

Comments

on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive

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A. General remarks

The German Banking Industry Committee (GBIC) welcomes the opportunity to respond to ESMA's proposals for Level 2 implementing measures for the Alternative Investment Fund Managers (AIFM) Directive.

The AIFM Directive contains considerable scope for Level 2 measures. This should be made use of carefully, and with the objectives of the AIFM Directive in mind. As well as enhancing investor protection and financial market stability, the directive aims at strengthening Europe's position as a centre for alternative investment vehicles. These three elements should be the guiding principles for developing the Level 2 measures.

Our member banks will be affected by the directive not only when selling alternative investment products but also, and especially, in their capacity as depositaries. Depositary banks offer investors a guarantee that their assets will be kept safe and that all applicable legal and contractual requirements will be complied with. It should nevertheless be borne in mind when drafting the proposals that the depositary merely exercises a control function and that it is the asset manager who is primarily responsible for making investment decisions and ensuring compliance with the rules.

We believe this aspect should be reflected in the sometimes very detailed proposed requirements concerning the responsibilities of the depositary.

B. Specific comments

V. Depositaries

V.I. Appointment of a depositary, especially the depositary agreement

GBIC basically agrees with ESMA's proposals concerning the depositary agreement. A written agreement is not only mandatory under the UCITS IV Directive, which has recently come into force, but is also now a legal requirement in national jurisdictions (e.g. Germany).

We also agree that it makes good sense to refrain from formulating a model agreement and to leave the agreement's precise form to the market. This approach reflects the wide variety of funds which will be regulated by the AIFM Directive and gives the parties involved the flexibility they need to accommodate this diversity.

By contrast, we believe the requirements for written agreements listed in box 74 are too far-reaching and detailed to ensure that it will always be possible to comply with them in this form. In particular, the inclusion of a

description of *procedures* should not be mandatory but at the discretion of the parties to the contract and/or it should be sufficient to make reference to a service level agreement.

A key element of the agreement is set out in no. 7 of box 74, which highlights the asset manager's obligation to provide the depositary with all the information it needs. This item is absolutely essential, in our view, if depositaries are to be able to exercise effective control.

We would like to suggest also making it mandatory to include information about a possible (and permissible) transfer of liability since this point is highly important in practice.

V.II. Duties of the depositary

The duties listed by ESMA (cash monitoring, safekeeping, oversight, due diligence and segregation) correspond to the framework set out in the AIFM Directive and are therefore basically appropriate. Specific comments on these duties can be found in Section V.III. below.

V.III. Depositary functions

1. Cash monitoring

• **Question 25:** Given that the Level 1 directive expressly retains the possibility for cash accounts to be opened at entities other than the depositary, Level 2 measures should not insist on cash accounts being opened at the depositary only (be they for general operating or subscription/redemption purposes). Major problems would be caused by a requirement of the kind referred to in Q25. First of all, there would be significant and unnecessary operational difficulties. Second, it might have an adverse impact on distribution channels, thus increasing costs. In our opinion, the current arrangements enable AIF accounts to be promptly credited with subscription monies. We therefore see no added value in disrupting the administrative channels that best suit distribution procedures. The depositary function in Germany combines both the transfer agent function (subscription and redemption of fund units) and the custody function for the fund. As a result, the cash account related to the transfer agent function has to be operated by the depositary and cannot be outsourced. Cash flow monitoring by the depositary is therefore guaranteed. In Germany, moreover, depositaries of funds regulated by the German Investment Act have to be banks.

When the depositary carries out its custody tasks, it is market practice to open a general account with the depositary. Carrying out custodial tasks

such as processing the settlement of, or corporate actions for, AIF assets actually necessitates the opening of a cash account on the depositary's books. So even if cash accounts are opened in the AIF's name with a third party, the global proceeds are credited to the account opened at the depositary.

- **Question 26:** In practice the fund administrator/valuer reconciles all cash flow movements at least at every NAV calculation. This frequency doesn't depend on the type of assets. The reconciliation of all cash flows (cash accounts at the depositary or third party to be reconciled with the cash accounts in the fund accounting system) is performed at each calculation of the NAV by the administrator/valuer of the AIF. The depositary has to verify this reconciliation performed by the administrator/valuer on a periodic basis.

- **Question 27:** No, we see no practical problems.

