Reply form for the Call for Evidence

Asset Segregation and Custody Services

15 July 2016

esma European Securities and Markets Authority

Date: 15 July 2016

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Call for Evidence Asset Segregation and Custody Services (ASCS), published on the ESMA website.

Instructions

Please note that, in order to facilitate the analysis of the responses, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

- use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
- do not remove the tags of type <ESMA_QUESTION_CE_ASCS_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

- if they respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives that ESMA should consider

Naming protocol

In order to facilitate the handling of stakeholders’ responses, please save your document using the following format:

ESMA_CE_ASCS_NAMEOFCOMPANY_NAMEOFDOCUMENT.

E.g. if the respondent were XXXX, the name of the reply form would be:

ESMA_CE_ASCS_XXXX_REPLYFORM or

ESMA_CE_ASCS_XXXX_ANNEX1

Deadline

Responses must reach us by **23 September 2016.**

All contributions should be submitted online at www.esma.europa.eu under the heading ‘Your input/Consultations’.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the headings 'Legal notice' and 'Data protection'.

Introduction

Please make your introductory comments below, if any:

<ESMA_COMMENT_CE_ASCS_1>

The Luxembourg Bankers' Association ("ABBL") is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector ("PSF"), financial service providers and ancillary service providers to the financial industry.

ABBL ID number in the COM Register of interest representatives: 3505006282-58

Introduction

In our view the consequences of relying on a "Level 3 guidance" to solve the complex topic of segregation and transparency in the custody chain go beyond the remit of such a legislative tool. Therefore we aimed at evidencing the issues in the context of fund regulations but with an eye on the potential impact on the custody at large. We invite ESMA to complement this answer with the one we submitted in the context of the *to the ESMA consultation paper on Guidelines on asset segregation under the AIFMD of December 2014 (ESMA/2014/1326).*

To support our recommendation, we would like to raise several concerns that pertain to these regulations (UCITS/AIFMD) but that are also present in other recent regulations (MIFID II for example). From our perspective, everything should be rewritten again with a clear policy objective in mind : answer the question : what is the reasons why we have the segregation requirements ? In our view there are two sets of reasons :

- one is investor protection,
- the second is transparency.

Regarding investor protection, more specifically in context of funds, the assets are held by a financial intermediary for the account of a client, in this case a fund (this approach is largely for many financial instruments). These assets are not held for the profit of the depositary, in fact one could argue that this belongs to contracts law (the financial intermediary is tasked with placing an order on markets and holding instruments). In the situations where the depositary has proprietary assets, they should be segregated, from clients and duly identified. This distinction: own assets vs. clients assets is largely recognised across

the globe, it means that in case of insolvency of an intermediary the model of account holding is agnostic to the protection of the assets of the client. Consequently we do think that the first policy objective is served.

Regarding transparency, the necessity to create securities accounts has a lot of drawbacks notably in terms of reduced efficiency and increased cost, on top of this the multiplication of accounts at each layer adds complexity exponentially. Then we should keep in mind that in most markets today securities are held on electronic account under electronic form, which means that it is now easier, simpler and more efficient to maintain accurate books of records of entitlements. Namely each intermediary in a custody chain should be able to know its clients and to whom belong which instrument, the only difference with accounts is that the recording is performed on an omnibus account, not through individual account. That process facilitates reconciliations, access to instruments and offer the possibility to use modern financial techniques to optimise portfolio management or simply to facilitate collateralisation of instruments. From a practical perspective this reliance on book records could be performed all along the custody chain and could be ensured by appropriate due diligence checks on the governance organisation by the layer N+1 in the custody chain.

We are concerned as well by the uncertainty with regard to the qualification of CSD and the potential mismatch regarding liability standards between depositaries and their delegates on the one hand and, on the other hand, CSDs. For the industry to operate on a level playing field, we are of the view that clarifications need to be made to recognise the dual role CSDs can play as either “issuer” or “investor” CSDs. We note that relying solely on the “issuer” CSD / “investor” CSD distinction might be problematic (*see question 29*) which is a reason why we plead to address the issue in the respective Level 1 rule.

Before answering the specific questions, we would like to remind that whatever the legal objective pursued the account holding structure is largely indifferent when it comes to the protection of the investors, but some approaches are definitely more cumbersome and costlier than others, the optimal route should not be the costliest one. In the end for information, we have contributed to the ETDF (European Trust and Depositary Forum).
<ESMA_COMMENT_CE_ASCS_1>

Q1: Please describe the model of asset segregation (including through the use of 'omnibus accounts') in your custody chain/the custody chain of the funds that you manage. Please explain what motivates your choice of asset segregation at each level (e.g. investor demand, local requirements, tax reasons).

In your description, please take into account the following:

a) please describe – <u>with the use of a chart/diagram</u> – at least three levels of account-keeping in your custody chain, as follows:

i) the first level should be the level of the AIF/UCITS-appointed depositary,

ii) the second level should be the level of a third party delegate of the depositary, and

iii) the second level should be the level of a third party delegate of the depositary, and

iv) the third level should be the level of a sub-delegate of the third party delegate or the CSD, where applicable.

You may wish to add further levels of accounts, depending on your custody chain.

b) if you use 'omnibus accounts' (i.e. accounts, in which the assets of different end investors are commingled, rather than each individual investor's assets being held in a separate account) at any level of the custody chain, please provide, in as clear and detailed a manner as possible:

i) an explanation including at which level of the chain you use them;

ii) a description of the features of these accounts (e.g. whose assets are held in them, who holds title to those assets or is considered to be the end investor, etc. - e.g. AIF, UCITS, other clients, depositaries or their third party delegates);

iii) an explanation on how any restriction on reuse of the assets applying to the funds (AIF/UCITS) which you have in custody/manage (e.g. the restriction under Article 22(7) of the UCITS Directive) is respected, when they are held in an omnibus account at a given level; and

iv) the number or percentage of 'omnibus accounts' versus 'separate accounts' in your custody chain.

c) if you do not use 'omnibus accounts', please specify why and how far down the chain it is possible for you not to use them (i.e. whether this works in all situations or, if it is necessary to use 'omnibus accounts' at some level of the custody chain, at which level)?

d) in the chart/diagram to be provided under a), if applicable, please refer to the five options in the table under Q22 below and specify if your model matches or closely matches with any of the models described therein.

e) if your model makes any distinction between AIF and UCITS assets, please highlight the difference between the two in the chart/diagram to be provided under a).

f) According to a Briefing Note[1] published by ECON in 2011, there are five basic models for holding securities with an intermediary: the trust model[2], the security entitlement model[3], the undivided property model[4], the pooled property model[5] and the transparent model[6]. ESMA is interested in gathering evidence on whether there may be any link between certain securities holding models and certain asset segregation models. Therefore, ESMA invites stakeholders to provide input to the following questions:

i) What securities holding model do you use?

ii) Is such model the market standard in your jurisdiction?

iii) Is the market standard model in your jurisdiction one of the five mentioned above, or a different one? If a different one, please provide details.

iv) Does the model you refer to under f) i) require a particular way of segregating assets or omnibus accounts at one of the levels referred to at letter a) above? If yes, please specify.

g) Please explain the naming conventions (i.e. in whose name is the account opened) applied to the accounts with the delegates/sub-delegates of the depositary in the model described under answers to questions a) to e) above. Please also specify if there are instances where the accounts with the immediate delegate of the depositary are opened in the name of the funds.

