Depositary And Trustee Association

ESMA Secretariat
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Sent by e-mail

Dear Sirs

ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Manager Directive ("AIFMD")

The Depositary and Trustee Association (DATA) represents all depositaries and trustees of UK based authorised funds. At the end of July 2011, the members of DATA were responsible for safeguarding £597 billion of fund assets.

We welcome the pragmatic approach taken by ESMA to the very difficult task of drafting Level 2 measures arising from the implementation of AIFMD. We would like to commend ESMA for producing detailed guidance in a very compressed timetable. In many areas, the suggested measures have taken into account concerns expressed by the industry and reflect ESMA's efforts to achieve a workable and proportionate framework in which industry will have to operate. However, concerns still remain or arise with regard to ESMA's proposals, and we believe further clarifications and modifications are required to ensure that, not only will the right balance be struck between additional protection and increased cost, but also a robust framework is implemented that avoids real unintended consequences.

Should these concerns remain unaddressed, especially in the context of liability and the consequences of fraud being perpetrated on an AIF by someone other than its depositary, then end investors are likely to suffer the increased cost of addressing the risks which will be transferred to depositaries in the proposed measures. One of the ways of depositaries mitigating their risk would be to limit their service offerings for certain types of asset and market, which will in turn limit investment choice and potentially reduce available returns to investors. With the initial decision and consequently the macro-level decision on where an AIF can invest being determined by the depositary, it will in effect move them into the realm of investment

management, something that we do not believe was the intended outcome of AIFMD.

There is also a serious concern that inappropriate allocations of risk have the potential to increase systemic risks among depositaries and those relying upon their services. This would be further pronounced if, as expected, similar or more onerous standards apply to the UCITS framework in forthcoming reforms.

In the Consultation, ESMA is asking for comments and feedback with respect to likely costs if certain provisions relating to depositaries were to be implemented. Given the current level of uncertainty around the final rules, as well as commercial sensitivities around such information, DATA at this stage refrains from providing specific cost implications. Indeed, any cost estimates for addressing issues such as the risk of third party fraud which is perpetrated on an AIF and its depositary would be entirely speculative, as the risk arises from criminal activity which is intended to avoid detection and not from operational processes which are relatively well understood. However, wherever appropriate, DATA makes reference in its response to general cost implications of the suggested implementing measures.

DATA believes that, in drafting the Level 2 legislation, European authorities should ensure:

- a proper distinction between the roles of the AIFM and the depositary;
- sufficient regulatory flexibility to reflect the diversity of alternative funds structures and underlying assets;
- proportionate requirements which reassure investors but do not impose unnecessary cost and administrative burden; and
- drafting which properly reflects the policy intentions as set out in the explanatory text.

In relation to the advice relating to depositaries, we provide detailed comments in the attachment to our letter.

In summary, our main comments are as follows:-

- In a number of instances, the Level 2 measures go beyond that required by AIFMD. Such proposals should be deleted or, where they are options, should not be pursued. One example is that of 'mirroring'. We believe that this would go beyond what is envisaged in AIFMD. Another example relates to Box 82. These measures appear to suggest that depositaries should oversee an AIFM's organisations and by inference that the AIFM is complying with Articles 15 and 20 of AIFMD. There is nothing in Article 21 which places a responsibility upon the depositary to ensure an AIFM's compliance with these articles. Responsibility for ensuring compliance with these Articles rests with the AIFM. The attachment to our letter highlights these and other instances where we believe Level 2 proposals go beyond AIFMD.

- It is vital that the Level 2 measures set out workable steps that a depositary can take to discharge its obligations in the event that it has advised the AIFM that it believes the only appropriate action is to dispose of particular

assets and the AIFM chooses not to act upon that advice. The roles of each of the depositary and AIFM should be distinct, but where there are conflicts between their approaches, the means of resolving the conflict should be specified.

A further matter which requires particular comment relates to depositary liability. The restitution obligations of depositaries in Article 21(12) of the AIFMD are quite clearly expressed; and, on the plain meaning of the text, will protect investors against the risk that a depositary will act without proper attention and care, resulting in the loss of financial instruments held in custody. We are concerned, however, that the positions reflected in Box 90 and the accompanying explanatory text, together with Box 91, are neither consistent with the plain meaning of Article 21(12), nor with settled legal principles, in certain respects.

In Box 90, the determination that a "loss" has occurred, which is relevant for the restitution analysis, as a result of "falsified evidence of title, accounting fraud, etc.", casts upon the depositary the burden to demonstrate that it can meet several conditions, which are found in Box 91. Among them is that, "Despite rigorous and comprehensive due diligences it could not have prevented the loss." In our view, this formulation is of a different legal character to the requirement in Article 21(12) that the depositary show that "the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been ***unavoidance despite all reasonable efforts to the contrary***" [Emphasis added]. "Reasonable efforts" is well understood to require the depositary to take the actions that would be expected of a person who has assumed their duties, but it does not require the depositary to take steps which would otherwise be unreasonable. The "rigorous and comprehensive due diligences" requirement could be understood to go beyond "reasonable efforts", so that the due diligence work of the depositary has to be accurate and complete in all possible respects; whether the steps that could have been taken to detect and address fraud are reasonable or unreasonable expectations. In cases of falsified documents or accounting fraud by third parties, we are concerned that the use of a "rigorous and comprehensive due diligences" standard will present a significant evidentiary obstacle to depositaries, which appears inconsistent with the plain meaning of Article 21(12).

We would also note that the restitution obligation of the depositary appears to arise from the point that the relevant assets have been taken into custody. If the depositary conducts due diligence on assets which have been placed with it after receiving them into custody, it would be too late to discharge its liability. In cases where falsified documentation is delivered to the depositary (for example, bearer instruments) for safekeeping, the depositary would have to perform "rigorous and comprehensive due diligences" on the documentation before accepting the relevant instruments. That is simply not practically possible: the depositary is not part of the transaction in which the documentation has been used, and in order to fulfil its custody function will have to accept financial instruments and physical assets delivered to it (usually by book entry through chains of intermediation) as they are presented.

Depositary And Trustee Association

In the enclosed attachment, we provide our detailed comments on the depositary provisions for your attention. Please do not hesitate to contact us if you would like to discuss any aspect of our submission.

Yours sincerely

David Morrison
DATA Chairman

ATTACHMENT

Depositary Provisions

Introductory paragraphs – pages 135-137

Paragraph 4 – The oversight wording does not reflect the requirements of AIFMD in that it is drawn too widely. We recommend that it is reworded to read "...and to oversee a number of specified tasks."

Box 74

Given that the contract appointing the depositary is a commercial agreement, the depositary will be aware of the need to set out the rights and obligations of the respective parties. While we question the benefit of including references to confidentiality obligations (which are governed by other legislation) we strongly support the inclusion of the obligation on the Manager to inform the depositary of all cash accounts.

We note that there may be suggestions from other respondents that the Level 2 measures should require additional elements to be included in this agreement. We would note that we believe that the Level 2 measures in this regard provide sufficient coverage.

Comments on "Explanatory Text" after box 74

While in principle we support the inclusion of termination provisions in paragraph 10, we however doubt whether under the proposed framework they will work in practice. There is always the potential for the depositary to resign but in order for the AIFM to remain compliant with AIFMD we envisage that a replacement depositary would need to be willing act. Where the existing depositary is resigning due to being dissatisfied that the "assets are correctly protected" it is highly unlikely that an alternative depositary would be willing to act.

