BNY MELLON

Paul Bodart
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ESMA – European Securities Markets Authority
103, rue de Grenelle
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Brussels, September 13, 2011

Subject: **The Bank of New York comments on ESMA's consultation paper "ESMA's draft technical advice to the European Commission or possible implementing measures of the Alternative Investment Fund Managers Directive – 13 July 2011 – ESMA 2011/209**

VIA ELECTRONIC SUBMISSION

Dear Sir
Dear Madame,

You will find in attachment to this letter the comments of the Bank of New York Mellon to the consultation in reference.

As you will see, our organization is sending comments only to the part of the consultation that refers to the activity of our organisation.

With regard to the response to the question 47 of the consultation where ESMA is asking to provide an evaluation of the possible impact to the proposed Depository Liability Regime, we have not been able to complete a satisfactory evaluation before the deadline set for the response to this consultation. However we continue our work to try to provide such evaluation, conscious that such information will be valuable to ESMA. As soon as our evaluation is complete and to the extend that we arrive to a meaningful result, we intend to send to ESMA a complement to this response.

We remain at your disposal should you need additional information.

Yours sincerely,

Paul Bodart
Executive Vice President
Head of EMEA Operations

ESMA Consultation on AIFM Level2 measures

BNY Mellon responses

Section III - Article 3 Exemptions

Questions 1 – 8
We will not be answering these questions

Section IV - General Operating Conditions

Section IV.I – Possible Implementing Measures on Additional Own Funds and Professional Indemnity

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

Yes, we believe the conditions should apply to an appointed external valuer. We note a 3rd party administrator ("price provider" as referred to in the explanatory text) is not considered an external valuer per Paragraph 10, p. 115 and also at Paragraph 24, p. 119, of the ESMA consultation paper.

The AIFM is ultimately responsible for the valuation of AIF assets and the choice to use an "external" or "internal valuer". As a result, the AIFM should ensure compliance with the valuation and delegation requirements as set out in Article 19 and 20 of the AIFMD. If the AIFM feels that the external valuer has acted negligently the AIFM may have recourse to the external valuer depending of the circumstances. This is consistent with the BNYM approach to Box 84 (i.e clarification of depositary duties relating to the valuation of shares).

Question 10 to Question 15
We will not be answering these questions

Question 16
Paragraphs 4 & 5 of Box 11 set out additional due diligence requirements with which AIFMs must comply when investing on behalf of AIFs in specific types of asset e.g. real estate or partnership interests. In this context paragraph 4(a) requires AIFMs to set out a 'business plan'. Do you agree with the term 'business plan' or should another term be used?

Fund Managers regulated by UCITS are required to submit a business plan. As the basis of ESMA's paper is to find consistency between UCITS and MiFID we think that the AIFM should have to set out a business plan. However we think the term business proposal is more appropriate. The AIFM business proposal will require more leverage than the business plan under UCITS. For instance it may need to be updated from time to time to take into account the complexity and nature of securities.

Under UCITS the business plan is submitted to the regulator. We do not suggest this for the AIFM. Submitting a business proposal to the regulator could cause delays in getting funds authorised. In addition to this the regulator could impose further restrictions on the AIFM with regard to what constitutes a less liquid asset and the AIFM could find itself in the position of having to submit a business plan for its entire portfolio.

Box 19

Fair treatment by an AIFM

Option 1
~~Fair treatment by and AIFM requires that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors~~.
Option 2
Fair treatment by an AIFM includes that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors

Question 17
Do you agree with Option 1 or Option 2 in Box 19. Please provide reasons for your view?

We agree with option 2 because if the requirements are too stringent or prescriptive the guidelines may have the opposite effect to what was intended. If for instance the AIFM finds a loophole in the mandated legislation laid down under option 1, the investor could be left unprotected. A principle of fair treatment that contains an element of objectivity can take account of circumstances on a case by case basis and provide for maximum investor protection.

Section IV.III – Possible Implementing Measures on Conflicts of Interest

ESMA is proposing a 'principles' based approach more in line with UCITS. Two small comments that require further consideration are :

1) It may be difficult for an AIFM to establish a conflict of interest policy that covers the activities of the entities to which it has outsourced e.g. external valuer.

2) It may be harder for small AIFMs to demonstrate independence due to lack of resources.

Section IV.IV - Possible Implementing Measures on Risk Management

Operational Risk Management Function and Section IV-VII Compliance Function. The paper seems to suggest that the first must be carried out by the AIFM but that the second (Box 48, 2(d)) could be delegated. It would be helpful to understand which might be expected of an Administrator in respect of both functions and if the discharge of the compliance role would be similar to the UCITS IV regime. Box 30 on page 73 seems to suggest that those carrying out operating functions can have no role in risk management. As it is unlikely that certain AIFMs will have a fully fledged risk management unit, is it intended that the Administrator would carry out such a role? What would be the extent of the duties?

Question: Where BNY Mellon have a fiduciary role (trustee/depotbank) there will/maybe reporting deliverable to this function from the Risk Management of the AIFM? The document states a reporting deliverable to a supervisory function. Would this be deemed to be the trustee/depositary?

Box 25

Permanent Risk Management Function

1. The AIFM shall establish and maintain a permanent risk management function that shall:

(a) implement effective risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks relevant to each AIF's investment strategy, to which each AIF is or may reasonably be exposed;

(b) ensure that the risk profile of the AIF disclosed to investors in accordance with Article 23(4)c of Directive 2011/61/EU, is consistent with the risk limits that have been set in accordance with Box 29;

(c) monitor compliance with the risk limits set in accordance with Box 29 and notify the AIFM's governing body and where it exists the AIFM's ~~supervisory function~~ **regulator** in a timely manner when it considers the AIF's risk profile

is inconsistent with these limits or where it is aware there is a material risk that it will be inconsistent with these limits;

(d) provide the following regular updates to the governing body of the AIFM and where it exists the AIFM's supervisory function at a frequency which is in accordance with the nature, scale and complexity of the AIF and/or the AIFM's activities:

(i) the consistency between and the compliance with, the risk limits set out in [Box 29, Risk Limits] and the risk profile of that AIF as disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU; and

(ii) the adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have or will be taken in the event of any actual or anticipated deficiencies; and

(e) provide regular updates to the senior management outlining the current level of risk incurred by each managed AIF and any actual or foreseeable breaches to any risk limits set out in Box 29, so as to ensure that prompt and appropriate action can be taken.

2. The AIFM shall ensure that the permanent risk management function shall have the necessary authority and access to all relevant information necessary to fulfil the tasks set out in paragraph 1.

We suggest a minor change to ensure that it is clear that the supervisory body is in fact the regulator and not a trustee or depositary.

Question 18
ESMA has provided advice as to the safeguards that it considers AIFM may apply so as to achieve the objective of an independent risk management function. What additional safeguards should AIFM employ and will there be any specific difficulties applying the safeguards for specific types of AIFM?

AIFMD may seek to clarify the position with regard to the outsourcing of the Risk Management function to fund administrators or other specialist providers of risk analytic services If this outsourcing or delegation is permissible, clarity is required on what responsibilities will be allowed to be transferred and on whether ultimate oversight is retained by the AIFM. This should be viewed in the context of proportionality for smaller sized AIFMs.

Question 19
ESMA would like to know which types of AIFM will have most difficultly in demonstrating that they have an independent risk management function? Specifically what additional proportionality criteria should be included when competent authorities are making their assessment of functional and hierarchal independence in accordance with the proposed advice and in consideration of the safeguards listed?

New and small sized AIFMs may face challenges demonstrating an independent risk management function. Again clarity on whether this role may be contractually modified or outsourced would enable further detailed analysis on this section**.**

IV.V - Possible Implementing Measures on Liquidity Management

Issues that require further clarification:
Only tools and arrangements which are disclosed to investors in the AIF's offering document can be used to manage liquidity in normal and exceptional circumstances.