<ESMA_QUESTION_CE_ASCS_1>

(Q1 a): The attached chart describes the typical set ups in relation to safe-keeping services for financial instruments provided by a Luxembourg Depositary to several investment funds which are AIF or UCITS.

One model is that a Depositary (first level in our chart) provides custody services nationally and appoints a 'Global Sub-Custodian' (second level lower side of our chart) that provides custody services internationally for multiple markets through one service agreement. The financial instruments are ultimately held by national CSD (third level, lower side in our chart).

The other model is that the Depositary - instead of appointing one Global Sub-Custodian - appoints, a Sub-Custodian (second level in the upper side of our chart) for each relevant market. Again, ultimately the financial instruments are held by a national CSD (third level, upper side, in our chart). Depending on the

[1] http://www.europarl.europa.eu/document/activities/cont/201106/20110606ATT20781/20110606ATT20781EN.pdf
[2] See pages 14-15 of the Briefing Note.
[3] See page 16 of the Briefing Note.
[4] See page 17 of the Briefing Note.
[5] See page 18 of the Briefing Note.
[6] See page 19 of the Briefing Note.

requirements of the relevant market, the accounts with the Sub-Custodian are segregated accounts (upper left side in our chart) or omnibus accounts (upper right side in our chart).

Own assets and customer assets are, of course, segregated at each level.

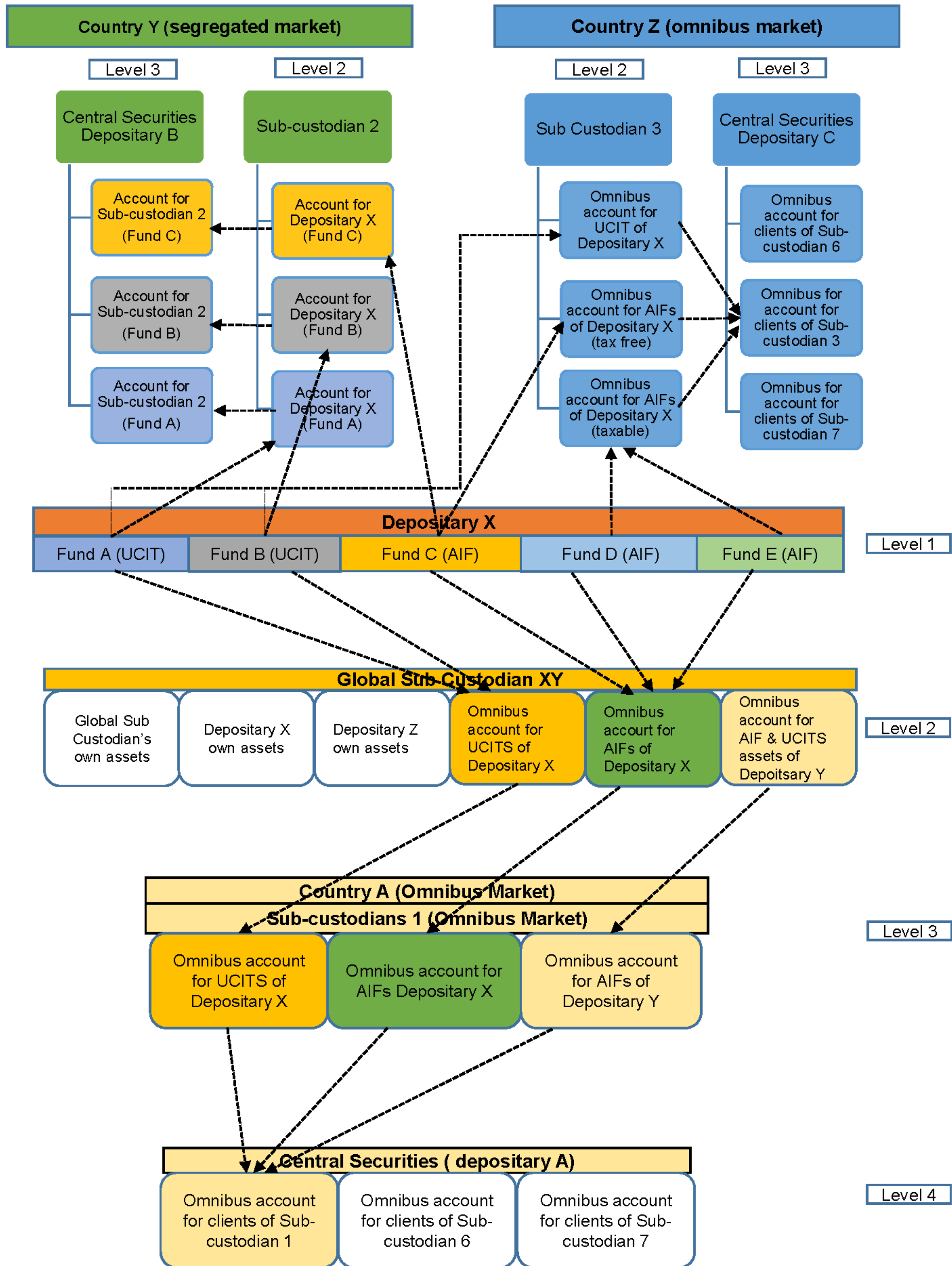
A combination between Global Sub-Custodians and individually appointed sub-custodians can be encountered; there is thus not a unique model. Also the three levels are somehow a simplified view where in reality there are often more than three levels.

In parallel to the accounts, records are kept at each level. Such records permit to follow and establish the entitlement of each investment fund throughout the whole chain of custody, sub-custody, CSD.

In terms of entitlement, the investment fund would be able to claim at level 1 a given financial instrument from the depositary. At level 2 it is the depositary that can claim against the Sub-Custodian or the Global Sub-Custodian, as the case may be. At level 3 it is then the (Global) Sub-Custodian who can claim against the CSD.

In case of dispute the investment fund must obviously be in a position to adduce conclusive proof of the entitlement against the depositary and then the depositary against the (Global) Sub-Custodian and finally the (Global) Sub-Custodian against the CSD. Such proof takes typically the form of records and hence proper record keeping and re-conciliations are of such paramount importance.

Accounts are of a relatively lesser importance in this respect. To provide an imagined example: an investment fund can establish proof to be entitled to a given financial instrument, then the depositary must normally provide such financial instrument, regardless of whether such financial instrument is or is not in the financial instruments account of such investment fund. The same is true vice versa. The fact that a given financial instrument is in a given account does not necessarily mean that the relevant investment fund is entitled to such financial instrument. It can be in such account by error.