- **Question 28:** The AIFM should have the obligation to require the Prime Broker to transmit all information to the depositary in order to allow it to perform its control (ref. Q. 29). The obligation should apply to both securities and cash. Moreover, in our view, the Prime Broker should have to fulfill the conditions of Article 18 of the Directive 2006/73/EC (point 18) and the AIFM should have to ensure that the Prime Broker has satisfied its obligation. It is important to bear in mind that the depositary will have to rely on the prime broker or AIFM to submit sufficient documentation to demonstrate that cash accounts opened at a third party are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked). The depositary itself will not have access to this information.

- **Question 29:** GBIC does not support option 1 because it would require a complete change of operating model and generate substantial additional costs without delivering any real added value. Implementing option 1 would require the depositary

1. to duplicate part of its middle office and valuation functions,
2. to modify its relationship with the fund manager,
3. to put a new system in place and increase the number of depositary staff,
4. and to bear additional running costs far in excess of double the current amount for AIFs with a high number of cash movements.

We are only in favour of option 2 for outsourced cash accounts (accounts held in the name of the AIF/AIFM at a third party, not at the depositary bank). In Germany, the depositary function combines both the transfer agent function (subscription and redemption of fund units) and the custody function for the fund. As a result, the cash account related to the transfer agent function has to be operated by the depositary and cannot be

outsourced. Cash flow monitoring by the depositary is therefore guaranteed. When the depositary carries out its custody tasks, it is market practice to open a general account with the depositary. Carrying out custodial tasks such as processing the settlement of, or corporate actions for, AIF assets actually necessitates the opening of a cash account on the depositary's books. So even if cash accounts are opened in the AIF's name with a third party, the global proceeds are credited to the account opened at the depositary.

• **Questions 30 and 31:**

• **Set –up costs**

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

Option 2: no major additional costs

• **Running costs**

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

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

2. Safekeeping duties

Safekeeping is one of the core duties of depositaries. It is therefore particularly important to ensure that all requirements in this area are practicable.

• **Question 32:** We prefer option 2 because it allows a clear distinction to be made between financial instruments covered by the custody function and instruments which are not protected by international custody and settlement systems.

• **Question 33:** Instruments which can be held in custody are described in option 2 of box 78.

• **Question 34:** It is very difficult in practice to differentiate between title transfer and security transfer collateral arrangements. We would therefore welcome further clarification of option 2.

• **Question 35:** It is not normal practice in Germany to delegate safekeeping duties since there is no separation of safekeeping and

associated administrative tasks (such as processing corporate actions, dividend payments, etc.)

• **Question 36:** We assume that the question relates to transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC. When the assets are registered either in the name of the depositary on behalf of the AIF and in the name of the depositary on behalf of a group of unidentified clients, information related to these assets is directly transmitted to the depositary by the register. The depositary does not depend from the AIF to receive the necessary information with its controls. Where the assets are registered in the name of the AIF directly, the depositary depends on the AIF to receive this information.

• **Question 37:** We believe this is both possible and desirable, particular reports indicating daily mark-to-market valuations and any assets of the AIF which are held off-balance sheet (e.g. assets subject to re-hypothecation but not re-hypothecated).

Regarding the responsibilities and role of the prime broker GBIC has the view that:

- They should not be considered as prime custodians of the AIF.
- They should not be viewed as a sub-custodian to the Depositary when holding assets as collateral but instead they should be required to accept liability on the collateral portion.
- They should be required to provide relevant statements of transactions or binding statements of holdings to enable the Depositary to perform its oversight and record keeping function so as to have a full overview of the assets and the cash movements of the AIF.
- They should be required to provide a daily update (including re-used assets).
- Assets of the fund with the Prime Broker should be clearly identified and segregated.