Question 20
It has been suggested that special arrangements such as gates and side pockets should be considered only in exceptional circumstances where the liquidity management process has failed. Do you agree with this hypothesis or do your believe that these may form part of normal liquidity management in relation to some AIFs?

We do not believe that the use of special arrangements such as side pockets and gating should be restricted to exceptional circumstances, and recommend that such arrangements should be considered as essential liquidity management tools.

Question 21
AIFMs which manage AIFs which are not closed ended (whether leveraged or not) are required to consider and put into effect any necessary tools and arrangements to manage such liquidity risks. ESMA's advice in relation to the use of tools and arrangements in both normal and exceptional circumstances combines a principles based approach with disclosure. Will this approach cause difficulties in practice which could impact the fair treatment of investors?

Liquidity conditions are subject to change and thus liquidity management should involve flexible arrangements; thus we encourage the adoption of a principles based approach rather than a more prescriptive approach. The risk of impacting the fair treatment of investors can be lessened by putting appropriate procedures as well as communication and disclosure protocols in place.

Question 22
Do you agree with ESMA's proposed advice in relation to the alignment investment strategy, liquidity profile and redemption policy?

We agree that investors should be able to redeem their investments in accordance with the AIF's communicated redemption policy, which should cover conditions for redemption in normal and exceptional circumstances, and in a manner consistent with fair treatment of investors, capturing the use of gates, suspensions and side pockets.

Section IV.VI – Possible Implementing Measures on Investment in Securitisation Positions

The requirements placed on the AIFM in respect of investors of the AIF will work towards better aligning interests especially with respect to risk/skin in the game. It is important to note however that similar provisions exist across several pieces of legislation including the CRD, Solvency II etc and it would make sense for harmonisation to take place in this regard, not just in light of potential regulatory arbitrage but also for consistency.

Qualitative and quantitative requirements placed on the AIFM could be met through the use of 3rd party services providers such as BNY Mellon for verification of risk retention levels on the part of the originator or additional qualitative reporting metrics.

Section IV.VII - Possible Implementing Measures on Organisational Requirements

Question 23
Should requirement for complaints handling be included for situations where an individual portfolio manager invests in an AIF on behalf of a retail client?

We suggest following the MiFID and UCITS guidelines that are already in existence for retail clients.

Section IV.VIII - Possible Implementing Measures on Valuation
We are not responding to this section.

Section IV.IX - Possible Implementing Measures on Delegation

Box 64

General principles

1. Where an AIFM delegates to third parties the task of carrying out on its behalf one or more of its functions, the AIFM should comply, in particular, with all of the following conditions:

   (a) the delegation should not result in the delegation of senior management's responsibility;

   (b) the obligations of the AIFM towards its investors under the AIFMD should not be altered due to the delegation;

   (c) the conditions with which the AIFM must comply in order to be authorized in accordance with the AIFMD, and to remain so, should not be undermined;

   (d) the AIFM should ensure that the delegate carries out the delegated functions effectively and in compliance with applicable laws and regulatory requirements and must establish methods for reviewing the services provided by each delegate on an ongoing basis. The AIFM should take appropriate action if it appears that the delegate may not be carrying out the functions effectively or not in compliance with applicable laws and regulatory requirements;

   (e) the AIFM should retain the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation. The AIFM should also ensure that the delegate properly supervises the carrying out of the delegated functions, and adequately manages the risks associated with the delegation

(f) the AIFM should ensure that continuity and quality of the delegated tasks are guaranteed also in case of a termination of delegation by either transferring the delegated tasks to another third party or incorporating it into the AIFM;

(g) the respective rights and obligations of the AIFM and the delegate should be clearly allocated and set out in a written agreement. In particular, the AIFM must contractually ensure its instruction and termination rights. The agreement should make sure that sub-delegation could take place only with the AIFM's consent;

(h) whenever the portfolio management is delegated, the delegation must be in accordance with the investment policy of the AIF. The delegate should be instructed by the AIFM how to implement the investment policy and the AIFM should monitor whether the delegate complies with it on an ongoing basis.

2. The AIFM should in particular take the necessary steps to ensure that the following conditions are satisfied:

(a) the delegate must disclose to the AIFM any development that may have a material impact on its ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements;

(b) the delegate must protect any confidential information relating to the AIFM the AIF affected by the delegation and the investors of these AIF;

(c) the delegate must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions.

We would like section 1(g) to be clarified to cover the question of whether the prohibition on sub-delegation without the AIFMs consent extends to affiliates.

At present administration agreements typically allow for a delegate to sub-delegate to affiliates without consent.

Question 24
Do you prefer Option 1 or Option 2 in Box 65? Please provide reasons for your view.

We will not be answering this question

Section V – Depositaries

Section VI - Appointment of a depositary

Box 74

Particulars to be included in the written agreement evidencing the appointment of a single depositary and regulating the flow of information deemed necessary to allow the depositary to perform its functions pursuant to Article 21 (2) of the AIFMD.

The depositary on the one hand and the AIFM and / or the AIF on the other hand shall draw up a written agreement setting out the rights and obligations of the parties to the contract.

This agreement should include at least the following elements:

1. A description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which may be entrusted to the depositary;

2. A description of the types of assets that will fall within the scope of the depositary's function which should be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents, regarding the assets in which the AIF may invest;

3. A statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with the requirements of Article 21 (13) or (14); and where applicable, the conditions under which the AIF or the AIFM may allow the depositary to ~~***transfer***~~***limit*** its liability ~~***to a sub-custodian including the objective reasons that could support that transfer***~~ ***for certain identified sub-custodians and the conditions under which the depositary will pursue recovery of any loss from such sub-custodians on behalf of the AIF or AIFM***;

4. The period of validity, and the conditions for amendment and termination of the contract; and, if applicable, the procedures by which the depositary should send all relevant information to its successor;

5. The confidentiality obligations applicable to the parties in accordance with prevailing laws and regulations; these obligations should not impair the ability of Member States competent authorities to have access to the relevant documents and information;

6. The means and procedures by which the depositary will transmit to the AIFM or the AIF all relevant information that the latter needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate situation of the accounts of the

AIF. The details of such means and procedures should be described in this agreement or set out in the service level agreement or similar document;

7. The means and procedures by which the AIFM will ensure the depositary has access to all the information it needs to fulfil its duties, including the process by which the depositary will receive information from other parties appointed by the AIF or the AIFM***. The details of such means and procedures should be described in this agreement or set out in the service level agreement or similar document***;

8. Information regarding the possibility for the depositary or a sub-custodian to re-use the assets it was entrusted with or not and where relevant the conditions related to the potential re-use;

9. The procedures to be followed when a modification to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary should be informed, or where a prior agreement from the depositary is needed to proceed with the modification;

10. All necessary information that needs to be exchanged between the AIF, the AIFM and the depositary related to the sale, subscription, redemption, issue, cancellation and re-purchase of units or shares of the AIF;

11. Where the parties to the contract envisage appointing third parties to carry out their respective duties, an undertaking to provide, on a regular basis, details of any third parties appointed; and upon request, information on the criteria used to select the third party and the steps taken to monitor the activities carried out by the selected third party;

12. All information regarding the tasks and responsibilities in respect of obligations relating to anti-money laundering and combating the financing of terrorism;

13. Information on all cash accounts opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and procedures by which the depositary will be informed prior to the effective opening of any new account opened in the name of the AIF or in the name of the AIFM on behalf of the AIF;

14. Details regarding the depositary's escalation procedure(s), **which may be set out in this agreement or in a service level agreement or similar document,** including the identification of the persons to be contacted within the AIF and / or the AIFM by the depositary when it launches such a procedure.