Country Y (segregated market)
Level 3
Level 2
Central Securities Depositary B
Sub-custodian 2
Account for Sub-custodian 2 (Fund C)
Account for Sub-custodian 2 (Fund B)
Account for Sub-custodian 2 (Fund A)
Account for Depositary X (Fund C)
Account for Depositary X (Fund B)
Account for Depositary X (Fund A)
Country Z (omnibus market)
Level 2
Level 3
Sub Custodian 3
Central Securities Depositary C
Omnibus account for UCIT of Depositary X
Omnibus account for AIFs of Depositary X (tax free)
Omnibus account for AIFs of Depositary X (taxable)
Omnibus account for clients of Sub-custodian 6
Omnibus for account for clients of Sub-custodian 3
Omnibus for account for clients of Sub-custodian 7
Depositary X
Fund A (UCIT)
Fund B (UCIT)
Fund C (AIF)
Fund D (AIF)
Fund E (AIF)
Level 1
Global Sub-Custodian XY
Global Sub Custodian's own assets
Depositary X own assets
Depositary Z own assets
Omnibus account for UCITS of Depositary X
Omnibus account for AIFs of Depositary X
Omnibus account for AIF & UCITS assets of Depoitsary Y
Level 2
Country A (Omnibus Market)
Sub-custodians 1 (Omnibus Market)
Omnibus account for UCITS of Depositary X
Omnibus account for AIFs Depositary X
Omnibus account for AIFs of Depositary Y
Level 3
Central Securities (depositary A)
Omnibus account for clients of Sub-custodian 1
Omnibus account for clients of Sub-custodian 6
Omnibus account for clients of Sub-custodian 7
Level 4

First Level

At the depositary level, a separate account is opened for each investment fund and each sub-fund so as to solidify the segregation of assets and liabilities between investment funds and sub-funds. The creditors of a given investment fund or sub-fund can only seize the account corresponding to such investment fund or sub-fund. The record keeping follows the same logic. A key task of the depositary is to ensure that there is a constant accuracy of the records of entitlements and holdings per investment fund or sub-fund.

Second Level

At the second level in the custody chain the depositary will typically open at least three accounts, namely one omnibus account for own financial instruments, one omnibus account for UCITS and/or AIF financial instruments and one omnibus account for the financial instruments of other customers. Only for the good order, the (Global) Sub-Custodian must separate own transferable financial instruments from the above referenced accounts.

In terms of entitlement, the creditors of the (Global) Sub-Custodian can potentially get hold of the (Global) Sub-Custodian own financial instruments but typically not of the other financial instruments. Similarly, the creditors of the depositary can potentially get hold of the own financial instruments of the depositary but not of the other ones. The investment funds and their creditors can, however, not directly claim against the (Global) Sub-Custodian and get hold of the financial instruments on the omnibus accounts opened for UCITS and/or AIF and the omnibus accounts for other customers. They have to claim against the depositary that then, in turn, must claim against the (Global) Sub-Custodian. Consequently, it is of lesser importance whether separate omnibus accounts are opened for UCITS, AIF and other customers. For a variety of reasons, the market practice appears to be to have at least separate accounts for UCITS and AIF (collective asset management) on the one hand and other customers on the other hand. However the most important is to ensure that there is segregation between own account and clients' assets.

As already mentioned there may be a Global Sub-Custodian or a country specific Sub-Custodian at level 2 or a mixture, depending on the circumstances and preferences.

Further, the preference of typically to use omnibus accounts but local rules may impose segregated accounts.

Third level

From this level until the CSD the prevailing standard is segregation between own assets and customer assets as no further protection seems to be required.

Q. 1b.). As outlined above at the first level the norm is to open segregated account for each investment fund or sub-fund and hence omnibus accounts are not the entry point.

Omnibus accounts are often used for a variety of good reasons at the levels below but own assets and customer assets are segregated as described.

The typical chain of entitlement is for example investment fund/sub-fund – depositary, depositary –Global Sub-Custodian, Global Sub-Custodian - Sub-Custodian and finally Sub-Custodian – CSD. From this results that, whatever the account structure, the record keeping is paramount because ultimately it determines the entitlements to the specific financial instruments.

This being said, the account structure model in a given market is in particular driven by a combination of local settlement and safekeeping practices in the specific market concerned, systemic and reporting capabilities of the local agent and CSDs and the local regulatory requirement and established market practices.

Q. 1c) Please find an answer in the previous section; the general approach is to use omnibus account throughout the custody chain, unless required otherwise by a given jurisdiction or required for practical purposes such as tax reporting. In any case, from our point of view, what prevails from the perspective of protecting fund' assets is that records of entitlements are maintained accurately and timely.

1d) As mentioned above, the account structure model in a given market is in particular driven by a combination of local settlement and safekeeping practices in the specific market concerned, systemic and reporting capabilities of the local agent and CSDs and the local regulatory requirement and established market practices and finally is also subject to clients' needs.

1e) From an operational perspective, both types of funds are largely managed according to the same, or very similar, custody structure. Indeed, a UCITS or an AIF buying an equity share, are acquiring the same instruments, and this through the same channels. Acquiring such instruments imposes to maintain the same types of recording or processing in both cases. This applies unless the assets justify a specific treatment or are for any (regulatory) reasons excluded from the reach of a type of fund.

1f) Since the vast majority of financial instruments is not kept in custody in Luxembourg but elsewhere, this may not be very relevant.

The choice for omnibus accounts in level 2 and below is less driven by these considerations than by reasons of operational certainty and efficiency, cost, ease of quick repatriation and similar considerations.

<ESMA_QUESTION_CE_ASCS_1>

Q2: Please explain how, under the framework you have described in your response to Q1, the assets of the AIF/UCITS are protected against the insolvency of any of the parties involved in the custody chain (depositary, delegate, sub-delegate, – including prime broker – CSD) and – in case of use of 'omnibus accounts' – of their other clients whose assets are also held in this same account. In particular, what happens if a party, whose assets are held in another party's 'omnibus account', becomes insolvent? Does this place at any disadvantage the other parties using the omnibus account who are not in default?

<ESMA_QUESTION_CE_ASCS_2>

See above. As long as own financial instruments and customer financial instruments are properly segregated by accounts and records, there should be protection against creditors of the custodian at each level. The fact that financial instruments of several customers are commingled in one omnibus account does normally not entail a direct entitlement of a customer to the financial instruments on such omnibus account but the customer must claim against the depositary that then must obtain the financial instruments from the omnibus account.

Consequently, if such customer becomes e.g. insolvent, the bankruptcy receiver must claim against the depositary and the customers whose financial instruments are commingled at the level of the omnibus account are not concerned.

The fact that omnibus accounts are already used since a very long time and in a quite general manner and not limited to investment funds without – to the best of our knowledge – major failings despite a number of very important insolvencies appears to confirm these findings in reality.

<ESMA_QUESTION_CE_ASCS_2>

Q3: Please describe the differences (if any) between 'omnibus accounts' (i.e. books and records segregation) and separate accounts in terms of return of the assets from the account in a scenario of potential insolvency or insolvency. In particular, please indicate whether the assets may be transferred to the depositary or another delegate more easily and/or quickly under a particular insolvency regime from either of the two types of account and explain why. If possible and relevant, please (i) distinguish among the various jurisdictions of which you have knowledge and (ii) explain whether a specific type of account may have an impact on the timeline for the aforementioned transfer of assets or, more generally, on the order of events in a scenario of potential insolvency or insolvency.

<ESMA_QUESTION_CE_ASCS_3>

In line with our response to the ESMA consultation paper on Guidelines on asset segregation under the AIFMD of December 2014 (ESMA/2014/1326) we consider that segregation should not be an aim by itself but it is a way to enhance the protection of custodiable financial instruments in case of insolvency of the depositary or its sub-custodians. This can be effectively achieved by using segregated accounts or omnibus account structure that are commonly recognised as an effective method of protecting end investors.

Segregation between a depositary's proprietary assets and its customer's assets by way of separate accounts as well as at the levels below between delegate's proprietary assets, depositary's proprietary assets and customer assets is generally regarded as an efficient way of protecting the customer's assets against depositary and/or delegate insolvency. This can be effectively achieved by using segregated accounts and/or omnibus structures, which are commonly recognised as an effective method of protecting, end investor's interests.

