

13 September 2011

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**ESMA consultation on the technical advice to the European Commission on
possible implementing measures of the AIFMD**

Euroclear response

We are pleased to be given the opportunity to offer Euroclear's¹ views on the ESMA's consultation on AIFMD implementing measures dated July 13 2011. As a provider of market infrastructure services related to securities settlement and custody (as a Central Securities Depository), our comments solely relate to Section V on Depositories. We also focus on those financial instruments that are qualified as "securities" (i.e. typically equity, fixed income and fund securities) as derivatives and other financial instruments are out of the scope of our activity.

General remarks

- While Central Securities Depositories (CSDs) or Securities Settlement Systems (SSSs) do not act as fund depositaries themselves, the vast majority of listed and non-listed securities are issued into, and held through, a CSD/SSS². Therefore, a fund depositary will hold a fund's securities assets either:
 - Directly with a CSD, by keeping a securities account in the CSD; or
 - Indirectly, by maintaining a securities account with an agent (acting as a sub-custodian), which in turn keeps a securities account with another agent (sub-custodian) or directly with the CSD.
- In the AIFM Directive, article 21 §10 on delegation of depositary functions recognises the specific role of CSDs by stating that the deposit of securities into a SSS as designated by the Settlement Finality Directive (Directive 98/26/EC) is not considered as a delegation. Its last sentence states: *"For the purposes of this paragraph, the provision of services as specified by Directive 98/26/EC of the*

¹ The Euroclear group is the world's leading provider of domestic and cross-border settlement and related services for bond, equity, fund and derivative transactions. User owned and user governed, the group comprises the international central securities depository Euroclear Bank, based in Brussels, as well as the national central securities depositories (CSDs) Euroclear Belgium, Euroclear France, Euroclear Nederland, Euroclear UK & Ireland and NCSD, the CSD for Finland and Sweden.

² In this response, we use the terms CSD and (operators of) SSS as synonyms.

European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems as designated for the purpose of that Directive 98/26/EC or the provision of similar services by non-European securities settlement systems shall not be considered a delegation of the custody function". The AIFMD Recital 28 provides further explanation on how to understand this sentence.

The result of this clause is that fund depositaries are not subject to the liability provisions of the AIFMD for the assets deposited in a CSD. They are, therefore, not considered liable in case of loss of securities at a CSD. The main rationale for this relates to the fact that CSDs are subject to a specific regulatory framework (comprising national legislation, EU and global standards such as the ESCB/CESR and CPSS/IOSCO recommendations for SSSs) making a loss of securities at this level extremely unlikely. Moreover, CSDs will be subject to their own specific legislation which is being prepared by the Commission (proposal foreseen for Q4 2011).

The AIFMD implementing measures on depositaries should take into account the specific role of CSDs and the specific clause in Art 21§10.

Answers to specific questions

➤ **Box 78 – definition of financial instruments to be held in custody.**
Q32 - Do you prefer option 1 or option 2 in Box 78?

Criterion 3:

On the definition of the financial instruments to be held in custody, we believe that Option 2 may not be workable in practice for the following reasons:

- Not all CSDs offer title transfer on their books. This is the case e.g. for Euroclear France. Option 2 would therefore be meaningless for e.g. French securities.
- Some assets, which are generally considered to be in custody, are not held in a CSD. For example, UCITS securities are not always deposited in CSDs. As a consequence, Option 2 would reduce the group of assets covered by the AIFMD requirements.
- Option 2 would require the AIFM to know which securities are ultimately held or settled in CSDs and which ones are not. This information is not always readily available to the AIFM or even its depositary.

- In addition, the AIFM would need to be transparent towards its investors about the different liability regime that applies to certain securities (i.e. those not deposited into a CSD), and this information would need to be available for each security held by the AIF.

We therefore believe that Option 1 should be applied and any instrument held in the securities account in the name of the depositary (and fulfilling other criteria) should be considered in custody.

➤ **Q33 – Under the current market practice, which kinds of financial instruments are held in custody in the EU Member States?**

With regard to securities, we believe that in all EU Member States, almost all securities are kept in book-entry form in securities accounts, even if the underlying securities are held in physical form. In the latter case, securities are immobilised (often in a CSD but sometimes also with an issuer or registrar) after which securities circulate by book-entry in securities accounts provided by custodian banks and CSDs. It is our view that most (if not all) securities that are kept for AIF will be in book-entry form and are therefore considered to be “in custody”.

➤ **Box 80 – Safekeeping duties**

As mentioned above, the AIFMD art 21 §10 specifically covers the situation where securities assets are held in a CSD and stipulates that such a situation should not be considered as a delegation of the custody function. This also means that the related liability clauses on delegation of the custody function to third parties do not apply. By implication, this means that depositaries are not considered responsible for failures occurring at CSDs. As mentioned above, EU CSDs are subject to specific national and EU legislation that aims to ensure the safety of these financial market infrastructures.

Should ESMA nevertheless conclude that a specific assessment of the CSD must be made by the fund depositary, we believe this assessment should rely on the regulatory assessment, disclosures and transparency measures already required under ESCB/CESR and CPSS/IOSCO standards applicable to CSDs. Furthermore, these CPSS/IOSCO standards are currently under review in view of being strengthened further and this should give the necessary comfort to the AIF(M).