Subject to national law, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIF managed by that AIFM to which it applies.

The parties may agree to transmit part or all of this information electronically. Proper recording of such information shall be ensured.

The agreement shall include the procedures by which the depositary, in respect of its duties has the ability to enquire into the conduct of the AIFM and / or the AIF and to assess the quality of information transmitted including by way of on-site visits. It shall also include a provision regarding the possibilities and procedures for the review of the depositary by the AIFM and / or the AIF in respect of the depositary's contractual obligations.

The law applicable to the agreement shall be specified.

We support this box with the amendments as set out above.

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~~ **as soon as reasonably possible** 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 this information, the AIFM will have been deemed not to have satisfied the requirements of Article 21of the directive.

We support this box with the amendments as set out above

Section V.III –Depository functions

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 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);

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

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

4. review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year;

5. 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.

We support option 2, with the amendment as specified above, for the reasons given in our answer to question 29.

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 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

We support this text with the amendment as specified above.

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

We believe that when the depository is not the transfer agent or registrar of the fund, the requirement to have a subscription / redemption account at the depository will be very onerous, complex and inefficient and will not result in a safer and less riskier monitoring of all cash movements of the Fund.

If the depositary is not the transfer agent, the requirement to have the subscription / redemption account of the depository will in reality create operational difficulties and risks by not giving to the appointed transfer agent the tools that he needs to comply with his duties.

The requirement to have the subscription / redemption account opened at the depository is only a viable option when the depository and transfer agent are one and the same entity (as it is mostly the case in Germany).

Question 26
At what frequency is the reconciliation of cash flows performed in practice? Is there a distinction to be made depending on the type of assets in which the AIF invests?

The frequency of the reconciliation of cash flow should be aligned with the activity of the Fund.

If subscription / redemption can be performed on a less frequent basis (weekly, monthly, quarterly), then daily reconciliation should not be required. As a minimum however monthly reconciliation should be imposed.

The same logic to the reconciliation of the trading / investment account which should be aligned with the frequency of the trading investment activity.

Question 27
Are there any practical problems with the requirement to refer to Article 18 of MiFID?

We do not foresee any practical problems with the requirement of Article 18 of MiFID.

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

We foresee potentially the following challenges with the advice:

1. If the prime broker is the depositary of the fund and is not a bank, how will it be able to comply with the requirements of having cash account opened at the depository?
2. If the prime broker is not the depositary and if the requirement to ensure that the cash belonging to the AIF is booked in an account opened at the depositary, then our response to question 25 is applicable.

Typically, sufficient reporting is received from the prime brokers ('PB') to enable timely cash reconciliations to be reviewed by the depositary on a periodic basis. It is important to note that the depositary will be relying on the PB or the AIFM to present sufficient documentation to it to demonstrate 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) as the depositary will not have access to that information.

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

Our clear preference is for Option 2

Option 1, is only viable in jurisdictions where the depositary is also the Transfer Agent of the Fund. As explained in Question 25, Option 1.1 is not workable in the other jurisdictions. Option 1.2 would represent a significant increase in cost for fund resulting from the duplication / mirroring of cash activities.

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

Our initial analysis concluded that Option 1, if applied in jurisdiction where the model is not in place today, would increase the costs for monitoring the cash flow of the fund four to six times. More staff will be needed to perform the tasks as set out in Option 1, in particular mirroring the transaction of these cash accounts in a position keeping system and making periodic reconciliations between the account statement and the AIF records in the internal bookkeeping system. This will introduce unneeded additional layers of administration and controls with little if only benefit in terms of risk reduction, with the AIF and its underlying shareholders bearing the ultimate cost associated with the implementation of Option 1.

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

In jurisdictions, where the depository function includes Transfer Agency and custody, there is no cash mirroring needed, because the operating account and the subscription and redemption account is within the depository.

For all custody positions which depositories hold on behalf of a fund – without the additional function of a transfer agency and custodian - the depositary maintains a record. For all assets that cannot be held by depositary, these positions are recorded by the administrator in the records of the fund. The administrator or custodian prepares periodic reconciliations of these positions with the 3rd party bank and the depositary would oversee these reconciliations on a periodic basis. If at any time the depositary wishes to obtain a full list of 3rd party cash held by the fund it would request such information from the administrator. The suggestion that the depositary should 'mirror' the transactions of the cash accounts held with 3rd parties that are already being accounted for by the administrator is completely unnecessary duplication and will involve increased costs to fund shareholders, to cover additional headcount and system enhancement costs.

The cost to perform such mirroring will be at least four to six times higher.

Box 78

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

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;
2. they are not provided as collateral in accordance with the provisions set out in Box 79; and

Option 1
~~they are registered or held in an account directly or indirectly in the name of the depositary~~.

Option 2
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 maintained by:

(i) a settlement system as designated by Directive 98/26/EC or:
(ii) a similar non-European securities settlement system which acts directly for the issuer or its agent

Additionally, financial instruments which ~~can be~~ **have been** 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 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.

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BNY Mellon believes that Option 2 is the right option, as there are fundamental differences in legal, regulatory and contractual status between holding securities with a CSD (as covered under Option 2) and holding securities with a registrar or transfer agent (as would also be covered if Option 1 were chosen).

The choice of a registrar or of a transfer agent is fundamentally a choice of the issuer, and the depositary has no control over their function or their activities. A depositary is not entitled to ensure the adequacy of procedures of registrar, even where it wishes to do so. A registrar or transfer agent is regulated in a very different manner from a CSD.

A registrar merely passes confirmations of trades on to the depositary. Confirmations would not be sufficient to rely upon if these types of assets are to be held in custody. These documents are not evidence of title and are more akin to a receipt. Further, confirmations are frequently subject to change after they have been delivered to the depositary. These circumstances would lead to a great deal of uncertainty for the depositary in a position which it is not able to control. Equally, investment managers may have difficulty in finding a depositary that is willing to take on liability for such assets.

For the sake of clarity, we have made one very small amendment to Option 2.

Additionally, we would ask that the phrase “financial instruments which can be physically delivered should be held in custody” be replaced by “financial instruments which have been physically delivered should be held in custody”.

We believe that this clause should be consistent and compatible with two fundamental concerns :

(a) That – for financial instruments that it would normally accept to receive in physical form - a depositary bank cannot artificially and inappropriately reduce its potential liability for refusing to accept these financial instruments in physical form
(b) That there is no artificial or inappropriate incentive, or obligation, on market participants to transfer financial instruments in physical form.

We believe that an important public policy objective should be to encourage, or to mandate, dematerialisation of financial instruments, and book-entry settlement.

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

Option 2 is preferable, for the reasons stated above.

Question 33
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?

With constant market development, e.g. derivative clearing and other evolutions, we do not believe it is possible to provide a definitive list at this time.

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 **or similar collateral arrangements under other applicable law.**

BNY Mellon believes that Option 3, with the amendments as specified above, is preferable, as we believe that a broad exclusion of securities provided as collateral is appropriate.

We also believe that Option 3 has the advantage of the greatest simplicity and clarity in application since a “financial collateral arrangement” is well defined in the directive on financial collateral arrangements. It is 1) a title transfer financial collateral arrangement or 2) a security financial arrangement whether or not covered by a master agreement or general terms and conditions.

We believer that Option 1 (“title transfer collateral arrangement”) is too narrow since it does not cover a security financial arrangement.

Furthermore we believe that Option 2 will give rise to confusion in view of article 2 of the financial collateral directive. We note that in article 2 of the financial collateral directive, “providing financial collateral” is in any event giving control or possession to the collateral taker. There is no other way that financial collateral can be provided. In Option 2 it is suggested by “transferred away from the AIF or the depositary” that there is another way of providing financial collateral by “not transferring” to the collateral taker.