We believe that there is no material differences between 'omnibus accounts' (i.e. books and records segregation) and separate accounts in terms of return of the assets from the account in a scenario of potential insolvency or insolvency. Moreover, asset segregation is not the key factor in determining the recoverability of assets in the event of the sub-delegate's insolvency.

In our view, if a party whose assets are held in another person's omnibus account becomes insolvent, this in itself would not disadvantage the position of solvent parties whose assets are in the same omnibus account. The position of the insolvent party post-insolvency should not be any stronger than it would have been prior to the liquidation i.e. it would not have a claim on assets to which it would not have been entitled prior to the insolvency.

In any insolvency scenario, the key requirement is that the assets are clearly identifiable as belonging to the AIF/UCITS. This is ensured by having a link from the books and records of the depositary, which will maintain separate accounts for each AIF/UCITS, through omnibus accounts with sub-custodians to the position held at the CSD. Without such a link, it would not be possible for the various parties in the chain to reconcile their respective records.

The ability to distinguish between clients' interests where separate accounts are opened may initially assist in identification; however it is unlikely to lead to greater ease of speed in the return of assets on insolvency due to a number of factors, including the following:

- the differences in insolvency law and practice in the relevant jurisdictions at the various levels of the custodial chain;

esma

- problems involved in unravelling securities lending and other derivative contracts to which the assets may be subject;
- resolving the security claims and interests (including liens) of the various parties throughout the custodial chain.

In addition, we are of the view that separate physical accounts would be likely to lead ultimately to greater difficulty in record reconciliation and risk of error. It would also have a significant impact upon cost which would outweigh any benefits to separate accounts (see below). Finally we do believe that the choice between 'omnibus accounts' (i.e. books and records segregation) and separate accounts does not alter the insolvency risk.

<ESMA_QUESTION_CE_ASCS_3>

Q4: Should you consider that asset segregation pursuant to options 1 and 2 of the CP does not provide any additional protection to the existing arrangements you described in your response to Q1 in case of insolvency, and that these arrangements provide adequate investor protection, please explain which aspects of the regime contribute to meeting the policy objective through measures including:

i) effective reconciliation,

ii) traceability (e.g. books and records), or

iii) any other means (e.g. legal mechanisms).

Please justify your response and provide details on what any of the means under i) to iii) consist of.

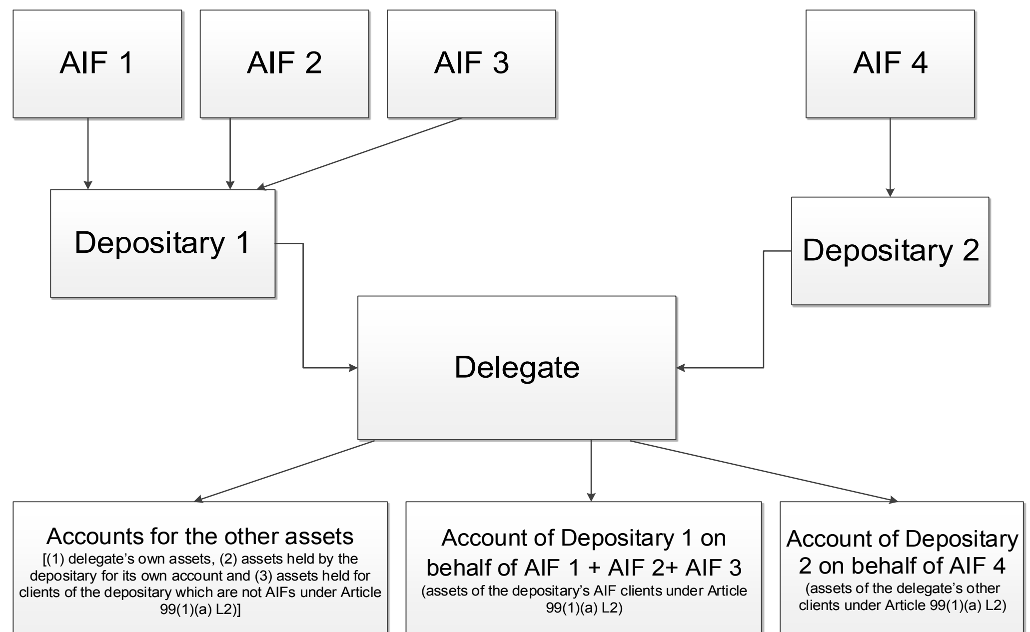
<ESMA_QUESTION_CE_ASCS_4>

Individual client accounts and omnibus client accounts held at the level of its delegates are reconciled with the depositary's own records on a daily basis. Discrepancies are escalated within a quick turnaround time and tracked through to resolution. In case of insolvency proceeding, daily effective reconciliations are fundamental for the traceability of client's assets throughout the custody chain when books and records are used.

<ESMA_QUESTION_CE_ASCS_4>

Q5: In the chart below (option 1 of the CP), AIF 1 would only have recourse against Depositary 1 under the PRIMA concept.

a) In the event of, for instance, a default of Depositary 2, would separate accounts at the level of the Delegate make it easier for Depositary 1 to enforce the rights in respect of the assets held in the account on its behalf against the Delegate?



b) In the event of the default of the Delegate, would separate accounts at the level of the Delegate make it easier for Depositary 1 and Depositary 2 to enforce their rights in respect of the assets held in the account on their behalf against the Delegate or its liquidators?

<ESMA_QUESTION_CE_ASCS_5>

Q.5a.) Referring to the chart above, our understanding is that Depositary 1 would not be impacted by the default of Depositary 2. The account structure will not give rise to different rights or impeach some of the depositary 1 clients' rights to enforce theirs. What is key, in this scenario, as in others, is that records of entitlements are accurate and up-to-date, so that a liquidator is able to allocate the assets to the right "entity". The default of Depositary 2 would only affect its own assets held by the Delegate (proprietary assets of the Depositary 2) as securities that are allocated *do not form part of property* of 'Intermediary', but are allocated to the *rights* of account holder, irrespective if it is an omnibus account or an individual separated clients account.

5b.) As a general remark, securities that are allocated do not form part of property of Delegate, but are allocated to the rights of Depositary 1 and 2 clients (the 'account holders'). Therefore, we believe that the failure of the delegate will not impact the depositary 1 (or 2) clients holdings as long as the jurisdiction is recognising that there is a separation between own assets and clients assets. As such, those assets do not form part of the property of the delegate and are not available for distribution among or realisation for

the benefit of creditors of the delegate (*see also Art 25 (2) UNIDROIT CONVENTION ON SUBSTANTIVE RULES FOR INTERMEDIATED SECURITIES*).

<ESMA_QUESTION_CE_ASCS_5>

Q6: Many respondents to the CP argued that, in an insolvency scenario, imposing a model where investors have individual accounts throughout the custody chain would not necessarily provide any particular benefit over the use of IT book segregation in an omnibus account (i.e. books and records instead of separate accounts). Please explain how the level of protection indicated in the policy objective at the start of this paper can be achieved through the use of omnibus accounts. Please also:

a) describe how segregation in books and records would ensure the aforementioned investor protection;

b) provide an example of how such books and records are used in insolvency proceedings to trace and return client securities when omnibus accounts are used; and

c) explain how the above-mentioned segregation in books and records would address any of the risks of 'omnibus accounts' mentioned in recent IOSCO work[7].