We support ESMA's decision not to provide a model agreement. We agree that the advice combined with the Level 1 text provide a robust framework. In addition a model agreement could not be sufficiently flexible to reflect the wide range of alternative funds structures and investments that fall within the scope of AIFMD.

Introductory paragraphs – pages 143-145

Paragraph 5 – A regulatory obligation should be placed upon AIFMs to comply with the cash placement requirements set out in Article 21(7) where AIFMs open cash accounts. Placing cash is an investment decision and as such AIFMs should be required to place monies only with entities specified in Article 21(7). Such an obligation should not simply be left to contract. Such an approach would also be consistent with MiFID which requires investment firms to place money only with suitable institutions.

Box 75

The Level 2 measures should make provision for consequences of the AIFM being deemed not to have satisfied the requirements of Article 21 of the Directive. In other words, what action should the depositary exercise in the event of the AIFM not satisfying the requirements (for example notification to the regulator)? In our view, the last sentence of Box 75 should be amended to say that if the AIFM does not satisfy the requirements, the depositary cannot exercise its duties and should therefore be exonerated from its liability.

Comments on "Explanatory Text" after box 75

The Level 2 measures require that the AIFM should ensure the depositary is provided with all information to comply with its cash monitoring duties. The explanatory text states that such information can be provided directly by the AIF/AIFM or by another entity such as a prime broker or third party bank. Historically depositaries have encountered difficulties in receiving information from such third parties and DATA would encourage ESMA to require AIFMs to impose corresponding disclosure obligations on their counterparties/agents.

Box 76

DATA prefers option 2. Requiring the depositary to act as a central hub would be disproportionately costly and administratively difficult. Depositaries would be required to build platforms capable of managing a very large volume of cash payments. Such platforms would confer very little benefit to investors but would be costly and create an additional layer of operational risk for AIF/AIFM and investors. Furthermore, option 1 might limit AIF/AIFM investment choice to the detriment of the investor by creating network inefficiencies. Rather, the depositary should exercise an oversight role as set out in option 2, which is proportionate and overlay the existing arrangements rather than involving unnecessary disruption of current processes.

In addition, the wording of AIFMD strongly suggests that the intention was not for the depositary to act as a central hub. The AIFMD states that the depositary **shall in general, ensure** that cash flows **are properly monitored**. It does not say that the depositary **shall monitor** (our emphasis) and therefore goes beyond the requirements of Article 21.7. The Directive clearly anticipates another party monitoring and the depositary overseeing that process.

If option 1 were pursued, clarification of the term 'mirror' would be required and also it is unclear how such an approach would enhance investor protection.

Comments on "Explanatory Text" after box 76

We support the use of terms such as "appropriate interval" and "review periodically" in Box 76 as they confer flexibility on the depositary to determine the frequency of

verification and oversight checks. Therefore, we are concerned by the suggestion in the explanatory text that where reconciliations are performed on a daily basis the depositary would be expected to perform its verifications on a weekly basis, and indeed paragraph 9 contains significantly more detail than appears in Box 76 under option 2 (such as conducting a full review of the reconciliation procedures on an annual basis). Given the diversity of alternative funds, the frequency should be decided by the depositary reflecting the nature, scale and complexity of the fund and the underlying investor base. We suggest that ESMA adopts the approach as set out in relation to oversight of the valuation process: ensuring that the appropriate procedures are in place and that they are effectively implemented.

We agree that AIFMD on oversight of cash and subscriptions and redemptions is somewhat inconsistent and DATA supports the decision of ESMA not to provide further guidance in relation to the depositary's duties regarding subscriptions. We believe that the requirement is covered by the depositary's general oversight duties.

Paragraph 9 - This should include a similar statement to that included in relation to option 1; namely, that investment decisions remain in the sole hands of the AIFM.

First bullet point in paragraph 9 – The requirement should be to that of monitoring to ensure that the AIFM has processes and procedures in place to swiftly identify any anomaly and take corrective measures without undue delay. In addition, we believe that the AIFM should be under a regulatory obligation to report any anomalies it identifies together with corrective action to the depositary. This should not simply be left to contract.

Box 77

A regulatory obligation should be placed upon AIFMs to comply with the cash placement requirements set out in Article 21(7) where AIFMs open cash accounts. Placing cash is an investment decision so AIFMs should be required to place cash only with entities specified in Article 21(7). Such an obligation should not simply be left to contract. Such an approach would also be consistent with MiFID which requires investment firms to place money only with suitable institutions.

Paragraph 1 requires the depositary to '[…] *take 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*. It is not possible for the depositary to satisfy this requirement in practice. If cash is booked with a third party as a deposit, the third party accepts that cash as banker with the result that the cash would not be considered to be distinct from cash belonging to it. The AIF, and more specifically the depositary acting on behalf of the AIF, would only hold a claim as a creditor on the third party. For this reason, we strongly recommend the deletion of the reference to cash of the third party.

In addition, paragraph 2 mandates that the depositary '[…] *must ensure that the AIF's cash is booked in one or more cash accounts opened at an entity referred to in* [MiFID Level 2] *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'. However, AIFMD only refers to accounts being opened 'in the relevant market where cash accounts are required' without mentioning further limitations. It is important that the implementing measures recognise that accounts may be opened for other purposes, such as facilitating distribution of income or to satisfy local marketing/distribution requirements. DATA therefore suggests the following additional changes to 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**ed** a cash account ~~in relation to an investment decision~~ **in the relevant markets where it is in the best interest of the AIF.** "

Q25: How difficult would it be to comply with a requirement by which the general operating account and the subscription / redemption account would have to be opened at the depositary? Would that be feasible?

It would be inappropriate to require these accounts to be opened at the depositary. AIFMD explicitly provides for cash accounts to be opened with authorised entities different from the depositary and so any proposal which required such accounts to be opened only at the depositary would result in a restriction of the flexibility expressly provided for in AIFMD. In fact in many instances the depositary, while often being a subsidiary of a bank, is often not a credit institution. It should be the responsibility of the AIFM to decide where to open the accounts in the best interests of investors. This requirement could also have a damaging impact on distribution channels and serious cost and administrative impacts on accounts and systems. Such costs would ultimately be borne by investors. The obligation should be for the depositary to have access to information regarding such accounts in order to have proper oversight of cash flows.

Please also see comments on explanatory text following box 83.

Q26: At what frequency is the reconciliation of cash flows performed in practice? Is there a distinction to be made depending on the type of assets in which the AIF invests?

Frequency of reconciliation of cash flows depends on many matters including the nature of the fund and the size and nature of the investor base. For example, whether a fund is open ended or close ended and the liquidity of the underlying assets will impact the frequency of reconciliation. It is the AIFMs responsibility to ensure that it has the systems and controls to monitor cash flows and this will include the frequency thereof. The depositary's role is one of oversight of the AIFM.

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

WE are unaware of any practical problems in this regard.

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

Yes. There may be difficulties accessing the necessary information from the prime broker and there should be a disclosure obligation on all counterparties/agents of the AIFM/AIF.

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

DATA prefers option 2 – further detail is provided in response to Box 76.

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

We consider that option 1 would be vastly more expensive than option 2.

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

See response to Q30 above.

Box 78

DATA prefers option 2 as it is in line with our view that only assets over which the depositary has control and is able to retrieve if necessary should be required to be held in custody.

In addition, edits to the proposed provisions concerning financial instruments that are directly registered with the issuer itself or its agent are suggested. Our recommended edits take into account that financial instruments may be held directly with the issuer itself or its agent in the name of the depositary or its sub-custodian/agent and the depositary as the depositary does not select the issuer or the registrar/transfer agent. A parallel can be drawn with CSDs or settlement

systems as referred to in explanatory text of Box 80 of the Consultation.