Additionally, there is an inconsistency between Box 77 (Definition of financial instruments to be held in custody) and Box 81 (Safekeeping duties related to “other assets” – ownership verification and record keeping), whereby the explanatory text states that title transfer collateral arrangements are to be considered “other assets” and thus subject to the verification of ownership requirement under Box 81, even though the fund no longer owns the assets. We would appreciate ESMA’s clarification in this regard.

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

Yes, we believe that a further clarification of option 2 box 79 would be necessary.

Box 80

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

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 registered 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 ***associated with sub-custodians and central securities depositories***. ~~*In particular, depositaries should be required to assess the custody risks related to settlement systems and inform the AIFM of any material risk identified.*~~

2. Where the depositary has delegated its custody functions, the depositary would remain subject to the requirements of Section 1 (c) and would further have to ensure the third party (hereafter referred to as the 'sub-custodian') complies with Section1 (b) as well as with the segregation obligations set out in Box 16.

Paragraph 1(c) states that depositaries are required to assess custody risks in relation to settlement systems and inform the AIFM of material risks identified, while the explanatory text at Paragraph 35 seems to go further, stating that the depositary should monitor the risks associated with CSDs and registrars. It would be more appropriate to require the depositary to monitor Central Securities Depositaries, as "settlement system" could be interpreted to apply to counterparties and internal clearing platforms. BNY Mellon has edited 1(c) accordingly above.

BNY Mellon welcomes acknowledgment from ESMA that the depositary is not liable for failures that occur at CSD level, at Paragraph 35 and at Box 91: Paragraph 30. This recognises that the choice of settlement system is dictated by the assets in which the AIF invests.

On a general note, the explanatory text seems to create some confusion. Paragraph 35 of the explanatory text extends the scope of Paragraph 1(c) in Box 80 to registrars, although assets recorded by a registrar are not considered in custody.

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.

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

Option 2

~~**mirror all transactions in a position keeping record**~~

In the context of Section (b) the AIFM should be required to ensure that the relevant third party provides the depositary with certificates or other documentary evidence 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.

Additional requirement if Option 2 is retained in Box 78 with regard to the definition of financial instruments to be held in custody.

In the context of Section (a), the depositary should ensure the AIF, its investors or the AIFM acting on behalf of the AIF, are able to exercise their rights if a problem arises that affects assets for which the depositary or its delegate is the registered owner either by clearly identifying the AIF as the ultimate owner of the assets or, where the depositary or its delegate is the only registered owner of the assets on behalf of a group of one or more unidentified clients, by taking appropriate actions to ensure the AIF's ownership right is recognised by the relevant parties. Where a legal action is required, the costs related to such an action would have to be borne by the AIF, the AIFM or as the case may be the AIF investors.

4. The depositary should set up and implement an escalation process for situations where an anomaly is detected (e.g. to notify the AIFM and if the situation cannot be clarified / corrected, alert the competent authority).

In relation to the depositary's record-keeping function, BNY Mellon strongly prefers Option 1, that is; the depositary will ensure procedures are in place so assets registered in the name of the AIFM cannot be assigned, transferred, exchanged or delivered without the depositary being informed, or that the depositary shall have access to appropriate documentary evidence of each transaction.

This approach is flexible enough for the depositary to rely on the records of third parties, leaving the depositary better able to perform its oversight duties. The depositary will oversee the procedures and controls of the third party to ensure that the proper reconciliation procedures are in place to record and verify the assets of the AIF.

BNY Mellon welcomes ESMA's acknowledgement in relation to the delegation of such tasks in Paragraph 5, p.173. The ability to delegate is necessitated by the wide variety of assets that AIFs invest in and the different locations involved, the range of documentation used to evidence ownership, and the complexity of the assets themselves.

We believe Option 2 (mirroring) would be costly and redundant as such functions are already performed by relevant third parties and would direct resources away from substantive monitoring performed by the depositary, providing no further protection to the investor.

In relation to the verification of ownership, BNY Mellon considers that "other assets" that have cleared through approved clearing platforms that the depositary is a participant with, directly or indirectly, should be considered "verified" for the purposes of Box 81.

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

BNY Mellon would expect delegation of non-custody safekeeping duties to be dealt with in the same manner as custody due diligence i.e. by performing on-going monitoring to ensure that the relevant party complies with the necessary criteria for verification.

Question 36
Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

Control is with those parties who are authorised to instruct on the movement of those assets. In some cases this may be with depositary, in other cases it may be with a sub-custodian or other authorised delegates, such as a nominee company. A key point to note here is that the depositary may not always be in a position to instruct transfer of title.

In relation to Point 1, as outlined above, there is no relationship between the depositary and issuer/registrar. The relationship is directly between the AIF and the issuer/registrar. Therefore, the depositary is fully reliant on the third party or the AIFM to provide relevant information on such assets, as the issuer or registrar may refuse to provide information directly to the depositary.

It is often necessary to utilise the naming convention set out under Point 1 for assets in emerging markets, as the market or legal structure of the investment may require the asset be held directly in the name of the AIF. Additionally, limited partnerships typically invest in their own name, to ensure that the beneficial investor is fully liable under the terms of the partnership agreement.

In such instances, it is unlikely the depositary's instruction to transfer title would be accepted as the AIF is both legal and beneficial owner.

In the instance of Point 2, which is typical of a fund of funds investment, the asset may be registered in the name of the depositary or a group affiliated nominee company, on behalf of the AIF. This allows the depositary to control the execution of the investment and to specify the mailing address and bank accounts that must be used in relation to the assets. The underlying registrar is notified that the depositary is acting on behalf of the AIF, and provides the relevant information to assist the depositary in segregating the depositary's proprietary assets from those of the depositary's clients.

The approach laid out in Point 3 is commonly used for open-ended funds that have significant or complex distribution requirements. This type of "omnibus" registration in the name of the depositary will not identify the beneficial owner on the name of the account. The depositary maintains records to ensure that assets can be attributed to clients at all times. This model allows for lower investor costs and greater efficiencies.

All of the above approaches are commonly used and accepted as best market practice. The depositary does not choose which approach is selected, as that will depend on a variety of factors, e.g. market, asset type, fund structure. Thus, it is vital that any approach adopted recognises and allows for their differences.

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

This approach is to be welcomed.

However, it should be noted that prime brokers in other jurisdictions are not required to provide the level of reporting required by the depositary to perform oversight over assets. This is particularly relevant to U.S prime brokers. It should be noted that any changes to the level of reporting currently provided by such prime brokers, in order to align the process with the FSA rules, could be cured by amending respective agreements with each individual prime broker to include the prescribed level of services, but that in itself could result in additional costs to AIFMs, AIFs and their shareholders, notwithstanding the technical challenges faced a prime broker in terms of implementation of the enhanced reporting protocols and their delivery.

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

BNY Mellon believes Option 2 would result in substantial costs to depositaries with little benefit to the investor. Depositaries would be forced to invest in large numbers of staff and IT systems. It is likely this type of mirroring would detract from the substantive monitoring performed by the depositary.

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

The depositary should ensure that the AIF has robust procedures to confirm that assets not held at the depositary are verified by the AIF and reconciled by the administrator. The reconciliations will be to the records of the parties with whom the transactions are conducted (e.g.; brokers, counterparties) and to statements / confirmations from third party administrators.

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 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.

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) including by third parties and particularly that the depositary 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

Box 83

Clarifications of the depositary's oversight duties

Duties related to subscriptions / redemptions (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

2. ensure and regularly check the compliance of the procedures regarding the **primary market** 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.