<ESMA_QUESTION_CE_ASCS_6>

The principal objective of a depositary is to effectively manage the risk and safety of its client's assets. Across the custody chain proper segregation is maintained between the proprietary assets of the depositary and its delegates chain from client's own assets. When client's assets are identifiable and safe through the chain, with the use of books and records, and provided that reconciliations are conducted in a timely and accurate way, such segregation would ensure investor protection.

In the event of an insolvency of a delegate, the Insolvency Practitioner would undertake a full reconciliation of delegate records to the records held at the level of the depositary and it must undertake a number of controls on any right over the assets, before is able to return these assets. There is no evidence that assets that are held on segregated client accounts instead of omnibus client accounts would make any material difference to the speed at which the assets are recovered from the delegates.

[7] See paragraphs 29 and 30 of the Standards for the Custody of Collective Investment Schemes' Assets – Final Report (FR25/2015): "*Depending on the operational framework in the jurisdiction, there is a risk that CIS assets in the custodian's care can become co-mingled with (i) assets of the responsible entity; (ii) assets of the custodian; or (iii) the assets of other clients of the custodian (although it should be noted that CIS assets may be held in a permissible "omnibus account"). The consequences of these risks could result in the ownership of the assets being called into question in the event of misuse or insolvency of the custodian, which may create difficulties differentiating ownership of the assets*". The positive and negative aspects of omnibus accounts are also mentioned on page 11 of the IOSCO Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets – Final Report (FR05/11).

<ESMA_QUESTION_CE_ASCS_6>

Q7: Please describe the impact of settlement process and account structures on the different levels through the custody chain in the case of

- **Cross-border investments**
  - **Through CSD Links**
  - **In relation to cross-border investments through CSD links, what are the functions of an investor CSD[8]?**
  - **Through T2S**
- **Prime broker services**
- **Tri-party collateral management / securities lending.**

<ESMA_QUESTION_CE_ASCS_7>

While the scope and complexity of this question exceeds this call for evidence, in summary it is fair to say that an excessive granularity of accounts is detrimental to efficient and secure operations and settlement as well as economies of scale and therefore better cost management without an apparent added advantage. The market infrastructure such as CSD links, T2S as well as prime broker services and securities lending are based on standardisation and pooling transactions together into blocks as to reduce the number of operations so as to gain efficiency and reduce cost.

<ESMA_QUESTION_CE_ASCS_7>

Q8: It has been argued that each time a new end investor or new AIF or UCITS is added as a customer, instead of one new account being created, many new accounts would need to be created at multiple levels in the chain of custody. If you agree with this statement, please provide further details of how this would work in practice.

<ESMA_QUESTION_CE_ASCS_8>
Every time there is a new AIF or UCITS at first level, the depository is setting up a new account for the recordkeeping of this new entity in their system. Replicating additional new accounts at further levels of the custody chain would result in many new accounts and would increase risks, operational complexity and upfront and ongoing costs regarding the opening and maintenance of multiple accounts held at the level of the delegates. Please also refer to our answer to question 9.

[8] According to Article 1(g) of the ESMA draft technical standards under CSDR (ESMA/2015/1457/Annex II), 'investor CSD' means a CSD that is a participant in the securities settlement system operated by another CSD or that uses an intermediary that is a participant in the securities settlement system operated by another CSD in relation to a securities issue (available at www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457_-_annex_ii_-_csdr_ts_on_csd_requirements_and_internalised_settlement.pdf).

<ESMA_QUESTION_CE_ASCS_8>

Q9: If the number of accounts were increased, what effect would it have on the efficiency of settlement operations (e.g. the ability to net off transactions)?

<ESMA_QUESTION_CE_ASCS_9>

From efficiency standpoint the multiplication of accounts at the different intermediaries in the custody chain would inevitably imply greater operational risks, as all participants in the custody chain would need to process a far greater amount of settlement instructions and reconciliations.

For example, if full segregation were requested, global custodians would most probably open segregated accounts with their local sub-custodians as opposed to using omnibus, direct T2S-type links direct to the CSDs.

- Omnibus account structures are critical for the efficient functioning of internalised settlements. Key advantages of omnibus accounts that it allows for internalised (or net) settlement, especially with respect to the competitive nature; Clients could "settle" across the books of an account provider instead of using the CSD.
- If each clients' holding is held in a separate account with an upper-tier intermediary "internalised settlement" is impossible, since an account provider acting as lower-tier intermediary needs to process a transfer from a selling investor client to a buying investor client by means of external instructions to the upper-tier intermediary.
- By contrast, if an omnibus account is used, and the ordinary processing algorithms permit, an account provider would not need to issue any external instructions to settle such a transfer.
- Internalised settlement can reduce the cost of transfers and improve service levels (e.g., by offering "transfer finality" at an earlier moment than if settlement occurs at a higher tier intermediary).

By removing the benefits that the use of omnibus accounts brings to the industry, there would also be major consequences to the benefits that the T2S project aimed to introduce. Going ahead, the different depositaries, will not be able to rely in the single access to T2S for the settlement of the assets of the fund (requiring segregation), and would then need to establish direct access to the markets where they intend to settle.

Finally, an increase of accounts would reducing the efficiency of dealing block trades, result in less efficient reconciliations and in multiplication of trades and orders (*inter alia*, also to support daily securities

lending or EPM activities), thereby increasing the potential for false or erroneous account bookings and entries.

<ESMA_QUESTION_CE_ASCS_9>

Q10: Many respondents to the CP argued that option 1 in the CP would prevent asset managers from:

a) executing block trades; and

b) benefiting from internalised settlements (settling across the account provider's own books rather than the books of the sub-delegate).

If you agree with the statements under a) or b), please explain the relevant issue.

<ESMA_QUESTION_CE_ASCS_10>

In this regards the perspective to take into account should be both the one of the depositaries and that of the manager of the fund that are concerned by the custody network and how it could be both efficient, cost effective and secure.

These operations do present for asset managers or funds a key tool that would definitely be hampered by option 1. We might rely on example to illustrate why the process would be more cumbersome and not in the final interest of fund investors. We should assume that a fund manager has a range of i.e. 15 funds that all invest in the shares of X. That company for whatever reason announces a major event that the fund manager does not like, therefore it wants to sell the shares of X. Concretely it is unlikely that the decision will be to sell only for funds 4, 5 and 6 but to sell for all funds. Under option 1 this process will mean that there would be a need to check each fund position, place 15 orders (with relevant communications...) execute the orders, settle each transaction per fund, reconcile data... this sometimes for a few shares, as a consequence at least an impact on costs (transactions, settlement…). Alternatively, under option 4 or an omnibus structure, the managers decides to sell the position in share X, it place an order and that order is executed in a single trade that the depositary will books in the records of each fund and ensure that these are accurately updated.
<ESMA_QUESTION_CE_ASCS_10>

Q11: Many CP respondents indicated that the costs associated with option 1 are very significant. Please provide further data on quantifying the cost impact (including one-off and on-going) of option 1 on AIFs/UCITS (and their shareholders), depositaries, global custodians, prime brokers, delegates, their clients and the different markets?

<ESMA_QUESTION_CE_ASCS_11>
From an association stand point, it is always difficult to supply specific figures. However because the markets are highly competitive, both in the EU and globally, any difference may place the EU at a competitive disadvantage. The impact might be that less capital will be channelled to the EU companies and to the EU economy, which is in full contradiction with the objectives of the Capital Markets Union (CMU).
<ESMA_QUESTION_CE_ASCS_11>

Q12: Are there any advantages of using omnibus accounts not covered in your responses to other questions?