• **Question 38:** Where most assets (other than financial instruments) are concerned, it is simply not feasible to have monitoring procedures in place outside the AIF (or the AIFM acting on behalf of the AIF) to ensure that assets cannot be assigned, transferred, etc. without the consent of the depositary. Hence the depositary has to rely on effective procedures existing within the AIF (or the AIFM acting on behalf the AIF) and could at most verify whether such procedures are in fact in place. However, even this puts too many obligations on the depositary's shoulders: the depositary cannot be held liable for the relevant procedures being in place at the AIF (or the AIFM acting on behalf of the AIF). It should be up to the AIF (or the AIFM acting on behalf of the AIF) to make sure that its assets cannot be assigned, transferred, exchanged or delivered without informing the depositary or its

delegate. It is the responsibility of the AIF (or the AIFM acting on behalf of the AIF) to meet its organisational obligations and the responsibility of the supervisory authorities and auditors to verifying that the organisational procedures in place are fit for purpose. The AIF (or the AIFM acting on behalf of the AIF) should provide the depositary with an SAS 70 report or, to minimise costs for the AIF (or the AIFM acting on behalf of the AIF), at least with a certified report of the auditor. Otherwise, the depositary would incur substantial additional costs, e.g. for manpower, time (to undertake physical controls), risk premiums, etc. We prefer option 2. ESMA should make it clear that the AIF (or the AIFM acting on behalf of the AIF) is responsible for providing all relevant information in a timely manner and that the depositary should not be held liable if the AIF (or the AIFM acting on behalf of the AIFM) fails to fulfil its obligations.

• **Question 39:** We believe that access to transaction confirmations and contracts is normally sufficient to verify ownership. Where special assets are concerned, it may be appropriate to have their existence confirmed by a neutral party. Care should be taken when drafting ownership verification requirements to ensure that they are practicable and proportionate (the depositary cannot, for instance, be expected to satisfy itself personally that a tract of woodland in Siberia purchased for an AIF does, in fact, exist).

In addition, GBIC proposes amendments to Box 80:

To avoid any confusion, GBIC recommends rewording point 1 (a) to read *"ensure the financial instruments are properly recorded/booked in segregated accounts..."*

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

Therefore GBIC suggests to amend box 80 as follows:

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

1. To comply with its obligations pursuant to Article 21 (8) (a), the depositary should be required to at least:

- (a) Ensure the financial instruments are properly recorded/booked in segregated accounts in order to be identified at all times as belonging to the AIF
- (b) Exercise due care in relation to the financial instruments held in custody to ensure a high level of protection
- (c) Assess and monitor all relevant custody risks. In particular, depositaries should be required to assess the custody risks related to settlement systems and inform the AIFM of any material change in the market practices.

2. Where the depositary has delegated its custody functions, the depositary would remain subject to the requirements of §1 (c) and would further have to ensure the third party (hereafter referred to as the 'sub-custodian²³') complies with §1 (b) as well as with the segregation obligations set out in Box 16.

3. Depositary functions pursuant to §9 – oversight duties

• **Question 40:** The oversight duties recommended by ESMA are very extensive. This could be problematic, since they are not matched by corresponding requirements for the AIFM, e.g. an obligation to disclose all the relevant information the depositary needs to fulfil its oversight duties, an obligation to grant the depositary access rights so that it can monitor the AIFM's internal systems, etc. Another point is the cost of these oversight duties (need for more manpower, IT, etc.). It could become very expensive to be a depositary since it is open to question whether the AIFM will carry these costs. Moreover, there is a danger of the supervisory responsibilities of competent authorities being shifted to depositaries.

We see a need for clarification in the following areas:

- 1. There should be specific provisions describing how the depositary can execute its oversight duties and gain access to the relevant information and records. For example, the AIF (or the AIFM acting on behalf of the AIF) could be obliged to provide an SAS 70 report or its equivalent.
- 2. The envisaged assessment by the depositary of the risks associated with the fund's strategy, organisation and type of assets under management goes too far, in our view. There is a danger of the depositary being held liable for losses and bad performance.
- 3. Since the depositary is not directly involved in risk management at the AIFM, it would at most be in a position to check whether the AIFM has reasonable risk management procedures in place. Risk analysis and risk

decisions nevertheless remain the responsibility of the board of the AIF (or the AIFM on behalf of the AIF). GBIC would therefore recommend that the risk management procedures filed by the AIF (or the AIFM on behalf of the AIF) should include a precise description of how the Board exercises its supervision duties in this regard and of what information (SAS 70, KPIs/KRIs) will be made available to the depositary to enable it to fulfil its oversight duties.

- **Question 41:** No, GBIC sees no potential conflict of interest. In Germany, depositaries are also transfer agents for the funds, subscribing and redeeming shares. As a general duty, the depositary is required to have an organisation that identifies and mitigates all potential conflicts of interest (operational, functional and hierarchical segregation of functions).