BNY Mellon comments: BNY Mellon believes that the depositary oversight in relation to Article 21 (9) (a) should be limited to the primary market only. Shares or units negotiated on a secondary market should be excluded from the scope of this oversight

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 the nature, scale and complexity of the AIF and conducted at a frequency consistent with the frequency of the AIF's **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~~.

BNY Mellon believes that some of the provisions as described in box 84 go beyond the requirements included in the level 1 text. Level 1 indeed does not require the depositary to directly oversee the valuation of assets. The oversight by the depositary should therefore be limited to the verification on a periodical basis that the valuations and procedures as defined by the AIF or the AIFM on behalf the AIF are effectively implemented and periodically reviewed.

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 with applicable 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.

BNY Mellon considers that the point 1 goes beyond the level 1 provisions. Level 1 text which refers to the incorporation document (not offering documents, i.e. the prospectus 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. As the intent of this EU legislation is to promote harmonisation at EU level, we would recommend ESMA to limit its scope to EU rules.

Box 86

Clarifications of the depositary's oversight duties

Duties related to the timely settlement of transactions (d)

Option 1
No additional requirement

~~Option 2~~
~~To fulfil its obligation pursuant to Article 21(9)(d), the depositary should be required to set up a procedure to detect any situation where the consideration is not remitted to the AIF within the usual time limits, notify the AIFM and where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.~~

~~**Where the transactions do not take place on a regulated market, the usual time limits should be assessed with regard to the conditions attached to the transactions (OTC derivative contracts, investments in real estate assets or in privately held companies).**~~

BNY Mellon believes that option 1 is the preferred one as it provides the appropriate level of flexibility in the light of the very broad categories of asset classes and strategies falling under the AIFM directive.

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 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. **Once declared by the AIFM, c**heck the completeness and accuracy of dividend payments and where relevant of the carried interest.

BNY Mellon is of the opinion that the 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 for fund operations 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.

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

BNY Mellon 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. BNY Mellon also welcomes the right level of depositary duties which remain proportional in relation to the duties of the other involved parties. BNY Mellon does not believe that the advice on oversight duties will materially impact the depositary's relationships with AIFMs, AIF and third party providers. 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.

According to the general requirements as described in Box 82, the BNY Mellon understands that the oversight function as performed by the depositary should take into consideration the risks associated with the nature, scale and complexity of the AIF's strategy and the AIFM's organisation and essentially consist in assessing the control procedures and environment at the AIFM, the AIF or appointed third party. BNY Mellon broadly supports this approach but would like to make the following observations and comments:

a) Assessment of the risks associated to the product and AIFM's organisation: the AIF, or the AIFM on behalf of the AIF, is required to provide details on its risk management procedures to the Regulator as part of the incorporation documents. So far, the risk management papers were essentially focused on the risks associated to the management of the portfolio and did not really cover the aspects pursuant to article 21 (9) of the Directive. BNY Mellon reminds ESMA that the depositary is not directly involved in the risk management procedures from the AIFM and may therefore at best be in a position to check if the AIFM has –reasonable- procedures. Risk analysis and decisions shall remain the responsibility of the Board of the AIF (or AIFM on behalf of the AIF). As a consequence, BNY Mellon would recommend that the risk management procedures as filed by the AIF (or the AIFM on behalf of the AIF) should include specific provisions aiming at describing how the Board will exercise its supervision duties in that regards and the information (SSAE 16, KPI/KRI's) that will be made available to the depositary to fulfil its oversight duties. The timing for providing all the necessary information to the depositary is also critical. In some cases, at the time of the appointment of the depositary, a lot of variables affecting the product can still be unclear and as a consequence, it is very difficult for the depositary to perform an adequate risk assessment. The AIF or the AIFM on behalf of the AIF should give the depositary sufficient lead-time in order to allow him to conduct a proper risk assessment. On a related note, in order to ensure a level playing field and consistency amongst the services providers (administration companies, custodian, risk managers…), ESMA might consider imposing on the stakeholders playing a key function (fund administration, transfer agent, risk manager…) an independent assessment of their control environment (e.g. SSAE 16 or equivalent). Those independent assessments have become with time quite common in the depositary community and it would make sense to extend those standards to the other service providers. This would also constitute an alternative to the issue resulting from the situation where

competing firms would have to share detailed information on procedures and processes in the context of the due diligence. Finally, BNY Mellon wishes to point out that the general oversight procedures, referred in paragraph 1 of Box 82, should be reviewed on a regular basis and updated when necessary, rather than regularly updated

b) Ex post verifications of the procedures: according to the Note 49 of the explanatory text, BNY Mellon understands that, in order for the depositary to discharge its responsibilities, the "ex post verifications" should be limited the review of the adequacy of the procedures and escalate any gaps or issues as highlighted by its review. By consequence, the depositary is not required to monitor the actual and ongoing performance of the service providers (review of KPI/KRI's) as it should remain the responsibility of the AIF or AIFM on behalf of the AIF

c) Escalation process: as the AIF or AIFM on behalf of the AIF remains ultimately responsible for ensuring that an effective and sound control environment has been implemented at the level of the AIF, any issues identified by the depositary in the course of its oversight duties should be reported to the Board of the AIF or the AIFM if acting on behalf of the AIF

d) The written agreement between the AIFM or the AIF shall contain an obligation for the AIFM or AIF to provide or ensure any third party appointed by the AIFM or AIF provides all necessary information that permit the depositary the performance of its oversight duties, in compliance with Article 21 (9) of the AIFMD.

BNY Mellon foresees additional costs associated with the extension of the five oversight duties to local depositaries of AIFMs or AIFs. However, the proposed advice on the depositary control duties seems to ensure the right balance between flexibility, the harmonization's objective and the costs associated to the implementation and on-going monitoring of such duties.

The principle based approach properly clarifies the scope of each listed oversight duty and provides the necessary flexibility for depositaries so that they are in a position to undertake verifications and checks of management functions in the context of alternative investment funds. Therefore, BNY Mellon does not believe that there is a need for additional clarity in that regard.

Question 41
Could potential conflicts of interest arise when the depositary is designated to issue shares of the AIF?

It is important to mention that in some EU countries (e.g. Germany), the local regulation imposes on the depositary to issue the shares of the AIF. In other EU countries (e.g. Luxembourg, Ireland…), the depositary is not mandatory responsible for issuing the shares or units of the AIF. The AIFM, the AIF or a third party provider (acting as authorized transfer agent) can also be designated to issue shares or units of the AIF.

Under the AIFMD requirements, those entities involved in the issuance of the units of the AIF will have to maintain and operate under effective organizational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors.

As a consequence, the same legal entity should be authorized, under strict requirements, to act as depositary and transfer agent for AIFs. The interests of the investors are primarily protected by an adequate structure which proposes a clear segregation between the depositary and the transfer agent functions (introduction of “Chinese walls”).

Question 42
As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF is compliant with the applicable national law and the AIF rules and / or instruments of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

On a periodic basis, the depositary ensures that the AIF, the AIFM or the designated entity (transfer agent and administrative agent) have appropriate procedures to reconcile the subscription orders with the subscriptions proceeds. It also ensures that the procedure is reviewed on a regular basis and updated if necessary. The review of the effectiveness of these procedures should be performed ex-post based on samples. The completion of the above mentioned tasks should be the pre-requisite for the depositary to be discharged from its responsibilities. Notwithstanding the above, the depositary, where deemed appropriate, might decide to conduct complementary ex-post verifications based on information provided by the designated entity such as exceptions reports, key performance indicators, key risks indicators, etc. It is important to keep in mind that all these reviews are performed based on aggregated numbers as provided by the transfer agent and not based on individual shareholder / unitholder transaction.