<ESMA_QUESTION_CE_ASCS_12>

We think we appropriately describe the benefits of such accounts furthermore we note that they have been a fruit of the process of evolution in mature markets from individual accounts for paper securities to electronic accounts, then omnibus structures. They do exist notably because the legal environment is robust enough to support them.

<ESMA_QUESTION_CE_ASCS_12>

Q13: Please consider the case where a third-party delegate or sub-delegate in the custody chain also acts as a clearing member under EMIR. What would be the impact (if any) of the interaction between the approaches described under each of the options in the table under Q22 below and the choices provided for under Article 39 (2) and (3) of EMIR[9] (including if this may raise any operational difficulties)? Should you consider that there is any impact, please explain why.

<ESMA_QUESTION_CE_ASCS_13>

We do think that these are different types of issues. In our view, the context of EMIR the "fund" depositary is not in a material position to influence what is first and foremost a trading decision (with the consequence on margining and collateral). Furthermore the context of, or objective pursued, is different between the two regulations, notably considering that under EMIR transactions may be more cash intensive and that the

[9] Article 39(2) and (3) of EMIR states the following: "*2. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients ('omnibus client segregation'). 3. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients ('individual client segregation'). Upon request, the CCP shall offer clearing members the possibility to open more accounts in their own name or for the account of their clients*".

purpose is not recovery of assets but portability to an alternative CCP and the possibility to compensate in case of failure to preform a transaction not proceed to restitution of the assets.

What might be evidenced is the potential conflict of rules between EMIR and UCITS/AIFMD, thus call for increased consistency of rules at EU level.

<ESMA_QUESTION_CE_ASCS_13>

Q14: Please describe the functioning of the following arrangements and clarify the operational reasons why, and the extent to which, the segregation requirements under option 1 would affect them:

a) tri-party collateral management arrangements;

b) prime brokerage arrangements.

<ESMA_QUESTION_CE_ASCS_14>

Overall, the issues that option 1 would create are largely the same for items a) and b) although the underlying rationales of the trade are different. Option one will notably have for consequence to affect medium to small size asset managers. As the pool of assets they have with one of these counterparties is limited, the possibilities to use some collateral for any arrangements would only be suboptimal.

In addition, the option one presents one limitation, as the agent will be in the impossibility to supply collateral in time. As these 2 alternatives are used in the context of liquidity management, a timely access to available liquidity and collateral is of prime importance, which de facto discredits less optimal solutions.

Further, the complexity of management will be increased (numerous accounts instead of one omnibus) which would slower the process and negatively impact economy of scales.

Concretely, should a fully segregated approach be introduced, reconciliation will have to be done at each layer. It means that transaction under option 1 will have to be replicated at each layer of the custody chain. This is currently not necessarily the case as regards book records, where a bulk approach can currently be retained and tailored at each layer needs. A process that is both flexible and robust enough under most risk free market conditions.

By changing the existing prime brokerage arrangements to meet option 1, executing brokers would likely be required to handle a significantly larger number of (Standard Settlement Instructions ('SSIs') compared to a single omnibus SSI for each market as per today. This will naturally increase the operational complexity (for both executing brokers and prime brokers) that will lead to an inevitable increase in the error rate. Such errors can result in failed trades with the potential for buy-in's, additional cost and even

regulatory sanctions in certain markets. Should the trades not fail, they will be initially unmatched, causing unnecessary additional work to resolve. The technical complexity in the changes required to be made by the prime brokers will not only increase operational risk but most likely end up with the costs of such changes being passed on to their clients, i.e. the investors of the funds.

Finally, we believe that Option 1 bears a significant downside potential in harming the liquidity of European markets to the advantage of non-EU ones, while reducing available securities loan pools to the detriment of UCITS/AIF investors. This, at a time when the essential tenets of CMU should be embraced and applied.

<ESMA_QUESTION_CE_ASCS_14>

Q15: Are you able to source any data on quantifying the additional costs and market impact for prime brokers and/or collateral managers as a result of implementing option 1?

<ESMA_QUESTION_CE_ASCS_15>

Due to the short timeframe we would like to refer ESMA to the individual response of our members.

<ESMA_QUESTION_CE_ASCS_15>

Q16: Many respondents to the CP argued that the requirements under option 1 would trigger 'legal certainty risk' and 'attendant operational risk' in relation to collateral management. Should you agree with these statements, please specify what precisely you understand by "legal certainty risk and "attendant operational risk". How could those risks be mitigated?

<ESMA_QUESTION_CE_ASCS_16>

In our view, the major issue concerns the operational risk, which may at some stage trigger legal risks as well. For collateral management, flows of transactions should be smooth and efficient, and, regarding collateral, the combination of assets through pooling delivers the most desired outcomes. As previously mentioned, the option 1 will create costs and delays and will potentially trigger operational risks, as there will be an increased number of transactions to perform and to replicate at the various layers. Indeed, in the numerous replications there is a risk of fail, notably settlement fail, which will entail potential legal risks.

It is to be underlined that a segregated model does not entail any benefits in terms of investor protection and legal certainty. On the contrary, it can even have detrimental effects considering that the operational

risks are outweighing any potential benefits. Finally, it also risks excluding smaller accounts from using the tools offered to optimise the management of funds, where such tools are allowed.

<ESMA_QUESTION_CE_ASCS_16>

Q17: Could adaptations to IT systems help to face the challenges that option 1 represents in relation to collateral management? If so, please explain how, if possible indicating the costs and timescales of the work that would be needed.

<ESMA_QUESTION_CE_ASCS_17>

No, not necessarily – IT-enhancements are not a panacea solution. More complex IT-structures create a risk of their own. The drawbacks of implementing new IT options are so important (time efficiency, operational risks, general efficiency) that even by adapting the systems it won't overcome all potential problems before all stakeholders across the globe have upgraded their own. Furthermore, under option 1, if IT systems are to be adapted, the processes will have to be amended and the settlement will have to be processed in the market. As a consequence, one will face much more complex processes where the instructions would have to be instructed much earlier in the chain and replicated throughout each layer. This would mean that each layer will have to develop a fully identical IT systems, as it will not only be applied by a sub-custodian. This is not only applicable in the EU, but anywhere where collateral may be used or reused.

<ESMA_QUESTION_CE_ASCS_17>

Q18: Have you identified any operational (or other) challenges in terms of the impact of the requirements under option 1 of the CP for the functioning and efficiency of T2S? If your answer is yes, please explain in detail.

<ESMA_QUESTION_CE_ASCS_18>

Several preliminary remarks are necessary when exploring the impacts of option 1 on T2S. Firstly, the development of CSD links, encouraged amongst others by T2S, has resulted in more widespread availability of omnibus accounts at CSDs. Secondly, by design T2S operates with omnibus accounts. For the few, so called direct markets, linked to T2S, there is an intermediary structure that has been put in place to regroup segregated accounts into an omnibus structure, which is then linked to T2S. This process goes back and forth in T2S and the local market. If option1 is pursued, it will place all the operators in a similar situation, which is conceptually not desirable nor efficiently manageable.

T2S is currently in a migration phase across the different markets, which once completed will be followed by a “stabilisation” period. These phases have to be completed prior to the introduction of changes. Therefore, the first window that will be opened to accommodate the option 1 for the fund industry onto T2S will not be prior to 2022. As such, forcing the introduction of the option 1 today, will, in this respect, correspond to put the carts before the horses and it will add risk for the different counterparties.

