those events should rather qualify as external events beyond the reasonable control of the depositary, as their occurrence can by no means be prevented by controls that the depositary may perform on the assets of the fund. This point will be detailed in the answer to the following question.

Issue 17 – External events beyond reasonable control

Question 1: Unavoidable events to be considered as external, beyond control

As explained under Issue 13.2 question 1 above, we maintain that financial instruments in nominative form or held with issuer or registrars as well as financial instruments with security interest held with a third party are outside the scope of the custody function of the depositary because the depositary has not selected those third parties and has no control over them. In the event that a problem occurs that would lead to a loss of financial instruments, such event should in any case qualify as external, beyond the reasonable control of the depositary.

In addition, there are a number of conditions and circumstances where the depositary is not able to effectively control the assets of the fund held in custody. Two main categories of events correspond to these types of situations:

1. investment decisions made by the AIF or the AIFM acting on behalf of the AIF which prevent the depositary from having effective control over the assets. This would include for example:
   (i) investments in financial markets where the holding chain and the local legal environment do not provide for centralised infrastructures, do not require segregation of assets and protection of third party assets in case of insolvency;
   (ii) investments in markets considered as risky due to an unstable political environment;
   (iii) investments in markets where the sub-custodian services do not comply with the criteria defined in Article 21.10 of the Directive or where the sub-custodian was selected by the AIFM without involving the depositary.
2. Events which are not predictable by nature despite all controls performed by the depositary. These situations include:
   (i) Force majeure;
   (ii) crime;
   (iii) political instability affecting financial markets;

We believe that a non-exhaustive list of events which are representative illustrations of the various potential circumstances would be most appropriate. This list should contain – as a minimum – three categories of events where the depositary should be discharged from its own liability:

1. Failure of a sub-custodian resulting from
   - insolvency
   - fraud not detectable under the depositary's duties of supervision
2. Local market conditions
   - Settlement failure in non DVP markets
   - Market closures
   - Widespread defaults (domino effect)
   - Effect of political/ judicial decisions

3. Markets infrastructures deficiencies
   - Failure, outage and fraud
   - Local market rules imposing liens and/or reversals

Issue 18 – Objective reason to contract a discharge

We believe that there is no need for a list of conditions and circumstances constituting an objective reason for the depositary to contract a discharge of responsibility.

In addition, reasons for such discharge are very diverse and include legal (unsatisfactory legal environment), economical or operational aspects as illustrated in market practices.