"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**~~

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

~~**Option 2**~~

3. they are financial instruments with respect to which the depositary may itself or through its sub-custodian instruct the transfer of title or an interest therein by means of a book-entry on a register maintained by a settlement system as designated by Directive 98/26/EC or a similar non-European securities settlement system which acts directly for the issuer or its agent **and that the financial instruments are held in custody by the depositary within its sub-custody network**.

Additionally, financial instruments which ~~can be~~ **have been** physically delivered **in accordance with standard market practice** 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) **directly or indirectly** in the name of the AIF **or the depositary or its agent on behalf of one or more clients** should not be **considered to be** held in custody unless ~~they can be~~ **bearer instruments have been** physically delivered to the depositary, **in accordance with standard market practice**. 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. "

Comments on "Explanatory Text" after box 78

For purposes of identifying where the depositary's obligations arise under Article 21(8)(a), DATA shares the custody industry's view that it is important to distinguish financial instruments which are held in "nominee name" with a settlement system (CSDs, ICSDs) by a depositary/custodian or a nominee company from financial instruments such as units of a fund not traded on a regulated market or private equity shares that are merely registered in nominee name directly with an issuer (which are usually inscribed in a register by a registrar or transfer agent appointed by the issuer or its agent).

Where the depositary/custodian is the participant in the settlement system:

- Rights and obligations of ultimate owners of securities are addressed via the "participation" agreement or "rules" of the CSD, which often have the force of law.
- Securities are registered in a regulated settlement system (CSDs and ICSDs) that provides for the conditions necessary for the shares to be considered "held in custody" under the Directive. These conditions include providing for certainty of transfer of ownership arising from "delivery versus payment/receipt versus payment" ("DVP/RVP") on settlement of the relevant transaction, which the depositary/custodian effectively controls via its participant account at the CSD/ICSD (either directly or indirectly via the sub-custodian). This in turn provides assurance as to when customers (such as AIFs) become entitled to ownership of the relevant securities. The forthcoming Securities Law Directive is clearly relevant to providing a more uniform approach within the EU.
- The custody agreement with the depositary/custodian sets out the conditions (and rights) surrounding these shares: the AIF's rights to the relevant financial instruments are made subject to the rules of the CSD, for example.

Where the financial instruments are merely "registered in the nominee name" of the depositary/custodian or its subsidiary nominee company:

- In the case of funds or securities not traded on a regulated market, there is no participation agreement linking the depositary/custodian to the registrar or transfer agent. Instructions to invest in such financial instruments involve an instruction to deliver cash "free of delivery" (unlike a CSD setting, where investments are legally effected by settling on a "DVP/RVP" basis).
- The choice of investment, including relevant due diligence, is carried out by the AIFM.
- The client of the depositary/custodian typically discusses all aspects of possible

investment with the issuer and then – if it prefers not to make the investment itself directly - might instruct the depositary/custodian to make the investment on its behalf by filling out the necessary subscription documents: the subscription documents would indicate that the depositary/custodian or its subsidiary nominee company is the registered owner, usually "for the benefit of ("FBO") underlying client". The client may or may not be named. The depositary/custodian's records would not normally indicate such investments as being "held in custody" per se.

Both private equity shares and interests in funds may be invested in without use of a depositary/custodian's or its subsidiary's nominee name. It is common for such investments to be held "directly" (i.e., in the name of the AIF) as well. In some cases, this is necessitated by the legal structure of the target investment or other factors. If "option 1" is selected, it seems likely that all such holdings will migrate to a "direct" approach if depositaries are to avoid taking unwarranted risk that they cannot control.

In respect of "[…] *financial instruments which can be physically delivered to the depositary should be held in custody*", the text should be revised slightly so that it does not ***require*** interests in funds to be "certificated" or physically issued simply because this is possible. Not all fund shares and interests should be required to be "physical" simply because this is allowed under the AIF's rules. There are many potential reasons why this would not be desirable, including costs associated with printing and maintaining certificates, increased risk of error and continuation of the EU's prudential policy goal of reducing fraud risk associated with bearer certificates.
Furthermore, the proposal that "[…] *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*", should be revised. If re-hypothecation could result in title transfer, the suggested approach would be inconsistent with the proposed rule in Box 79.

Finally, the last bullet point of explanatory note paragraph 29 refers to "*cash deposits with a third party*" as "*financial instruments*" which would fall under the "*other assets*" category. This bullet point should be deleted because cash is not considered a "*financial instrument*" within the meaning of MiFID. There is no need to include cash within the definition of "*other assets*" since the depositary's cash monitoring and other obligations separately arise pursuant to Article 21.7.

With regards to the '*other assets*', we support the suggested *a contrario* approach as it avoids interpretation difficulties and allows for a clear distinction.

Q32: Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view.

Please see our comments in response to Box 78.

Q33: Under current market practice, which kinds of financial instrument are held in custody (according to current interpretations of this notion) in various Member States?

No comment.

Box 79

DATA prefers option 3 as the most pragmatic approach: not only does it ensure consistency with other EU legislation, it avoids the need for the depositary to analyse the legal effect of each individual collateral arrangement.

The text would benefit from a small change, so that it says, "Financial instruments provided as collateral shall not be regarded as held in custody if and when they are provided…". Otherwise, there may be ambiguity which could lead to the interpretation that assets that are pledged as collateral should be taken out of custody; i.e., placed with a separate collateral agent. We understand that the intention is only to clarify that, so long as financial instruments are being held as collateral, they are not to be treated also as assets under custody. This drafting change will align the text with that intention more closely.

Q34: How easy is it in practice to differentiate the types of collateral defined in the Collateral Directive (title transfer / security transfer)? Is there a need for further clarification of option 2 in Box 79?

If option 3 is adopted, there will be no need to differentiate between the two types of structure. Obviously, title and security transfer constitute the structure, rather than the "collateral" per se as suggested by the question.

Box 80

We believe paragraph 1(b) should be amended to read "Exercise due care in relation to the financial instruments held in custody to ensure a level of protection which is proportionate to market convention and infrastructure."

We would also welcome further clarification in respect of the requirement under 1 (c). Currently depositaries provide AIFMs with information of the markets they are invested in. This includes assessments of certain perceived and potential risks in these markets. The requirement as set out goes beyond what is market best practice, especially by establishing a legal obligation for the depositary to inform the AIFM of any material risk identified. In the context of very recent political developments in North Africa, such risks can materialise without prior notice. We would therefore recommend that the wording be amended as follows :

"1 (c) **Ensure that appropriate processes are in place to collect, monitor and** assess **information on** ~~and monitor all~~ relevant custody **conditions and** risks **existing in the markets where the AIF is invested**. In particular, depositaries should **make reasonable efforts to** ~~be required to assess the custody risks related~~

~~to settlement systems and~~ inform the AIFM of any material **changes in custody** risk **and conditions as such information becomes available** ~~identified~~."

There is a typographical error in paragraph 2. Box 16 relates to the handling of orders. We believe the reference should be to Box 89.

Comments on "Explanatory Text" after box 80

It should be clear in the implementing measures that the AIF and/or AIFM after receipt of information from the depositary, as well as from other legal or investment resources it may utilise, should weigh specific custody and country risks against the fund's own internal investment objectives. It should be recognised that the AIFM has an obligation to understand and assess the level of market and custody risk on an ongoing basis as part of an effective risk management framework as required by Article 15. Article 15 requires, amongst other things, that the AIFM identifies, measures and monitors appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed. This would naturally include custody, market and country risks.