This specific review is part of a general program on shares or units transactions with the objective of it is to check that the sale, issue, repurchase and cancellation of units or shares are carried out in accordance with the applicable

laws and regulations as well as the constitutional documents of the AIFM or AIF. In this respect, the depositary undertakes specific verifications of the performance of the AIFM, AIF or third party provider (transfer agent and administrative agent) for the purpose of reviewing procedures and methodologies, including sample checks as part of the assessment of the control environment.

We wish to point out that the verification of procedures implemented by the AIFM, the AIF or any third party should not necessarily be correlated to the frequency of subscription and redemptions. BNY Mellon suggests that the depositary verifies the procedures on a periodic basis.

BNY Mellon also believes that the control procedures as implemented by the AIF, the AIFM or the designated entity (transfer agent and administrative agent) should also include checks to ensure 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 these controls should be proportionate to the frequency of subscription and redemptions and defined at the time of the appointment.

Last but not least, some alternative products can introduce a further layer of complexity as they can operate on commitment and drawn-down basis at the discretion of the fund manager, use equalisation methods, commissions and retrocession's… Those features are typically not included in the records of the fund as they relates to individual shareholders transactions and positions. On that basis, we believe that in the context of the AIFM directive, those transactions should be excluded from the scope of the depositary bank oversight.

Question 43
Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

The scope of the review, as currently performed by the depositary, already includes not only subscriptions but also other types of shareholders related transactions, such as redemptions, switches etc…

Depositaries could meet that obligation by getting access to the relevant information and records of the AIFM, the AIF or the third party provider. In line with the requirements of Box 83, the depositary will ensure that procedures are implemented, reviewed and updated on a periodic basis, it will also undertake ex post to ensure that the procedures are effectively implemented.

To complete its oversight duty, the depositary will have the ability to leverage existing independent assessment of the control environment (e.g. SSAE 16) and/or conduct on-site visits at the AIFM, the AIF or the third party provider for

the purpose of reviewing procedures and verifying the quality of information transmitted by way of sample checks.

Notwithstanding the above, the depositary should in our views, not be required to confirm suitability, eligibility and other conditions of investment have been met.

Finally, and as indicated in box 83, the depositary oversight in relation to Article 21 (9) (a) should be limited to the primary market only. Shares or Units negotiated on a secondary market should be excluded from the scope of this oversight

Question 44
With regards to the depositary's duties related to the carrying out of the AIFM's instructions, do you consider the scope of the duties set out in paragraph 1 of Box 85 to be appropriate? Please provide reasons for your view.

It is important to keep in mind that the responsibility for implementing an effective and sound risk management process remains the responsibility of the Board of the AIF (or AIFM on behalf of the AIF), the depositary is in an execution mode vis-à-vis the AIFM/AIF. According to the general requirements as described in Box 82, BNY Mellon understands that the oversight function as performed by the depositary should mainly consist in assessing the control procedures and environment at the AIFM, the AIF or appointed third party. On that basis, the depositary could also rely on controls performed by the investment manager or any third party in charge of the compliance/risk monitoring. Combined with an initial due diligence over the investment management, including site visits if deemed necessary, the depositary will be in a position to discharge its oversight duty.

As indicated in the BNY Mellon comments relative to box 85, we consider that the point 1 goes beyond the level 1 provisions. Level 1 text which refers to the incorporation document (not offering documents, i.e. the prospectus 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.

Question 45
Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

BNY Mellon believes that no clarification is needed for this oversight duty and decides to select option 1. From a practical perspective, as far as financial instruments are concerned i.e. assets held within a sub-custody network, and as long as third party custodians involved in the safekeeping chain do provide the appropriate reporting, BNY Mellon believes that they are no fundamental

difference between the current market practice for monitoring timely settlement of transactions and the suggested measures in paragraph 1 of the second option. BNY Mellon is also in the opinion that any request for the restitution of the financial instruments from the counterparty should, in the first place, be initiated by the board of the AIF (or AIFM on behalf of the AIF). The depositary should be acting, where possible, as a facilitator in the process (in some circumstances, the depositary might not be able to access the assets e.g. financial instruments held by a third party custodian or prime broker appointed by the AIF or the AIFM on behalf of the AIF.

In regards to assets not held throughout the traditional custody network (derivatives, real estate, private equity…), and due to the non-standard nature of those transactions, BNY Mellon is of the opinion 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 singed 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.

Notwithstanding the above, and similar to other oversight duties, the depositary should be able to rely on his assessment of the existing control environment at the AIF, AIFM and/or a third party provider to discharge its responsibilities. Those control procedures should include assets and cash reconciliations, past due receivables and payables etc…

Section V.III.3 – section 2 - Due Diligence Duties

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, and enforceability of the **custody contract** ~~**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 sub-custodian 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

(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

BNY Mellon supports the approach proposed by ESMA with respect to a depositary's due diligence duties.

BNY Mellon welcomes ESMA's support for a principles-based approach, rather than a box-ticking approach, for consistency with other international standards and with EU legislation, and for the application of current best practice.
Specifically, BNY Mellon believes that Box 88 sets out a good statement of current best practice.

As set out above, BNY Mellon is making one specific textual suggestion. We believe that the reference to "contractual arrangements" in clause 1(a)(i) could be interpreted in different ways. We suggest a specific reference to the custody contact between the depositary bank and the sub-custodian. We do not believe that any further reference is necessary, given that clause 1(a) does include the general obligation to "assess the regulatory and legal framework". We believe that a broad reference to the "enforceability of contractual arrangements" may bring about an obligation to review the specific enforceability of a broad range of very disparate legal documents. As mentioned in our response to Question 46, the legal documentation that is associated with the opening of an account at a

sub-custodian in any particular country in order to ensure that the assets are "involvency-proof" may be extensive and diverse.

(2) <u>Segregation of Assets</u>

Box 89 :

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

1. Where safekeeping 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 safekept for the depositary on behalf of its clients from its own assets and 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 safekept 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 safekept;
   (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).

BNY Mellon supports the basic approach taken in Box 89, and believes that much of the text is appropriate.

BNY Mellon believes that there are two points which are potentially problematic.

These two points are clause 1(b) and clause 1(e). For both these clauses, we are proposing a revised text. We believe that the proposed changes do not change the meaning, but can help to avoid misinterpretation.

Discussion on clause 1(b) :

We believe that it is key to bear in mind the differences between the obligations that lie on the first party in the safekeeping chain (i.e. the custodian)and the obligations that lie on other parties in the safekeeping chain (i.e. a sub-custodian).

The "third party" to which a depositary bank delegates part or all of its safekeeping function may be either the first party in the safekeeping chain, or the second party (when the depositary bank acts as the first party).

The obligations that fall on the first party in the safekeeping chain and on other parties in the chain cannot in every respect be the same.

The requirements set out in clauses 1(a) and 1(b) should definitely apply to the first party in the safekeeping chain. A first party in the safekeeping chain will in its own books and records distinguish between each individual client of a depositary bank. This means that a first party in a safekeeping chain can comply with the requirement in the current text of clause 1(b) that it ensures that its books and records have a "correspondence to the assets safekept for the depositary's clients".

But this specific requirement cannot necessarily apply to further parties in the safekeeping chain. This is because a securities account holder that is an intermediary in the chain of custody can use an omnibus account at its securities account provider.

A second (or third or fourth) party in the safekeeping chain will not in its own books and records distinguish between each individual client of a depositary bank.

If the first party in a safekeeping chain is a depositary bank, then the second party in the chain can collectively identify the assets held on behalf of the clients of the depositary bank (but any third or fourth party cannot). If the first party in a safekeeping chain is not the depositary bank, then the second party cannot

collectively identify the assets of the clients of the depositary bank (nor can any possible third or fourth party).