- **Question 42:** Depositaries are required to handle the issue and redemption of the units of all German funds covered by the German Investment Act themselves. Clearstream Banking assists with these duties for assets held in custody in the CBF system.

- **Question 43:** Paragraph 2 of Box 83 should be clarified. Indeed, the oversight duties of the depositary cannot include “secondary” market transactions (i.e. sale or repurchase of shares and units) The oversight duties should apply to the compliance of the procedures at the level of AIF, AIFM or the designated entity only. The depositary has no view and access to the distribution channels. Furthermore, it is impossible to satisfy this requirement when the units/share are not issued in a nominative form.

- **Question 44:** In Germany two appropriate procedures are already in place for fulfilling the requirements set out in the first paragraph of box 85. First, depositaries verify the procedures of the AIF/AIFM and receive SAS 70 reports (“Model 1 of the BaFin circular on the duties and tasks of depositary banks”). Second, depositaries perform shadow accounting and independent compliance checks with their own systems (“Model 2 of the BaFin circular on the duties and tasks of depositary banks”).

Regarding box 85 it is the understanding of GEBIC that investment restrictions are defined by the Level 1 text which refers to the incorporation document (not offering documents that may change without the depositary being informed).

Furthermore in that regard, the reference to laws and regulations goes a little bit further than the Directive which refers to “national law”, the difference may be tiny, but legally speaking it may not be the same.

The explanatory note 62: ‘The depositary should also monitor the AIF’s transactions and investigate any ‘unusual’ transaction it has identified in conjunction with its cash monitoring duties.’ should not imply a review of all cash transactions by the depositary This would mean that the depositary

duplicates the process of reconciliation already performed by the fund accountant and this would lead to a significant additional cost.

• **Question 45:** The current arrangements, processes and market practices allow for a timely settlement of transactions and the identification of possible failings or anomalies. In the latter case, the depositary takes the necessary steps to inform the AIF/AIFM and request its instructions. Therefore, GBIC does not therefore think that Option 2 will bring any additional added value and safety to the current arrangements.

Furthermore, it believes that no clarification is needed for this oversight duty and decides to opt for option 1.

From a practical perspective, as far as financial instruments are concerned i.e. assets held within a sub-custody network, and as long as third party custodians involved in the safekeeping chain do provide the appropriate reporting, GBIC believes that there are no fundamental differences between the current market practice for monitoring timely settlement of transactions and the suggested measures in paragraph 1 of the second option. GBIC is also of the opinion that any request for the restitution of the financial instruments from the counterparty should, in the first place, be initiated by the board of the AIF (or AIFM on behalf of the AIF). The depositary should be acting, where possible, as a facilitator in the process (in some circumstances, the depositary might not be able to access the assets e.g. financial instruments held by a third party custodian or prime broker appointed by the AIF or the AIFM on behalf of the AIF).

In regards to assets not held throughout the traditional custody network (derivatives, real estate, private equity...), and due to the non-standard nature of those transactions, GBIC is of the opinion that the responsibility of assessing the usual time limits should not be transferred to the depositary and should remain with the contracting parties of the transaction. The documents supporting the individual transaction signed by the parties should clearly indicate a settlement date to be used as a reference for defining if the assets have been remitted within the usual time limits.

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

Section 2: Due diligence duties

ESMA's proposed due diligence requirements for depositaries appointing a sub-custodian are generally appropriate. The envisaged requirements for the selection and ongoing monitoring process are largely in line with current market practice. The breakdown of depositaries' due diligence duties into "selection" and "ongoing monitoring" is also basically appropriate.

With regard to selection, a more clear-cut distinction should nevertheless be made between general risk (e.g. country risk) and the specific risk associated with an individual sub-custodian. Whilst general risk involves a basic risk associated with the country of deposit, the specific risk that may arise from a sub-custodian's business activities is an individual risk that can be avoided by selecting a different sub-custodian. To assess the risk arising from the business activities of a specific sub-custodian, a check is usually conducted on various aspects of how the business is organised (e.g. qualification and experience of employees, reporting lines, complaint-handling procedures and market reputation).