Furthermore, we would note that the objective of individual account segregation according to the proposed Option 1 appears to be misaligned with the objectives of the Central Securities Depositaries Regulation (CSDR) and Target 2 Securities (T2S). Where the latter initiatives’ main objectives are to increase the safety and efficiency of securities settlement and settlement infrastructures, Option 1 would jeopardize these by impeding settlement at an earlier moment as a result of the increased operational complexity associated with the proliferation of accounts and standard settlement instructions (“SSIs”), likely to provoke frequent settlement failures and delays. With the penalties for settlement failures envisaged under Article 7 of the CSDR, this is likely to result in additional costs for market participants to the detriment of their clients.

Finally, conceptually T2S was created with the policy objective to support growth across MS markets in a secure environment (by relying on central bank money), so that large transaction volumes can easily move from one Member State to another. Thus, if we opt for segregated accounts, we fear that, this would disrupt the process and reduce speed.

<ESMA_QUESTION_CE_ASCS_18>

Q19: Many respondents to the CP argued that AIFs risk being shut out of key markets due to the following:

a) the mismatch that will arise between local jurisdiction securities ownership rules and the mandated level of segregation required under option 1 in the CP; and/or

b) the requirement in certain countries to hold omnibus accounts across multiple depositaries, as is the case for certain stock exchanges.

If you agree with the above statement, please explain your concern with reference to specific jurisdictions and/or stock exchanges and the relevant requirements.

<ESMA_QUESTION_CE_ASCS_19>

In reality, the option 1 approach is so incompatible with the market practices in some countries that to be enforced, it will require, at least, a special treatment.

Special treatment means additional complexity for the intermediary and additional costs. If the option 1 was providing outstanding benefits for the different stakeholders the option could have been envisaged,

but in the present scenario, it only introduces burden and complexity to be replicated along the custody chain for little, if no, benefit at all. This is barely acceptable within the EU because all stakeholders are under the same regime, but it is even more detrimental if it is exported to third countries as then, it becomes fully unviable.
The third country impacts also relate to prime brokers in the US (SIPA Rules) and amongst others potentially the excess to mainland China, depending on the qualification of CSDs.

<ESMA_QUESTION_CE_ASCS_19>

Q20: Should you/the funds that you manage comply with option 1 in the CP, please provide details on if and how you apply the requirements under this option when delegating safe-keeping duties to third parties outside the EU.

<ESMA_QUESTION_CE_ASCS_20>

As trade association, we are not able to answer conclusively as it depends on each specific set up. Therefore, we refer ESMA to the individual replies of our Members.

<ESMA_QUESTION_CE_ASCS_20>

Q21: Many respondents to the CP argued that, given that many delegated third parties are located outside of the EU, option 1 of the CP could lead to higher fees charged by the delegated parties. Are you able to source any data on the potential higher fees charged by the delegated parties outside the EU as a result of implementing option 1?

<ESMA_QUESTION_CE_ASCS_21>

At our level it is difficult to assess the cost since they depend on the structure of each of the stakeholder. However, for sure, applying option 1 will add complexity, regulatory constraints and new risks. Non-EU markets may not find/understand the commercial incentives to pursue or set up specific models to accommodate the specific EU demands, generally speaking may even add that to the exception of the largest funds, others may not be in a position to impose their particular views. Moreover, we refer ESMA to the individual replies of our Members.

<ESMA_QUESTION_CE_ASCS_21>

Q22: How would you compare and contrast the five options in the cost-benefit analysis (CBA) of the CP in terms of achieving the policy objective described in the above introduction? In your opinion, does any one of the options offer a better solution for achieving this aim, and

if so, how? In answering to these questions, please refer to the table below which is copied from the CBA of the CP and adds the sub-delegate level.

Please note that as the present call for evidence is intended to cover asset segregation requirements for both AIFs and UCITS, with regard to the latter any reference in the table below to 'AIF' should also be read as 'UCITS', i.e. when applied to UCITS, references to 'AIF' should be read as 'UCITS' and references to 'non-AIF' should be read as 'non-UCITS'.

Option 1	AIF and non-AIF assets should not be mixed in the same account and there should be separate accounts for AIF assets of each depositary when a delegate is holding assets for multiple depositary clients. When the delegate appoints a sub-delegate, this should hold separate accounts for AIF assets of each depositary and should not mix in the same account non-AIF assets of that depositary or AIF assets coming from different depositaries.
Option 2	The separation of AIF and non-AIF assets should be required, but it would be possible to combine AIF assets of multiple depositaries into a single account at delegate or sub-delegate level.
Option 3	AIF and non-AIF assets could be commingled in the account on which the AIF's assets are to be kept at the level of the delegate. However, the delegate could not commingle in this account assets coming from different depositaries. When the delegate appoints a sub-delegate, this should hold separate accounts for assets coming from different depositaries. However, AIF and non-AIF assets could be commingled in the account of a given depositary in which the AIF's assets are to be kept at the level of the sub-delegate.
Option 4	AIF and non-AIF assets could be commingled in the account on which the AIF's assets are to be kept at the level of the delegate. The delegate could commingle in this account assets coming from different depositary clients. When the delegate appoints a sub-delegate, this could commingle in the same account AIF and non-AIF assets and assets coming from different depositaries and the delegates' clients (but should not be mixed with the delegate's or depositaries' own assets).
Option 5	AIF assets should be segregated on an AIF-by-AIF basis at the level of the delegate or sub- delegate.

<ESMA_QUESTION_CE_ASCS_22>

There is a clear preference for Option 4 as the default option. Our members considers that option 4 offers the best mix of protection and efficiency, provided that as stated across our response there is an accurate and timely booking of records and entitlement at each intermediary in the chain for its clients. In our view, option 4 meets the objective pursued of ensuring protection of client's assets in case of failure of an intermediary, the main reason why the segregation concept was introduced.

However and importantly, this does not mean that other models should be discarded. Indeed, there may exist circumstances under which other alternative options may have some merits. Other alternatives can have merits for specific reasons like local legal constraints, the fund manager demand (commercial basis) or specificities of the assets. The choice of a certain custodian chain model may vary from market to market. It is driven by a combination of local settlement and safekeeping practices in the specific market concerned, systemic and reporting capabilities of local agent and CSDs and the local legal/regulatory requirement that has evolved over time to support the established market practices.

Overall, mature markets have come to the conclusion that the best mix to ensure both protection of investors and efficiency is to rely on omnibus structures, segregating own assets from clients' assets. With today's technology, booking of records could be timely and accurate, and serves as satisfying the traceability of assets foreseen under an option 1 model.

<ESMA_QUESTION_CE_ASCS_22>

Q23: Articles 38(3) and (4) of the CSDR state that a CSD shall offer its participants the choice between:

i) 'omnibus client segregation' at the CSD level (holding in one securities account the securities that belong to different clients of that participant);

ii) 'individual client segregation' at the CSD level (segregating the securities of any of the participant's clients, if and as required by the participant).