What this specifically means is that – under a possible interpretation of the phrase – many parties in safekeeping chain cannot comply with the requirement that they ensure that their books and records have a "correspondence to the assets safekept for the depositary's clients".

BNY Mellon suggests that any risk of misinterpretation can be eliminated by having clause 1 (b) read simply "to maintain records and accounts in a way that ensures their accuracy", and by deleting the last phrase of the clause.

Discussion on clause 1(e) :

We are concerned about the risk of misinterpretation. In particular, we are concerned that a reader may believe that this clause sets out requirements with respect to how a bank manages its own cash accounts with other banks. We do not believe that this clause sets out any such requirements. Our suggestion is intended to reduce the risk of misinterpretation.

To explain :

The custody of cash (through a bank) is fundamentally different from the custody of securities.

Cash deposited on a cash account with a bank is a claim on that bank, while securities deposited on a securities account with a bank are not a claim on that bank.

As cash deposited with a bank is a claim on that bank, it is – for a depositor – irrelevant how that bank manages the structure of its cash accounts with third parties.

In other words, we believe that the requirements of clause 1 (e) apply only, and should apply only, to the first party in the safekeeping chain for cash.

Also, we would welcome a clarification from ESMA concerning the practical implications of explanatory note (5) (page 176 of the Consultation Paper) that seeks to widen the scope of the segregation duty to assets in 'recordkeeping'.

Article 21.11(d)(iii) AIFMD is referring to assets belonging to the depositary's clients for the safekeeping of which the depositary wants to appoint a third party. This paragraph stipulates that the depositary needs to ensure that its (clients) assets are properly segregated by the appointed third party. This requirement apparently implies that the depositary is part of the custody chain, hence excluding 'record keeping' assets (indeed, for record keeping assets, the third parties would not be appointed by the depositary, so it is hard to see how the level 1 text that specifically focuses on delegation by the depositary can be expanded through level 2 implementing measures to require the depositary to ensure segregation at a third party not appointed by it.

Question 46

What alternative or additional measures to segregation could be put in place to ensure the assets are 'insolvency-proof' when the effects of segregation requirements which would be imposed pursuant to this advice are not recognised in a specific market? What specific safeguards do depositaries currently put in place when holding assets in jurisdictions that do not recognise effects of segregation? In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

For securities issued in the countries of the European Union, BNY Mellon believes that a key measure that should be undertaken in order to ensure that assets are "insolvency-proof" is that the European authorities should pass into European law a "Securities Law Directive". This would remedy the current unsatisfactory and risky legal situation that exists in several European countries.

For securities issued globally, BNY Mellon understands Q46 as asking for details of possible measures that a custodian would take (as a result of its obligations under §2 of Box 89) in the event that the measures taken under §1 of Box 89 are insufficient.

BNY Mellon believes that the obligations set out under §2 of Box 89 are far-reaching in their effect, and that no specific additional obligations should be imposed.

Here follows an explanation of measures that can be taken (under the obligations set out under §2 of Box 89) to make assets "insolvency proof".

Basic Scenario and Objective :

The basic scenario is that a custodian A located in country A opens a securities account with a custodian (sub-custodian) B in country B, in order to hold securities on behalf of clients of custodian A. The sub-custodian B will, in turn, typically hold the securities on a securities account provided by the central securities depository (CSD) of country B. The securities held on that account with the CSD may exist in bearer or registered form, and, if in registered form, may be registered in the name of the CSD, or of the subcustodian or of another party.

The fundamental objective is to ensure that these arrangements protect the securities of the clients of custodian A in the event of the insolvency of either custodian A or subcustodian B (or the CSD).

Desirable Situation :

The desirable situation is that the legal environment in country B recognises what is commonly called the "nominee concept", i.e. recognises that a securities account holder (i.e. custodian A, and sub-custodian B) or a legal owner (the entity in whose names the securities are registered) is not necessarily the "real" or "beneficial" owner of the securities, but may be holding securities on behalf of its clients. In such a circumstance, a securities account holder can typically put in place an appropriate legal agreement with its provider, and can include a relevant mention in the name of the securities account, so as to ensure that the securities on the account are identified as "client assets", and not as proprietary assets of the account holder.

Solutions in the event of an "Undesirable Situation" :

The fundamental problem arises when the legal environment in country B does not recognise the "nominee concept" and considers one or other intermediary in the chain of safekeeping as the "real" or "beneficial" owner.

In many, but not all, such countries (i.e. countries that do not recognise the "nominee concept"), adequate protection can be achieved by custodian A opening up multiple securities accounts with sub-custodian B, ensuring that on each single securities account securities are held on behalf of only one single beneficial owner (so that each securities account is a "single beneficiary" account and not a "multiple beneficiary" or "omnibus" account), and putting in place adequate legal documentation (identifying and, in some cases, signed by the ultimate beneficial owner) so that the legal environment in country B will consider the ultimate beneficial owner as the "real" owner of the securities, and not any intermediary. This legal documentation may in some circumstances be extensive and diverse.

In many such countries, and in order to achieve adequate protection, such a set-up is required not only in the books of the sub-custodian B, but also in the books of the CSD, so that sub-custodian B will open "single beneficiary" accounts, and will put in place adequate legal documentation (identifying and, in some cases, signed by the ultimate beneficial owner), at the CSD.

BNY Mellon views on such arrangements:

BNY Mellon sees it as very important that the legal environment in each country recognises the "nominee concept", so that custodian banks can operate omnibus accounts, and that beneficial owners whose assets are held through omnibus accounts at one or more points in the chain of safekeeping do not suffer any discrimination, whether with respect to asset protection, or to the exercise of rights, or to the possibility to benefit from appropriate tax regimes.

BNY Mellon sees any legal or practical requirement to operate single beneficiary accounts, as an inferior solution, as such a requirement imposes additional costs, creates additional risk throughout the safekeeping chain, and in practice will exclude some categories of investor from being able to invest directly in some categories of securities.

Countries with legal or practical obligations to operate "single beneficiary" accounts :

BNY Mellon believes that there are up to 52 countries within the current BNY Mellon custody network for which obligations to operate "single beneficiary" accounts exist for one reason or another. It should be noted that these obligations may exist not only, or not just, for asset protection reasons, but also for other reasons, including to safeguard rights. In a particular country, even if the legal environment recognises the "nominee concept" for asset protection purposes, it may well be the case that the tax authorities, or issuer agents, or other relevant parties, do not recognise the "nominee concept".

Securities in these 52 countries represent about 6.71% of the total securities held by BNY Mellon as a global custodian.

Section V.IV - The Depositary Liability Regime

Box 90

Definition of loss

1. Financial instruments held in custody by the depositary or, as the case may be, by a sub-custodian should be considered 'lost' within the meaning of Article 21 (12) if one of the following conditions is met:

(a) a stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed;
(b) the AIF has been permanently deprived of its right of ownership over the financial
instruments;
(c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments.

2. The assessment of the loss of financial instruments must follow a documented process readily available to competent authorities and lead to the notification of investors in a durable medium taking into account the materiality of the loss.

Where an AIF is permanently deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments, for example in situations where shares are cancelled and replaced by the issue of new shares in a company reorganisation, this is not considered to be an example of the loss of financial instruments held in custody.

In case of insolvency of a sub-custodian, financial instruments should be considered 'lost' as soon as one of the conditions set out in §1 is met with certainty and at the latest, at the end of the insolvency proceedings. To that end, the AIFM should monitor closely the proceedings to determine whether all

or part of the financial instruments entrusted to the sub-custodian are effectively lost.