As regards the ongoing monitoring of the business relationship, the ETDF welcomes ESMA's proposed risk-based approach. In normal market situations and where the conduct of the sub-custodian gives no cause for concern, periodic reviews in the form of spot checks should be sufficient. The contingency plans referred to in box 88 (paragraph 2) are standard practice. The requirements for the content of such a contingency plan should not go into excessive detail, however. If the sub-custodian commits a breach of duties, moreover, it should initially be sufficient for the depositary to remind the sub-custodian of its responsibilities. Only in the event of repeated breaches should the depositary be required to terminate its relationship with the sub-custodian.

Where a risk is posed not by the sub-custodian but by a general (e.g. political) risk, switching custodian will not help to solve the problem. In this case the depositary should inform the competent authority and AIFM so that the AIFM can make suitable arrangements (e.g. change its investment strategy). If the AIFM fails to take appropriate action, the depositary should be discharged from liability.

Section 3: Segregation

A statutory requirement for a custodian to segregate a client's assets from its own assets and from the assets of other clients is a key component of investor protection. Such a requirement is already enshrined in Article 13(7) and (8) of Regulation 2004/39/EC in conjunction with Article 16 of implementing Regulation 2006/73/EC. The practice of keeping assets in separate accounts to which different names are assigned and the obligation to keep appropriate records, even if so-called omnibus accounts are used, effectively prevent third parties from gaining access to clients' holdings.

In Germany, a contractual instrument known as a "Three-Point Declaration" may be used if a sub-custodian in a country outside the EU/EEA is involved, since national law cannot be enforced abroad. The objective of this declaration is to establish a legal position equivalent to that under national law which offers protection against insolvency and attachment. In the declaration, the foreign sub-custodian confirms the following three points:

- (1) it has taken due note that client assets are held in safekeeping,
- (2) it may assert a security interest, lien, right of retention or any similar rights only for such claims that may arise from the purchase, administration and safekeeping of the particular client assets in question; it will inform the German depositary of any attachment of the assets by a third party or any other measures of execution and
- (3) it is not entitled without the consent of the German depositary to entrust a third party with the safekeeping of the assets or to transfer them to another country.

The “standing” of the Three-Point Declaration can be enhanced by commissioning legal opinions to analyse the equivalence of the supervisory regime and legal position, and any restrictions in place in the country in question.

We see no need for any further measures since they must be regarded in the context of the required due diligence duties.

German depositaries generally refrain from delegating the safekeeping of assets to sub-custodians in countries where the principles of segregation are not observed and which refuse to issue a Three-Point Declaration.

- **Question 46:** Sub-custodians should be required to confirm, in addition to the above points, that segregation arrangements are insolvency-proof.

V. IV. The depositary’s liability regime

1. Loss of financial instruments

We welcome the clarification in Article 21(12) of the directive that an asset’s loss in economic value is not to be construed as the loss of a financial instrument held in custody in accordance with Article 21(8).

We also welcome ESMA’s clear statement in para. 19 of the explanatory text that it is the AIFM’s responsibility to determine whether a financial instrument is lost and, if necessary, demonstrate the fact. In the absence of other rules, this will also apply in the event of a dispute if the courts have to decide on an AIF’s claim for the replacement of lost financial instruments. In the light of the obligation on the depositary under Article 21(12) to replace instruments regardless of whether or not they are responsible for the loss, we consider this division of the burden of proof a sensible approach.

The definition of loss in box 90 is therefore largely appropriate, in our view.

Nevertheless, we believe the following restrictions should be applied to the definition of loss and would also welcome clarification of several points.

The definition in para. 1(a) should be modified so that the term *loss* does not cover cases where, from a legal perspective, the financial instrument was never actually created in the first place and thus never entered the safekeeping of the custodian and where, as a result, the AIF never acquired legal or beneficial ownership. The wording *or never existed* should then be deleted from para. 1(a). Unlike with *other assets* within the meaning of Article 21(8)(b) of the directive, the custodian is not required to verify that the AIF (or AIFM acting on behalf of the AIF) is the owner of the instruments that are taken into its safekeeping under Article 21(8)(a). A loss of assets in safekeeping logically presupposes by the very nature of the wording used that the AIF must have had ownership of the safekept financial instruments for at least a split second, thus enabling the instruments to be held in safekeeping by the custodian.

We are unclear about the distinction between conditions (b) and (c) in para. 1 of box 90. If the AIF is permanently unable to dispose of a financial instrument (c), it will inevitably be permanently deprived of its right to exercise ownership (b). Case (c) is therefore always likely to be a sub-category of condition (b). We therefore wonder what “added value” condition (c) represents. We would suggest considering its deletion.