Box 81

DATA supports option 1. To require the depositary to 'mirror' transactions would be duplicative, prohibitively costly and of little benefit to investors. We agree that the depositary should be required to keep an up to date inventory of the AIF's assets, however it should be able to rely on evidence from relevant third parties.

In order for the depositary to comply, at a reasonable cost, with its obligation it should be clarified that transactions such as listed derivatives and for transactions related to assets provided in collateral, the depositary can discharge its assets monitoring duties by receiving and storing electronic data flows which are periodically sample checked. We would therefore recommend the following wording is included in respect of option 1.

"or

(iii) receive and store electronic data flow from the relevant third party on a timely basis."

Comments on "Explanatory Text" after box 81

DATA would like to underline the need for a flexible approach to verification of ownership. We believe that option 1 provides sufficient flexibility while affording appropriate protection for investors. In determining the obligations of the depositary it is that sufficient guidance is given on what constitutes "sufficient and reliable information" to verify ownership. We are strongly of the view that further detailed guidance on this point is required at Level 3 and therefore would support ESMA

developing guidelines in this respect as referenced in paragraph 37. Insufficient clarity has been provided in the explanatory text in paragraph 38

DATA welcomes clarification from ESMA that a copy of an official document evidencing ownership or any formal and reliable evidence that the depositary considers appropriate may be used; but if the depositary has to validate the authenticity of such documentation, for the purposes of boxes 90 and 91, then there is a serious risk of inefficiencies arising. We assume that examples will be provided via Level 3 advice.

The Level 2 measures state that where a prime broker has been appointed, the reporting requirements imposed by the UK FSA could constitute a good reference point. We agree that these requirements are a good starting point but a commitment to provide fuller reporting would be helpful in order that, as AIFMD requires, the depositary may know "at all times where the assets are".

Not everyone will be familiar with the requirements the UK FSA places upon prime brokers and, in addition, paragraph 44 makes reference only to some of those requirements. The Level 2 legislation should set out clearly all such requirements which are relevant in order to ensure that a consistent approach is applied across all implementing jurisdictions.

We also believe that it would be helpful to clearly state the requirement placed upon the AIFM, as part of its investment decision making process, to satisfy itself of ownership when transacting in assets for the AIF, and to provide evidence of ownership. Again, this should not simply be left to contract.

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

DATA would expect delegation of non-custody safekeeping duties (presumably verification/recordkeeping of other assets) 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. The record-keeping arrangements have the potential to be very resource-intensive and the supervision of delegated functions will also require significant investment in personnel and systems.

Q36: Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

See comments regarding Box 78.

In addition, depositaries do not differentiate in levels of control between (i) and (ii), however we would point out that the majority of assets are held in the name of the depositary on behalf of the AIF, with the exception being where local legislation

dictates that that assets must be in the name of the fund directly. We are not aware of assets being held as per (iii).

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

Yes, this is possible and desirable.

Q38: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 8? Please provide an estimate of the costs and benefits related to the requirement for the depositary to mirror all transactions in a position keeping record?

Option 2 would be vastly more expensive than option 1 and the marginal benefits are unclear.

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

We agree with ESMA that it is important to adopt a pragmatic approach to verification taking into account the different types of assets. We believe that if the depositary is unable to rely on documentary evidence regarding ownership, it will have a significant impact on the efficiency of the savings and investment sector represented by AIFs.

In addition, legal and ownership structures can vary tremendously, especially as regards private equity and real estate. Therefore, the depositary should be able to rely on legal opinions or appropriate documentary evidence without incurring associated liability.

Box 82

The wording in the box should make it clear that the specific oversight duties as set out in Article 21(9)(a)-(e). In our view, ESMA's recommendation goes well beyond the requirements of Article 21.

Paragraph 1 - AIFMD does not place any responsibility on the depositary to assess the risks associated with nature, scale and complexity of the AIF of the AIF's strategy and the AIFM's governance arrangements. Such responsibility rightly sits with the AIFM as required by Article 15 and Article 20. For that reason, we believe the broad reference to the AIFM's organisation should be deleted from this paragraph.

Paragraph 3 - The text refers to 'potential irregularities'. This is too vague and gives rise to much uncertainty. Will these be elaborated upon in the Level 3 measures or will it be left to each national regulator to determine? We note that the implementing measures for UCITS IV (Commission Directive 2010/44/EC) contains a list of types of irregularity upon which we would encourage ESMA to give consideration to producing a similar list

Comments on "Explanatory Text" after box 82

Paragraph 48 – This paragraph is drawn too widely. It should be for the depositary to determine what factors it needs to take into account in relation to the matters for which it has an oversight responsibility under Article 21(9).

Paragraphs 49 and 51 could be taken to imply that a depositary needs to be satisfied that the AIFM has complied with Article 20 regarding delegation. This is not one of the depositary's oversight duties. Responsibility for ensuring that the requirements of Article 20 are met rests with the AIFM. The AIFM needs to be in a position to satisfy its competent authority regarding its delegation arrangements.

In addition, definitions of the third parties specified in paragraph 49 would be helpful.

Box 83

Paragraph 1 in Box 83 causes concern within the depositary industry: In certain jurisdictions, the registrar or transfer agent function is undertaken by the depositary and therefore a re-performance of the reconciliation is difficult to perform. ESMA should focus solely on the oversight by the depositary of this process.

Further information is provided in the comments below.

Comments on "Explanatory Text" after box 83?

There is not a 'one size fits all' in relation to creation/cancellation process across the European jurisdictions or product types. Depending on the jurisdiction the AIFM may be dealing as principal or as agent in relation to the units. Particularly where the AIFM is acting as principal (which is the case in the UK) the monies received from investors are, until they are paid into the fund on the settlement date, completely outside the fund and are held in the dealing account which is in the managers name and to which the depositary has no access. The managers dealing account will generally be opened and operated by the fund's registrar. In these circumstances it is not uncommon for the manager to hold units in his box (these are units held by the manager but not actually reflected on the fund's register) and as such it will not be possible for the depositary to directly reconcile the managers dealing bank account with the dealing orders as the manager may be utilising units held in its box. For existing funds the depositary does oversee the process in that at each dealing point where units are to be created or cancelled the manager will issue an instruction to the depositary noting the number of units to be created and cancelled, the number of units held in the manager's box and the total units in issue. The depositary will ensure that for the creation of units the manager/registrar instructs the cash transfer to the fund on the settlement date for payment of the units and for cancellations the depositary will instruct the cash transfer from the fund to the managers dealing account. Any failure in the cash transfer process would be logged as a breach. Separately as part of the depositary's due diligence process, it will conduct an on-site visit to the registrar, on a frequency determined by a risk assessment, to review the registrars processes and controls in relation to unit dealing which includes cash transfers.

In many other European sites the manager is acting as agent and as such the investor will be dealing direct with the fund and as such the transfer agent/registrar will perform a reconciliation process of the monies received or to be paid into and out of the subscription account for the creation and cancellation of units.

We believe it to be completely appropriate for the depositary to oversee the dealing process by reviewing the registrars, transfer agents or manager processes and controls so that the units in issue are reconciled to the cash receipts. Any suggestion that the depositary should be independently re-performing or mirroring the reconciliation would in our view be a cumbersome, time consuming and costly process which would in fact not create any additional protections for investors.

We wish to support ESMA's view, in the context of paragraph 56, that the depositary has no responsibility to ensure that no units/shares are sold where this has been defined in the rules of the AIF. Any suggestion in this respect would go beyond the requirements of Article 21.