In case of a fraud whereby the financial instruments have never existed or have never been attributed to the AIF (e.g., as a result of a falsified evidence of title, accounting fraud, etc.), all conditions described in §1 should be deemed to be met. **If the depositary is able to prove that it has exercised proper oversight, due diligence and supervision it will be discharged of its liability for fraud by third parties, the AIF, and the AIFM**.

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We agree with this box with the amendment as set out above.

Box 90 and Explanatory Note 15 under it indicate that depositaries would become accountable for fraud committed by third parties, if it transpires that the entry of custody assets into custody accounts has been based upon falsified documentation or other fraud. It should be recalled that the custody obligation of the depositary does not include verification of the authenticity of assets delivered to the depositary for safekeeping. It is difficult to understand, on the basis of the Directive or normal legal and commercial principles on the allocation of risk, that the depositary would be required to account for the fraud that a third party has committed and over which it has no effective control.

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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'

The depositary will not be liable for the loss of financial instruments held in custody by itself or by a subcustodian if it can demonstrate that all the following conditions are met:

1. The event which led to the loss did not occur as a result of an ***improper*** act or omission of the depositary or one of its sub-custodians to meet its obligations ***under the directive***
2. The event which led to the loss was beyond its reasonable control, i.e. it could not have prevented its occurrence by reasonable efforts
3. Despite ~~***rigorous and comprehensive due diligences***~~ ***the exercise of reasonable efforts,*** it could not have prevented the loss.

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 ***event it could reasonably identify as "***external***"*** 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.~~

In paragraph c) it is mentioned that the depositary has to take "appropriate actions" to prevent or mitigate a financial loss of financial instruments held in custody". The depositary may not always be in a position to prevent or mitigate. A situation could occur that the AIFM is in a position to prevent or mitigate and the depositary is not. Then the depositary, who cannot prevent or mitigate, should communicate this to the AIFM who will have to prevent or mitigate. This exception should be covered. Return on investment has to be in function of the

risk, so we shouldn't put all burden entirely on the depositary, this should be more balanced.

Box 92

Objective reasons for the depositary to contract a discharge

The depositary will be deemed to have an objective reason to contractually discharge itself of its liability in accordance with the requirements set forth in Article 21 (13) if it can demonstrate that:

~~***Option 1***~~
~~***1. it had no other option but to delegate its custody duties to a third party (e.g. as a result of legal constraints); 0r***~~
~~***2. it has agreed with the AIF or as the case may be the AIFM through a written agreement that it is in the best interest of the AIF and its investors to delegate such duties (e.g. if the delegate is in a country where the depositary does not operate).***~~

Option 2
Where the AIF or, as the case may be, the AIFM and the depositary have explicitly agreed through a written contract that the depositary can discharge its responsibility, it should be considered that the requirement to have an objective reason is fulfilled.

Of the two options Option 2 is the preferred option, i.e. if the AIF or the AIFM and the depositary explicitly agree in a written contract that the depositary can discharge of its liability, it should be recognised that the condition that the depositary needs to have "an objective reason" is fulfilled. Option 1 is less clear than Option 2.

Question 47
What are the estimated costs and consequences related to the liability regime as set out in the proposed advice? What could be the implications of the depositary's liability regime with regard to prudential regulation, in particular capital charges?

The liability regime as set out in the advice could have an impact on capital charges and hence on the revenue required from the customers to put in extra capital. Predicting costs at this stage may be a substantial challenge. With all applicable reservations we nevertheless believe that calculating the additional costs, based on the parameters we are having today, might be a useful exercise. We are currently in the process of exploring whether we can calculate the impact and if we would be able to produce meaningful figures we'll let ESMA know.

Additionally, the fact that the depositaries will be liable for their sub-custodians (since discharge might be difficult to obtain) can lead to strategic decisions. Will

the depositary still accept the risks in particular jurisdictions? This risk averse behaviour of the depositary may be disadvantageous for professional investors who are eager to invest knowingly and willingly in less obvious markets for the higher return on investment.

Furthermore we believe that the additional capital requirements will push smaller depositaries out of business. Other depositaries will become larger in some markets. This might put the surviving big depositaries in a dominant position which could be detrimental for competition, and for the price the users will be paying.

Question 48
Please provide a typology of events which could be qualified as a loss in accordance with the suggested definition in Box 90.

Providing a comprehensive typology of events which could be qualified as a loss in accordance with the suggested definition in Box 90 is very difficult. We prefer not to provide a list.

Question 49
Do you see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD?

No, we do not foresee 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. To the reference of “local legislation” should be added “and “local regulatory bodies and courts”.

We want to refer here to question 46 and Box 88. In the event the depositary delegates, he has to ensure that he carries out a due diligence process which aims to ensure that the sub-custodian provides an adequate level of protection. Let’s assume the assessment of the depositary is a thorough assessment including legal opinions confirming that the level of protection is adequate. Afterwards a loss occurs and the depositary finds out that the legal opinion was not correct and that that wrong information was at the basis of the loss. This should be an external event.

Question 50
Are there other events which should specifically be defined/presumed as 'external'?

Many events and circumstances are "external events" and it is impossible to provide an exhaustive list of all external events. Hereunder we list a few categories of "external events" with respect to which we currently would be discharged from liability, due to our inability to control the risks associated with them, even if these risks are theoretically foreseeable:

- Settlement system rules, market practices or other market infrastructure imposed constraints, e.g. rules which apply to settlement failure in non-DVP markets, liens imposed by CSDs
- Local market problems like market infrastructure failures
- Local market conditions such as market closures or currency devaluations
- Failure of counterparties chosen by the AIFM
- Force majeure or acts of third parties

We believe these are valid categories for ESMA to consider as 'external'.

Question 51
What type of event would be difficult to qualify as either 'internal' or 'external' with regard to the proposed advice? How could the 'external event beyond reasonable control' be further clarified to address those concerns?

Interconnectivity can lead to situations where it will be difficult to assess whether an event is "internal" or "external". Examples are the IT infrastructure such as the SWIFT messaging system used by the depositary and market infrastructure such as links of the depositary to clearing and settlement systems. Unless the depositary owns the relevant infrastructure we don't think issues caused by errors or unavailability of the infrastructure should be considered as 'internal'.

Question 52
To what extent do you believe the transfer of liability will / could be implemented in practice? Why? Do you intend to make use of that provision? What are the main difficulties that you foresee? Would it make a difference when the sub-custodian is inside the depositary's group or outside its group?

It may not be easy for the depositary to transfer the liability from a commercial perspective because of a subcustodian's unwillingness to accept it, and even so from a legal perspective it is unclear if the transfer of liability provisions can be made effective across all jurisdictions and legal systems. However we think there are two areas in which the liability should definitely be transferred:

- The AIFM decides to invest in an unstable exotic market
- The AIFM decides to invest in a financial instrument for which no suitable sub-custodian can be found

We also note that the commercial reality is such that sub-custodians sometimes are imposed upon the depositary by its client. In such a case the depositary may also want to transfer its liability.

Question 53
Is the framework set out in the draft advice considered workable for non-bank depositaries which would be appointed for funds investing mainly in private equity or physical real estate assets in line with the exemption provided for in Article 21? Why? What amendments should be made?

Both private equity and physical real estate assets are "other assets" hence the liability regime "liability for loss" would not apply. We are not aware that any amendments should be made.

Question 54
Is there a need for further tailoring of the requirements set out in the draft advice to take into account the different types of AIF? What amendments should be made?

We are not aware of any need for further tailoring

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Section VI - Possible Implementing Measures on Methods for Calculating the Leverage of an AIF and the Methods for Calculating the Exposure of an AIF

Questions 55-60
We will not be answering these questions.

Section VII - Possible Implementing Measures on Limits to Leverage

Questions 61 – 62
We will not be answering these questions.

Section VIII - Transparency Requirements

Questions 63-72
We will not be answering these questions.

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