It would also be desirable to spell out the concept of permanence in (a), (b) and – should it not be deleted – (c). One possibility would be to use as a starting point the determination of the sub-custodian’s insolvency and formal, incontestable decisions by courts or public bodies officially confirming the non-existence or loss of the property. In the case of insolvency proceedings for a sub-custodian, this normally means the end of the proceedings in the form of a court ruling (cf. para. 20 of the explanatory text: *As soon as there is certainty...*). It is therefore our understanding that the official, legally binding conclusion of the insolvency proceedings should be awaited before it can be assumed that financial instruments have been permanently lost. Temporary measures prior to insolvency proceedings, be they for the purposes of protection, reorganisation or restructuring (moratorium, asset freeze, etc), as well as temporary measures in the course of insolvency proceedings (loss of authority to dispose of or sell financial instruments) cannot, in consequence, be considered permanent loss. This approach should be rigorously applied to all forms of loss, e.g. also if assets are confiscated or become subject to state restrictions on their transfer. Here, too, the loss should be officially and incontestably confirmed. Given the fundamental division of the burden of proof when demonstrating that a financial instrument has been lost, ESMA is right to stress that, to this end, *the AFIM should closely monitor the proceedings...* (box 90 (2), third subparagraph). The same should also apply – a maiore ad minus – to any proceedings prior to the insolvency proceedings.

We welcome the view that a financial instrument should not be considered lost if it is replaced (box 90 (2), second subparagraph: *...this instrument is*

substituted by or converted into another financial instrument...). We would nevertheless like to suggest modifying the wording as follows to clarify that an instrument will not be deemed lost as a result of an AIFM's failure to accept a replacement:

*...this instrument **can be** substituted by or converted into another financial instrument...*

2. External events beyond reasonable control and

3. Objective reasons to contract a discharge

Circumstances that may be deemed external events and reasons for limiting liability are issues which have already been keenly discussed at Level 1. We have the following comments on ESMA's proposals:

• Box 91:

Condition 1 should be amended as follows:

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

Condition 3, sentence 1 should be amended as follows:

*Despite rigorous and comprehensive due diligences **and reasonable efforts** it could not have prevented the loss.*

The addition of this wording would bring the language of Level 2 into line with that of the directive.

• Box 92:

The hurdles associated with a contractual discharge of liability should not be further exacerbated by requiring the depositary to demonstrate the existence of objective reasons for the discharge. We therefore prefer option 2. It is reasonable to assume that a discharge of liability will not be contractually agreed in the absence of justifiable reasons. Unless the agreement between the depositary and AIF (or AIFM) is concluded on the basis of the depositary's general terms and conditions, moreover, there is no danger of the depositary dictating one-sided criteria for excluding liability.

• Question 47: It is not possible as yet to estimate the potential impact of modified liability rules. The answer depends very much on the country in which the sub-custodian is located (legal and political risk) and the exact level of the counterparty credit risk associated with the sub-custodian. We nevertheless anticipate that the additional risk will give rise to a massive increase in costs, which will ultimately be borne by the funds.

• **Question 48:** GBIC agrees with the principle and rules based approach laid down in Box 90. However, a typology can only be a non-exhaustive list. Below are suggested events (non exhaustive) that follow the current draft definition of "loss" proposed by ESMA in Box 90:

(a) A stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed:

Fraud resulting in the permanent loss of the financial instrument

(b) the AIF has been permanently deprived of its right of ownership over the financial instruments:

Nationalisation of the issuer – the financial instruments of the issuer are nationalised, expropriated or are otherwise required to be transferred to any governmental agency, authority or entity.

(c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments:

Change in relevant law – e.g. due to the adoption of or change in any applicable law or regulation (including tax laws) it becomes illegal to hold, acquire or dispose of the financial instruments.

In some cases, government action may result in "loss" – for example, where a government (or governmental institution or agency) has taken action which has had the effect of permanently and irretrievably preventing the transfer, sale or other disposition of the financial instruments.

In some cases, national or international embargoes (i.e., a government (or government institution or agency) or an international organisation has announced a trade embargo affecting the ability to transfer, sell or dispose of the financial instruments) may be sufficiently permanent that the financial instruments can be considered "lost".