We do note that this section does not appear to deal with what needs to be done for closed ended funds or for listed AIFs. We ask that this section be expanded to deal specifically with such funds.

Box 84

The responsibility of the depositary is to ensure that the **value of units or shares has been calculated** in accordance with the applicable national law, the AIF rules or instrument of incorporation and the procedures laid down in Article 19. Checking the appointment of a valuer is not captured by Article 21(9)(b). That Article requires the depositary to "[*...] ensure that the value of the units or shares of the AIF are calculated in accordance with the applicable national law, the AIF rules or instruments of incorporation and the procedures laid down in Article 19 [...]*".

Different from ESMA's recommendations, the depositary is hence not required to directly '*oversee*' the valuation of the AIF's assets. Accordingly, we recommend the deletion of point 1 of Box 84. Furthermore, we would advocate further clarification regarding the allocation of responsibilities in the valuation process and would therefore recommend the following amendments to point 2 of Box 84 as follows:

"*The depositary should ensure that the policies and procedures for the calculation of the value of the units or shares of the AIF are effectively implemented and periodically reviewed.*"

In addition, point 3 should be amended to replace '*valuation policy*' with '*policy for the calculation of the value of the units or shares of the AIF*' as the depositary is not required to oversee the valuations of assets or the decision to appoint an external valuer.

Point 5 should be deleted. It is the responsibility of the AIFM to ensure that it has properly appointed any external valuer in accordance with Article 19.

Comments on "Explanatory Text" after box 84

DATA welcomes confirmation that the AIFM remains responsible for the valuation process, in line with current expectations, and that the depositary is expected to ensure that reasonable procedures are in place to perform the NAV calculation and that they are effectively implemented. We note that ESMA advises that the frequency of the depositary's checks should be proportionate to the frequency defined in the AIFM's valuation policy. We support the reference to proportionality which better reflects the diversity of alternative fund structures/underlying assets as opposed to "one size fits all".

We also encourage ESMA to delete reference to the following sentence in the context of paragraph 58 "When setting up its oversight procedures, the depositary should ensure that it has a clear understanding of the valuation methodologies used by the AIFM or the external valuer to value the assets of the fund". This is outside the direct remit of the depositary. Lastly, we would disagree with ESMA's recommendation that the *depositary should ensure that it has a clear understanding of the valuation methodologies used by the AIFM or the external valuer to value the assets of the fund.* This requirement would be outside of the depositary's direct remit and the relevant sentence in ESMA's draft advice should therefore be deleted.

Box 85

No comment.

Comments on "Explanatory Text" after box 85

DATA agrees that the oversight duties related to the carrying out of the AIFM's instructions is the core of the depositary's ongoing oversight duty. We welcome confirmation that compliance consists in ex post oversight. We note that the oversight role of the depositary is potentially complex given restrictions under AIFMD, for example, on investment in securitisation positions and DATA would welcome clarification that the role is one of oversight not re-performance.

Paragraph 62 - This states that the depositary "should for example check the AIF's investments are consistent with its investment strategy as described in the AIF rules and offering documents with a view to ensure it does not breach its investment restrictions, if any." Any suggestion of monitoring investment strategy is crossing the line into investment management. Wherever possible the depositary will monitor the fund to the investment objective and policy and the any stated investment restrictions but to actually monitor the investment strategy to achieve the stated investment objective and policy is a different matter and should not fall within the remit of the depositary. Any suggestion or recommendation in this respect would go beyond Article 21.

In addition, paragraph 62 states that the depositary "should also monitor the AIF's transactions and investigate any 'unusual' transaction it has identified in conjunction

with its cash monitoring duties." We are concerned by the potential breadth of this undefined term and if such a transaction were not identified, whether that would be deemed to be a failing by the depositary.

Box 86

DATA prefers option 1 as there is little evidence of detrimental divergence across Member States regarding this duty and given the diversity of AIF, depositaries should be granted sufficient flexibility to assess appropriate time limits.

Comments on "Explanatory Text" after box 86

The question of appropriate time limits should be resolved at industry level – in any event we doubt whether all "relevant contracts" would necessarily detail the usual time limits.

Box 87

DATA notes that these duties 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. This is based on the fact that, especially in the alternative investment space, distributions may take many forms and are often declared only after the AIFM has decided on working capital requirements and other strategic issues.

Under points 1 and 3 in Box 87, the calculation of the net income for fund operations would require the depositary to enquire into the portfolio management decision regarding available cash, and possibly even 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 in our view would only interfere with management discretion and in any event only be possible by incurring significant duplication and thus higher costs without benefits to investor protection.

In addition, point 2 in Box 87 suggests requiring the depositary to ensure that appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements. In our view, this goes beyond the oversight duties required of the depositary. In the case of such concerns, it should be the duty of the auditor and ultimately the relevant competent authorities to ensure that appropriate actions are taken by the AIFM.

DATA recommends amending Box 87 as follows:

"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.Check the completeness and accuracy of dividend payments and where relevant the carried interest."~~

Comments on "Explanatory Text" after box 87

We would query the applicability of these requirements to closed end funds.

Q40: To what extent do you expect the advice on oversight will impact the depositary's relationship with funds, managers and their service providers? Is there a need for additional clarity in that regard?

We expect the advice to lead to closer liaison between depositaries and service providers. In order to perform their oversight and due diligence obligations (for example, delegated verification) depositaries will require evidence and information from entities such as prime brokers and administrators. It is important that depositaries are able to access this information and DATA reiterates the need for placing regulatory disclosure obligations upon AIFMs and services providers with respect to the depositary.

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

In the UK, it is the trustee (i.e the depositary within the meaning of AIFMD) which has to create or cancel shares due to the unit trust not having a legal identity. For open ended investment companies ('OEICs'), it is the OEIC itself which is responsible for creation and cancellation of share albeit that from an operational perspective the approach to both product types is identical. We are not aware of any conflicts arising from the depositary having such a responsibility but it is rather a control mechanism by which the depositary can monitor and oversee in particular the AIFM's box and also the cash movements in and out of the fund. We note that there is no functional or hierarchical segregation as it is in some circumstances the depositary that is issuing shares.

Q42: As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the

AIF is compliant with the applicable national law and the AIF rules and / or instruments of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

See comments in Box 83.

Q43: Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

We strongly support ESMA's opinion that there is no duty of the depositary to oversee the selling and buying of units on a second level e.g. secondary market.

With regard to Box 83, we do note that this section does not appear to deal with what needs to be done for closed ended funds or for listed AIFs. We ask that this section be expanded to deal specifically with such funds. Alternatively, it should be covered at Level 3 so that there is certainly as regards what needs to be done for such funds.

Q44: With regards to the depositary's duties related to the carrying out of the AIFM's instructions, do you consider the scope of the duties set out in paragraph 1 of Box 85 to be appropriate? Please provide reasons for your view.

DATA believes that while the scope of the duties may be appropriate, the depositary industry may benefit from clarification at Level 3 of the appropriate procedures to ensure compliance (see comments in Box 85). Additional clarity would be helpful concerning the scope of the proposed obligations in Box 85 given that paragraph 62 of the Explanatory Notes introduces the idea that the depositary should check whether "*the AIF's investments are consistent with its investment strategy […] to ensure it does not breach its investment restrictions*". While a depositary might seek to "*ensure*" that investment restrictions are not violated, a legal obligation for the depositary to ensure that an AIF's investments are consistent with its investment strategy would not be possible to be met for certain asset classes such as real estate in most cases and would involve an unacceptable level of subjectivity in the execution of the depositary function. In addition, we should welcome the explicit clarification that the monitoring of compliance with the fund's leverage limits does not require the depositary to assess and validate these limits.`

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

See text in Box 86.