➤ **Q45 - Box 86 – duties related to the timely settlement of transactions**

We would like to note that settlement of securities transactions should generally occur on a Delivery versus Payment (DVP) basis. This ensures that counterparties



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never deliver cash or securities without having received the corresponding securities or cash. If the depositary ensures that settlement occurs on a DVP basis, it is not possible for the AIF to have delivered securities or cash without having received the related cash or securities.

For settlement of transactions that do not occur on DVP basis, additional procedures may be required.

➤ **Box 91 – external events beyond reasonable control**

We agree that the loss of securities resulting from fraud, insolvency or default of a clearing or settlement system should be seen as an external event beyond reasonable control. The loss of securities at the level of the CSD is very unlikely. We believe it was for this reason that the clause in Art 21 §10 on SSSs was included in the AIFMD.

As this case is specifically dealt with in the text of the AIFMD itself, we do not believe that the AIFMD implementing measures would need to include additional details on this topic.

Illustration of delegation of the depositary's tasks

In the annex, we have included an example of how fund depositaries may delegate the securities holdings, and how the segregations of funds' assets will generally be implemented.

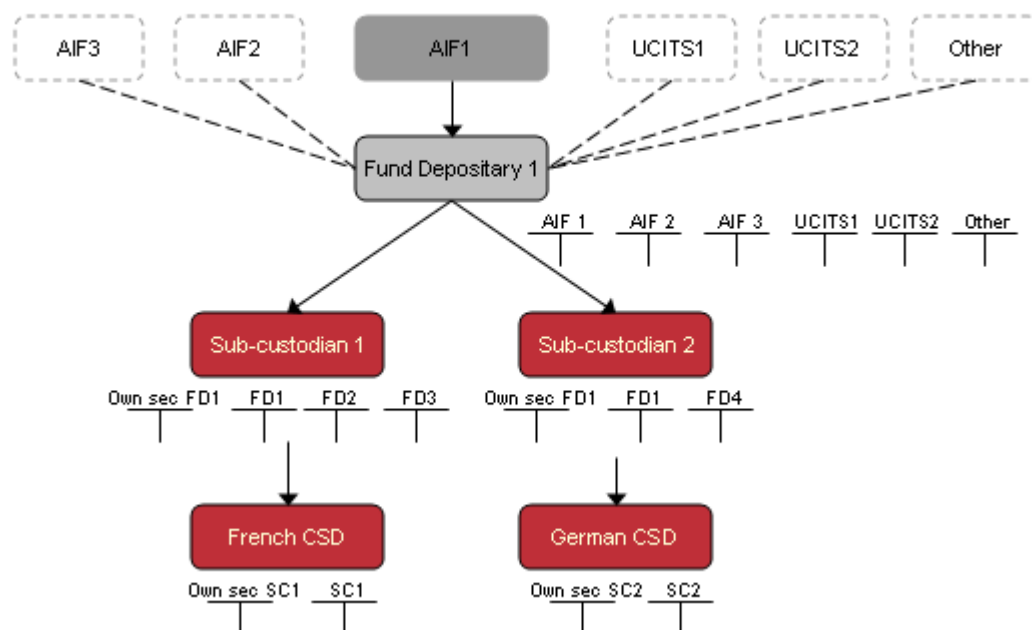
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ANNEX – illustration of typical holding pattern of fund assets (securities) using omnibus accounts (simplified)

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AIF1 invests in French and German equities.

AIF1 appoints Fund Depository 1 (FD1) as its depositary

FD1 is also fund depositary for AIF2 and AIF3, and for UCITS1 and UCITS2. It is also a depositary for 1 non-fund investor. In its own books, FD1 keeps separate securities accounts for AIF1, AIF2, AIF3, UCITS1, UCITS2, and the non-fund investor. FD1 can identify at all times which securities are held for each of these customers.

FD1 uses Sub-custodian 1 (SC1) for the French equities and Sub-custodian 2 (SC2) for the German equities.

FD1 opens **two** securities accounts with SC1:

- one to keep its own assets
- one to keep the assets of its customers (AIF1, AIF2, AIF3, UCITS1, UCITS2 and the non-fund investor): all assets are pooled into one securities account: SC1 does not/should not know the underlying customers and cannot/should not distinguish which securities are held on behalf of which underlying client, cannot/should not distinguish which securities are held on behalf of AIFs or UCITS.

FD1 opens two securities accounts with SC2 (same account set up)

SC1 is also the sub-custodian of FD2 and FD3. In its own books, SC1 keeps separate securities accounts for FD1, FD2 and FD3. SC1 can identify at all times which securities are held for each of its customers.

SC1 keeps **two** securities accounts in the French Central Securities Depository:

- one to keep its own assets



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- one to keep the assets of its customers (FD1, FD2, FD3): all assets are pooled in one securities account in the CSD. The CSD does not/should not know SC1's underlying customers and cannot/should not distinguish which securities are held on behalf of which customer, cannot/should not distinguish which assets are held on behalf of AIFs, UCITS or FDs.

SC2 has similar account set-up as SC1 but keeps securities with the German Central Securities Depository.

Note: account segregations are in line with MiFID requirements which require that client assets be segregated from own assets.

AIF1 appoints FD1, FD1 "delegates" safekeeping to SC1 and SC2; SC1 and SC2 deposit securities in the relevant CSD (no delegation).