Liquidation, dissolution or winding up of issuer – but, as ESMA rightly recognises, only where it becomes certain during (or at the end of) the insolvency process that the financial instruments are permanently and irretrievably lost.

In addition, GBIC would like to make the following comments:

Depositories cannot be made liable for events outside their sphere of control and influence. It should be clarified that in case of loss resulting from a fraud whereby the financial instruments have never existed or have never been attributed to the AIF as a result of a falsified evidence of title it is not the responsibility of the depository to return the assets. Indeed it is a part of investment process of the AIFM and it comes under its responsibility to ensure satisfactory title to financial instruments when the AIFM decides to invest in financial instruments in order to prevent fraudulent behaviour of the issuer or from the seller. The depository has to ensure the AIFM has set up an appropriate procedure to monitor this risk but requiring the depository to ensure satisfactory title to financial instruments would be beyond the current requirement to safe keep the assets would require additional processes in all markets and lead to significant additional costs.

The AIFMD Level 1 itself is clear on this as reference is made to "the loss by the depository or a third party to whom the custody of financial instruments ... has been delegated". Box 90 seems to go beyond what Level 1 permits. This is certainly not the intention and hence Box 90 should be clarified appropriately by adding at the end of paragraph 1. "due to a wrongful action or omission of the depository as prescribed by the AIFMD"

There is need for further clarification of the requirement of the "notification of investors". What will the rule be in case of a dispute concerning if there has been a loss and/or whether such loss is covered by the liability exemption of an "external event"?

We do not see how the depository can "determine" in case of a sub-depository's insolvency whether all or parts of the assets are "lost". This is ultimately a matter for the competent courts to decide and not for the depository. At best the depository can provide a non-binding preliminary assessment

• **Question 49:** German legislation has for many years required client assets to be segregated from a depository's own assets. This is why foreign sub-custodians are required to issue a so-called Three-Point Declaration, in which they undertake to keep clients' holdings separate from their own even if no such requirement exists under local law. The difficulty lies in verifying and maintaining the legal enforceability of such declarations. If the depository informs the AIFM that a sub-custodian has not issued a Three-Point Declaration because segregation does not reflect normal practice in its jurisdiction and if the client wishes to invest in this country even in the absence of the declaration, the depository should not be held liable if the assets are lost.

- **Question 50:** *External events* should cover all types of force majeure normally recognised for insurance purposes, such as natural disasters, war, insurgency/revolution, terrorism, etc.

Examples of other commonly accepted examples of force majeure events, such as acts of state (e.g. nationalisation), acts of God, market disruption and closure, technical failure at the CSD or other settlement systems, are already mentioned in the consultation paper.

- **Question 51:** We make reference to our comments in response to Q 48 regarding the sphere of influence and the need to clarify that the relevant due diligence and similar obligations are obligations of means.

- **Question 52:** The text of the directive envisages that the depositary can only discharge itself of liability if it can demonstrate that the AIF (or AIFM) has given its express consent in a written contract (para. 13(c)) and can also produce a written contract transferring liability to a sub-custodian (para. 13(b)). On a practical level, this arrangement only makes good sense if the sub-custodian delegates its functions to further sub-custodians, for whose negligence the depositary would otherwise be liable vis-à-vis the AIF. If, on the other hand, the sub-custodian is the final link in the custody chain, an agreement of this kind would oblige it to assume liability for the depositary's negligence.

When preparing Level 2 measures, ESMA should take care to ensure that its proposals would be feasible to implement and are compatible with national law.

- **Question 53:** GBIC considers that the framework set out in the draft advice must be implemented in non-bank depositaries. It is important to ensure a level playing field in the EU and for the third countries between all the depositaries.

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

- **Question 54:** We see no need for further differentiation of AIF types with respect to discharging liability. GBIC believes that, while generally speaking the salient points relate more to the specific class of assets, i.e. certain financial instruments, than to the type of AIF, it may be appropriate to account for fund type inherent specificities in relation to the "beyond reasonable control" requirement. Indeed what is reasonable for a more traditional AIF may not be reasonable for an AIF engaged in intra-day-trading.

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

- the type of investment fund (UCITS like funds, Real estate fund, Private equity fund) and the national law applicable to them (in particular in case of investment restrictions for tax matter purpose),
- the type of assets these funds invest in (listed/ non listed, in which way these underlying assets are regulated).

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

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