Box 88

In our response to ESMA's Call for Evidence in January 2011, we recommended that with regards to the **due diligence** requirements of the depositary, procedures for

the selection and appointment of third party entities such as sub-custodians and their periodic review and ongoing monitoring, should reflect existing international standards adhered to by both depositaries and global custodians. We therefore welcome that in its draft advice, ESMA is proposing a series of principles that are based on such best market practice.

Under point 1(a)(i), the depositary's duty to assess the enforceability of contractual agreements seems very wide and potentially very costly to implement in practice. A more targeted approach (e.g., specifying key contracts and, if possible, key provisions in such contracts) would potentially be more useful and cost effective (e.g., segregation provisions in sub-custody agreements), although it should be recognised this may entail obtaining legal opinions for each contract in each market beyond what might ordinarily be obtained - a significant additional expense. Absent more specificity here, DATA recommends deleting the reference to enforceability of contractual arrangements. In addition, under point 1(a)(i), the depositary is required to 'determine the potential implication of the insolvency of the custodian'. We believe that where a depositary delegates to a global custodian, the depositary should be able to rely upon the relevant diligence of that global custodian in relation to assets delegated further to sub-custodians.

Point 1(b)(ii) – The reference should be to box 89 rather than 16.

We would also recommend changes in relation to point 3 in Box 88. ESMA suggests that the depositary shall terminate the contract in the best interests of the AIF and its investors where its delegate no longer complies with the requirements. This approach seems too rigid. Instead, we would suggest a multistage process having due regard to the risks which would first allow the depositary to require its delegate to undertake appropriate remedial measures before having to terminate the contract if the non-compliance of the delegate with the requirements continues. This would allow for a more flexible and workable process that takes into account the operational realities around changing the sub-custodian. Where the sub-custodian does not meet the depositary's requirements because of external risks, the relevant authority and the AIFM should be informed, so as the AIFM can make arrangements. In such situations and following the informing of the AIFM and competent authorities by the depositary, liability in the event of a loss must rest with the AIF and not the depositary.

Comments on "Explanatory Text" after box 88

DATA supports the decision of ESMA not to adopt a box ticking approach to appointment and on-going monitoring and review. We agree that the depositary's potential liability for loss of financial instrument held by its sub-custodians is the strongest incentive to perform adequate due diligence.

Box 89

Ensuring the proper **segregation** of AIF assets is one of the main elements in the selection and monitoring process of the depositary's sub-custodians when it is performing the custodial function and plays a key role in the protection of investors' assets and interests. We therefore agree with the importance attributed to it and support the suggested implementing measures as set out in Box 89. In particular, we welcome and strongly support the explicit recognition of the validity of the use of *omnibus accounts* given their wide-spread use in the industry. Assets held in *omnibus accounts* are segregated by the records on the depositary's system, which ensure at all times that depositary can identify client assets. We do not believe that further segregation would bring additional benefits.

We would like to add one general comment with respect to segregation for cash accounts described in Box 89 1(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'*.

Adequate recordkeeping can be maintained by depositaries and their sub-delegates identifying cash assets as belonging to an AIF or as being held by a third party for the benefit of the AIF. However, it should be clearly understood in the implementing measures that, in accordance with industry convention, cash, unlike securities, deposited in a credit institution is not subject to physical segregation. The deposit of cash gives a contractual right to claim repayment from the credit institution but the cash deposited is not a separately identifiable asset. Deposit accounts are subject to some measure of credit risk to the institution taking the deposit.

Comments on "Explanatory Text" after box 89

DATA welcomes the acknowledgement that sub-custodians may use omnibus accounts and that in some countries the segregation requirements under AIFMD may still not be sufficient to protect the assets in certain cases, due to the nature of the legal environment.

As regards segregation of 'other assets' (referred to in Explanatory Note 5, page 176 of the ESMA consultation paper), we would recommend including this principle formally in the Level 2 measures, for legal certainty purposes. Absent a formal rule, depositaries may have difficulties imposing segregation requirements to their delegates for assets held in recordkeeping.

Q46: What alternative or additional measures to segregation could be put in place to ensure the assets are 'insolvency-proof' when the effects of segregation requirements which would be imposed pursuant to this advice are not recognised in a specific market? What specific safeguards do depositaries currently put in place when holding assets in jurisdictions that do not recognise effects of segregation? In which countries would

this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

Given the already existing strong focus and importance that is placed on asset segregation when selecting and monitoring sub-custodians, we do not see the need for additional or alternative measures to segregation. More specifically, when a depositary appoints a sub-custodian it will take the appropriate steps, such as consulting with regulatory authorities and other relevant parties, to ensure that assets are segregated in compliance with the requirements of local market practice and regulations. Furthermore, the depositary satisfies itself when conducting due diligence and at regular reviews that assets are segregated in line with that market.

Box 90

The central issue of the AIFM Directive is the envisaged liability regime. It has been particularly controversial given that depending on the final design of the regime, end investors could face higher costs, as the costs of addressing risks transferred to depositaries are priced into service arrangements. As an industry, we saw the risk that a too stringent regime could even lead to for the amplification of systemic risks.

Against this background, we welcome much of the work that ESMA has done in the context of preparing its draft advice on Level 2 implementing measures. In particular, we welcome ESMA's efforts to make the requirement practical and feasible. However in relation to the restitution regime for "lost" assets there remain some issues that we suggest do need to be looked at again, to ensure that they have those characteristics.

Comments on "Explanatory Text" after box 90

DATA supports the approach of ESMA to the definition of loss in relation to the notion of permanence. We also appreciate confirmation that in the event of insolvency of a sub-custodian, the assessment of whether or not financial instruments are lost will only be possible in many cases at the end of the proceedings. This mitigates one of the industry's main concerns with regards to the liability regime and it strikes the right balance between investor protection and an appropriate framework for the industry.

However, we are concerned by the suggestion that a "loss" event which is relevant for the restitution analysis will occur when it comes to light that ownership interests did not exist or cease to exist; particularly in cases of fraud. If there is an act of fraud committed against an AIF, in which the depositary is an innocent party, then the reasoning for transferring responsibility for the fraud to the depositary is unclear.

The restitution obligations of depositaries in Article 21(12) of the AIFMD are quite clearly expressed; and, on the plain meaning of the text, will protect investors against the risk that a depositary will act without proper attention and care, resulting in the loss of financial instruments held in custody. We are concerned, however, that the positions reflected in Box 90 and the accompanying explanatory text, together with Box 91, are neither consistent with the plain meaning of Article 21(12), nor with settled legal principles, in certain respects.

In Box 90, the determination that a "loss" has occurred, which is relevant for the restitution analysis, as a result of "falsified evidence of title, accounting fraud, etc.", casts upon the depositary the burden to demonstrate that it can meet several conditions, which are found in Box 91. Among them is that, "Despite rigorous and comprehensive due diligences it could not have prevented the loss." In our view, this formulation is of a different legal character to the requirement in Article 21(12) that the depositary show that "the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been ***unavoidance despite all reasonable efforts to the contrary***" [Emphasis added]. "Reasonable efforts" is well understood to require the depositary to take the actions that would be expected of a person who has assumed their duties, but it does not require the depositary to take steps which would otherwise be unreasonable. The "rigorous and comprehensive due diligences" requirement could be understood to go beyond "reasonable efforts", so that the due diligence work of the depositary has to be accurate and complete in all possible respects; whether the steps that could have been taken to detect and address fraud are reasonable or unreasonable expectations. In cases of falsified documents or accounting fraud by third parties, we are concerned that the use of a "rigorous and comprehensive due diligences" standard will present a significant evidentiary obstacle to depositaries, which appears inconsistent with the plain meaning of Article 21(12).

We would also note that the restitution obligation of the depositary appears to arise from the point that the relevant assets have been taken into custody. If the depositary conducts due diligence on assets which have been placed with it after receiving them into custody, it would be too late to discharge its liability. In cases where falsified documentation is delivered to the depositary (for example, bearer instruments) for safekeeping, the depositary would have to perform "rigorous and comprehensive due diligences" on the documentation before accepting the relevant instruments. That is simply not practically possible: the depositary is not part of the transaction in which the documentation has been used, and in order to fulfil its custody function will have to accept financial instruments and physical assets delivered to it (usually by book entry through chains of intermediation) as they are presented.

We strongly urge ESMA to reconsider these arrangements, so that the obligations of the depositary are practically possible and sound in principle.

We are also concerned by the proposal in the explanatory text that the AIFM should determine whether the financial instruments are lost. We believe that the proposal may establish perverse incentives for AIFM to declare instruments as lost in order to shift liability to the depositary, even in cases where the depositary has identified and communicated the risk which leads to the loss. Whilst the AIFM has a key role to play, including informing investors of material losses, its views are not and should not be solely determinative of the question whether a loss has occurred.

We believe that it would be more appropriate for the AIFM to consult and agree whether or not a loss has occurred in conjunction with the depositary (and discussion with the competent authority as the need arises). This proposal should not prevent the establishment of documented processes for communication to investors by the

AIFM on loss, which is a separate matter from the decision of "loss".

Proposed Advice for Article 21(12) concerning external events beyond reasonable control (CP pgs 182-86)

We understand that ESMA's goal in providing its advice on the depositary provisions of AIFMD is to "strike *the right balance between the directive's objective to set strict rules to ensure a high level of investor protection while at the same time not putting the entire responsibility on the depositaries as this would counterproductively create the incentive for regulatory arbitrage and in some cases may lead to increased systemic risk."*

We support this objective. It is also important that the Level 2 measures recognise and adequately reflect the key decision making role of the AIFM and provides access to AIFs that meet investors' needs. These factors are particularly important in considering the advice relating to 'external events beyond the reasonable control' of the depositary.

Box 91

Paragraph 1 - We believe that paragraph 1 should read as follows:-

" The event which led to the loss did not occur as a result of an improper act or improper failure of the depositary or one of its sub-custodians to meet its obligations".

We consider this qualification necessary as it would be inequitable to hold the depositary liable in circumstances where it has not acted improperly.

In addition, if an event which leads to a loss occurs in circumstances where the depositary has appointed a sub-custodian and the depositary is able to demonstrate that it has met the due diligence requirements in Box 88, such an event should be clearly categorised as 'external' to the depositary.

Paragraph 3 - Given that the Commission requested advice on what might constitute 'reasonable efforts' to avoid the consequences of an external event, we believe that the commencement of paragraph 3 should be amended to read:-

"Despite its reasonable efforts, it could not have prevented the loss.

The depositary or the sub-custodian should be regarded as having made reasonable efforts...."

This would better reflect the wording of the Directive and the request for advice. The Directive does not refer to 'rigorous and comprehensive due diligences' and, in any event, paragraph 3 is intended to spell out what might be considered 'reasonable efforts'. Please see our response to Box 90 for a detailed explanation of our concerns in this regard.

There is a link between 3 (a) and 3 (b) which is unhelpful and potentially imposes risk monitoring in a way which is not practical. For example this could imply that political or geographical issues also need to be addressed on an ongoing basis as the use of the phrases 'any external events' at (a) and 'significant risk of loss' at (b) leave a very open position.

In addition, the language in (c) is much too broad to be helpful in setting out the practical steps a depositary can and should take to demonstrate that it has taken reasonable efforts to avoid risk of loss. It should be restricted to actual events. 'Potential' events covers every eventuality, however remote.

In addition, it is not clear whether a depositary is expected to take action when there is limited verifiable information available to it. It is also unclear to us what is expected where a depositary receives non public information about a public company? Passing inside information to an AIFM would be against the law. A safe harbour for depositaries would seem important if there is any expectation that they will need to act upon receipt of such information.

The requirement for 'appropriate action' at (c) is open ended and impractical. The requirement in (c) should be to inform the AIFM, and if the AIFM disregards this advice, the only remaining appropriate action is that of notifying the AIFM's competent authority. Such notification to AIFM's competent authority should then result in discharging the depositary of its liability.

We also recommend further changes to the Box - please see comments regarding explanatory text paragraphs 37 and 38 below.

Comments on "Explanatory Text" after box 91

Paragraph 26 – This paragraph currently states "although some events appear by nature 'external' to the depositary (e.g., nationalisation, war, legal or political changes, etc)…" (Our emphasis). We think this should be made a more definitive statement by replacing "appear" with "are" and removing the "etc".

Paragraph 29 – With regard to fraud taking place within a sub-custodian, the final sentence implies that such fraud would be deemed internal and so the depositary would be liable. We strongly disagree with this statement. Provided that a depositary has met the due diligence duties in Box 88 then fraud within the sub-custodian should not mean the resulting loss is to be borne by the depositary, unless the depositary is otherwise culpable for the fraud (through the participation of its own employees, for example).

Paragraph 30 - We welcome ESMA's clarification that market closures or a technical failure at the level of the Central Securities Depositary or any other settlement system should be considered 'external' events.

Paragraph 31 - We request clarification of what is covered by (iii) *"the disruption in the entity's activity in relation to its default"* ? It is important that the meaning of this is clear given that it is one the insolvency aspects which incur depositary liability.

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Paragraph 34 – We consider that the last sentence is not necessary as the subject matter belongs to the next section (i.e. paragraph 35 onwards regarding the meaning of 'reasonable efforts').

Paragraph 37 – The last sentence makes this paragraph unclear. The first sentence rightly recognises the fact that there may not be any appropriate action to take except informing the AIFM and gives the example of a nationalisation where there is no 'appropriate action' to be taken by the depositary within reasonable efforts. The last sentence then contradicts all that has gone before that by stating that informing the AIFM is not sufficient to discharge the depositary of its liability. We believe that the last sentence should be deleted.

Paragraph 38 and 39 – We have serious reservations, consistent with our comments on 3(c) within Box 91, about the workability of the proposals regarding 'appropriate action' as outlined in these paragraphs. We also believe that it does not meet ESMA's goal of striking the right balance as mentioned at the beginning of this section. In addition, it does not recognise the key decision making role of the AIFM nor will it necessarily meet investors' needs.

In a situation where a depositary believes that the only appropriate action is to dispose of the financial instruments and it informs the AIFM, if the AIFM disregards this advice, the only remaining appropriate action is that of notifying the AIFM's competent authority. Such notification to the AIFM's competent authority should be sufficient to discharge the depositary of its liability as it will have made all reasonable efforts. It should not be unreasonable to expect the competent authority to have a responsibility to ensure that the AIFM is acting in a manner that is not going to cause investor detriment or potentially create greater systemic risk. That would be more consistent with the current arrangements for the roles and responsibilities of public agencies charged with overseeing markets including CIS..

The above approach also recognises the fact that it is the AIFM who has responsibility for portfolio management and who ultimately will make the decision whether or not to act upon the alert from the depositary.

The process outlined in these paragraphs would not work in practice and would leave a depositary with open-ended liability until such time as it is able to terminate the contract in respect of something it has made all reasonable efforts to address. The paragraphs indicate too that the AIF is to be given a period of time to find another depositary. If a depositary is terminating an agreement because the AIFM chooses not to act upon its advice, the AIFM might not be able to find another depositary willing to take on the AIF? We question also whether it would be in the interests of AIF investors to effectively force their depositary into terminating its contract as a means of discharging its liability, when that could lead to the winding up of the AIF if no other depositary is willing to assume the obligations. There may be circumstances in which the replacement of the AIFM could be considered, as might be the case when an AIFM is unable to continue with its own duties for other reasons. It might be that no single approach can or should be legislated and it does seem to us that expecting the depositary to resign its role is too limited a solution to cover all circumstances.

We recommend that the Advice sets out the following:-

- In a situation where a depositary believes that the only appropriate action is to dispose of the financial instruments and it informs the AIFM, if the AIFM disregards this advice, the only remaining appropriate action is that of notifying the AIFM's competent authority. Such notification to AIFM's competent authority discharges the depositary of its liability.

- In the above situation, the AIFM has a duty to consider the depositary's view. If it decides to retain the investments, that is an investment decision and, unless the AIFM has failed to meet its own obligations to the AIF, the consequences of the investment decision would be for the account of the AIF.

- A requirement for the depositary to periodically review the situation such that as and when the depositary is of the view that the issue which led to the transfer of liability is no longer a concern, the depositary informs the AIFM and liability is transferred back to the depositary. As an alternative this suggestion, the discharge could be the subject of a "sunset clause" – it would be time limited and the depositary would have to re-notify.

ESMA could also consider requiring AIFMs to cover this possibility in their pre investment disclosures to investors under Article 23(d). This would allow investors to make an informed decision. If the situation then arises, ESMA could require that an AIFM to inform investors of its decision following the notification received from the depositary and remind investors of the potential consequences of its decision for the AIF. Investors could then make an informed decision as to whether or not to retain their holding in the AIF.

The above proposal would "strike *the right balance between the directive's objective to set strict rules to ensure a high level of investor protection while at the same time not putting the entire responsibility on the depositaries".*

It is appropriate that depositaries comply with certain duties of supervision in respect of sub-custodians or other delegates which they choose to appoint, when it has retained its custody responsibilities, which may include certain periodic reviews and reconciliations of accounts designed to detect fraud. However, it would be inappropriate to impose liability on depositaries beyond such duties, where the loss of financial instruments is caused by a delegate or sub-custodian acting fraudulently, but which could not have been discovered by the depositary acting reasonably and in compliance with such standard of care. It would also be inappropriate to penalise depositaries which uncover fraud after the relevant financial instruments or physically-delivered assets have been delivered to it.

Box 92

DATA prefers option 2. Option 1 would significantly restrict the availability of the

contractual discharge route and there could be legal uncertainty as regards its use. It should be left to the AIF/M to agree with the depositary whether discharge is appropriate in the circumstances.

Comments on "Explanatory Text" after box 92

No comments.

Q47: What are the estimated costs and consequences related to the liability regime as set out in the proposed advice? What could be the implications of the depositary's liability regime with regard to prudential regulation, in particular capital charges?

The estimated cost as well as well as the potential impact upon capital requirements are extremely difficult to quantify.

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

We do not believe that it would be helpful to provide a typology of events. Our preference is for a principles-based approach. Each situation will have to be assessed based upon its particular circumstances.

Q49: Do you see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD?

DATA agrees that the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD should be considered 'external'.

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

DATA believes that the draft advice should not specifically seek to list external events.

As indicated in our response to ESMA's Call for Evidence earlier this year DATA considers the following events should be considered beyond the depositary's reasonable control and therefore '*external*':

- *force majeure events, such as political action, market changes, civil unrest, natural disasters, adverse weather, accidents etc*;
- terms or conditions imposed by post-market infrastructure;
- risk resulting from investment decisions taken by the AIFM or from following instructions properly given (including in markets where the post-market

infrastructure does not meet EU standards, as well as in highly volatile or unstable markets);

- use of a prime broker or sub-custodian which has been appointed by the AIFM or at the direction of the AIFM;
- securities holdings recorded by an agent of the issuer, such as a transfer agent or registrar;
- losses arising from legal proceedings invovlingthe insolvency of any properly appointed sub-custodian or other sub-depositary, exchange or post-market infrastructure (including CSDs and payment systems) unless the cause of the loss was the failure of the depositary to take the required steps to provide for the segregation of financial instruments;
- losses arising following the insolvency of any issuer; and
- certain generally recognised adverse market conditions or events, such as currency restrictions, sovereign default and the expropriation of assets.

It would be inappropriate to impose liability on depositaries, where the loss of financial instruments is caused by a delegate or sub-custodian acting fraudulently but which could not have been discovered by the depositary acting with reasonable efforts to avoid such issues.

Q51: What type of event would be difficult to qualify as either 'internal' or 'external' with regard to the proposed advice? How could the 'external event beyond reasonable control' be further clarified to address those concerns?

In view of the level of liability the depositary would be expected to undertake, it makes more sense to refer to entities that are '*controlled*' by the depositary in the corporate sense as '*internal*' because it is reasonable to premise a test based on those activities, entities and personnel that are actually capable of being '*controlled*' by the depositary in practice.

Q52: To what extent do you believe the transfer of liability will / could be implemented in practice? Why? Do you intend to make use of that provision? What are the main difficulties that you foresee? Would it make a difference when the sub-custodian is inside the depositary's group or outside its group?

We anticipate that a contractual transfer of liability may be challenging to implement in practice for the following reasons:

- A prerequisite is that the client has allowed such transfer of liability in the depositary agreement. Initial investigations with clients indicate that few are amenable to allow a transfer of liability. If they accept, most clients can be expected to accept such transfer selectively, on a case-by-case basis.
- It is fairly unlikely that sub-custodians will accept a transfer of liability which will result in stricter liability standards than those applicable to them under local liability rules. In addition, they risk to face multiple direct claims from AIFs save where the depositary acts as a coordinator.
- For a given sub-custodian it will be difficult to operate under two regimes in parallel: the transfer of liability regime for AIFs and standard regime for non-AIFs or for AIFs who reject the transfer of liability. In case of a liability trigger

event, the situation will entail significant administrative complexity, as it will first need to be established which funds are entitled to claim under the transfer of liability regime and which funds remain subject to standard regime

Q53: Is the framework set out in the draft advice considered workable for non-bank depositaries which would be appointed for funds investing mainly in private equity or physical real estate assets in line with the exemption provided for in Article 21? Why? What amendments should be made?

The framework should be explicit regarding the provisions of Article 21 and currently appears silent on this. The conditions of Article 21 should be built in to this guidance. The response also depends on the definition of financial instruments held in custody. If the definition does not include property and private equity and they are included as "other assets" then the framework would appear workable.

It would be workable as it would be expected that the written contracts with the AIF/AIFM would specify clearly that the assets may not be physically held in custody but there are other relevant controls to allow the transfer of such assets.

Q54: Is there a need for further tailoring of the requirements set out in the draft advice to take into account the different types of AIF? What amendments should be made?

The advice needs to be specific regarding how assets held with prime brokers will be treated as well as the supervision requirements that a depositary must discharge in relation to assets held with a prime broker. Without specifically addressing this matter, different practices will emerge within and throughout European jurisdictions.

The advice also needs to be tailored to cater for other types of fund such as closed end or listed funds.