In addition, under Article 38 (5) of CSDR, a participant shall offer its clients at least the choice between omnibus client segregation and individual client segregation and inform them of the costs and risks associated with each option[10].

a) Do you consider that a regime similar to the one under Article 38 of the CSDR but applied throughout the custody chain (according to which the manager of AIFs/UCITS, on behalf of their investors, informs the depositary of the level of asset segregation it wishes to apply throughout the custody chain to each individual AIF/UCITS, after having duly assessed the risks and costs associated with the different options) would achieve

[10] However, under Article 38(5) of the CSDR a CSD and its participant shall provide individual clients segregation for citizens and residents of, and legal persons established in, a Member State where required under the national law under which the securities are constituted as it stands at 17 September 2014.

the policy objective described in the above introduction? Please explain why and, if the answer is yes, how.

b) Applying a regime similar to the one under Article 38 of the CSDR to the AIF/UCITS framework would mean that the fund investors would have the choice to invest in a given fund or not, after having been made aware – through appropriate disclosures – of the level of asset segregation that the managers of AIFs/UCITS had chosen and the related costs. However, investors would not have the opportunity to participate in the choice of the level of asset segregation as such a choice would have to be made by the manager for each individual fund as a whole (i.e. it would not be possible to have different levels of segregation for the investors in the same fund). Do you consider that this could raise any concern in terms of investor protection or could any concern be alleviated through appropriate disclosures? Please explain the reasons for your answer.

c) Please comment on any implications of such a regime for the account related provisions under Article 39 of EMIR.

<ESMA_QUESTION_CE_ASCS_23>

a) We believe that ESMA's suggested approach goes well beyond what is required by the UCITS V and AIFMD Directives and the Delegated Regulation that require a segregation in the books of the depositary, the depositary's delegate and sub-delegates of such delegate.

Moreover, it seems debateable whether such an approach would be appropriate, given the fact that depositaries are responsible for the choice of the sub-custody network. We also believe that such an approach is likely to be complex and onerous for a depositary to administer, because a depositary would need to maintain systems capable of setting up both omnibus and individual accounts with all of its sub-custodians, and to maintain records and systems reflecting the different approach chosen for each fund (even where funds have the same manager), and the same would apply to sub-custodians and all other intermediaries through which the assets are held even though such entities have no direct relationship with the manager or the funds.

b) We believe that unless the fund or its representative has a specific interest in an option or another, the organisation of the custody network is a prerogative of the depositary. Conceptually speaking, we are not at ease with the proposal to let the - end -investor decide that structure, which in some jurisdictions (out of the EU) could in any case not be influenced. Furthermore it should still be demonstrated why a segregated approach would be superior and compensate for the costs, loss of efficiency. Finally, we wonder how the information about the different options might be explained, presented and proposed to the investors so that he/she can make an informed and qualified decision based on risk, costs and benefits and efficiency.

<ESMA_QUESTION_CE_ASCS_23>

Q24: Please describe any alternative regime which, in your view, would achieve the policy objective described in the above introduction.

<ESMA_QUESTION_CE_ASCS_24>

As explained above, we clearly favours option 4. This being said, one might wonder if a prescriptive regime is desirable, a principle based approach leaving room for natural adaptations that will arise due to market and technical developments could be preferable.

<ESMA_QUESTION_CE_ASCS_24>

Q25: Do you see a need for detailing and further clarifying the concept of "custody" for the purposes of the AIFMD and UCITS Directive?

<ESMA_QUESTION_CE_ASCS_25>

There is no need to further clarify the concept of "custody" in the AIFMD and UCITS Directive. The meaning of "custody" of financial instruments in both AIFMD and UCITS V is sufficiently clear. It refers to the holding of financial instruments (whether directly or indirectly through intermediaries), whereas "safekeeping" is a broader term, used to mean both the function of providing custody of financial instruments, and the function of verifying ownership of assets that are not financial instruments. This may be seen from the wording of Art 21(8) AIFMD, in which the first lines refer to "safe-keeping" which is then sub-divided into the depositary's obligation to "hold in custody all financial instruments" in 21(8)(a) AIFMD, and the depositary's obligation "verify the ownership of the AIF" in 21(8)(b) AIFMD. The wording in UCITS V, Art 22(5) is similar, and the same terms are used in a similar manner throughout the AIFMD and UCITS V Level 2 legislation.

<ESMA_QUESTION_CE_ASCS_25>

Q26: If your answer to Q25 is yes, should the concept of "custody" of financial instruments include the provision of any of the following services for the purpose of the AIFMD and UCITS Directive:

- **a) initial recording of securities in a book-entry system ('notary service');**
- **b) providing and maintaining securities accounts at the top tier level ('central maintenance service')[11];**

[11] These services are part of the core services of central securities depositories under Section A, point 2 of the Annex to Regulation (EU) No 909/2014 ("CSDR").

c) maintaining or operating securities accounts in relation to the settlement service;

d) having any kind of access to the assets of the AIF/UCITS; or

e) having any access to the accounts where the assets of the AIF/UCITS are booked with the right to pledge and transfer those assets from those accounts to any other party?

<ESMA_QUESTION_CE_ASCS_26>

None of the additional services listed above by ESMA should be included within the concept of custody. In our view, in a fund context, they do not constitute the function of holding of assets (even if may be carried out in connection with holding assets). Furthermore applying fund specific definition to these concepts risks to create unintended consequences in other regulations like MIFID for example. This said an EU wide recognition of book-entry and records and recognition of intermediaries such as the Geneva Convention model might present overall benefits for the EU. The European Commission is currently reviewing some of these concepts, thus there may be room for a common definition that we do not necessarily call for. In any case if it is envisaged to review or introduce new regulation in this area it should definitely not be done via guidelines or L2 legislation related to funds, the only valid approach is to do so via a new Level 1..

<ESMA_QUESTION_CE_ASCS_26>

Q27: If your answer to Q25 is yes, would you include any other services in the concept of "custody" of financial instruments for the purpose of the AIFMD and UCITS Directive? If your answer is yes, please list and describe precisely the services that should be included.

<ESMA_QUESTION_CE_ASCS_27>

N/A

<ESMA_QUESTION_CE_ASCS_27>

Q28: Please explain how, in your views, "custody" services interact with "safe-keeping" services, in particular those referred to under Article 21(8) of the AIFMD (as well as Article 89 of the AIFMD Level 2[12]) and Article 22(5) of the UCITS Directive (as well as Article 13 of the UCITS V Level 2[13]).

[12] Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012.

[13] Commission Delegated Regulation (EU) 2016/438 of 17 December 2015.

<ESMA_QUESTION_CE_ASCS_28>

We think that both regulations do offer satisfactory definitions of these concepts. Please refer to our answer to question 25.

<ESMA_QUESTION_CE_ASCS_28>

Q29: If you consider that the provision by a CSD of any of the core services (i.e. services mentioned under Section A of the Annex to the CSDR) or ancillary services (i.e. services provided in accordance with Section B or Section C of the Annex to the CSDR) should not result in the CSD being considered as a delegate within the meaning of Article 21(11) of the AIFMD and Article 22a of the UCITS Directive, please list the specific services and explain the reasons why.

<ESMA_QUESTION_CE_ASCS_29>
Answering this question is neither simple nor straightforward, in our view this should be solved first at Level 1 and furthermore not in the context of fund regulations. One of the reasons that may justify a special handling is that CSDs are crucial components of the functioning of markets above all in the context of EUR settlements under T2S. This said, under CSDR, CSDs are allowed to provide additional banking-type ancillary services relating to settlement such as collateral management, securities lending, enhanced asset servicing, etc. (see Annex B to CSDR). Issues arose because many of the latter services are also offered by UCITS/AIF depositaries and their third party delegates but are subject to different rules.

By offering identical services, both compete on unequal terms due to the fact that CSDs are exempted under EU regulation from the strict liability requirements by design of their regulatory framework when at the same time UCITS/AIF depositaries have to comply to such under the original objective of their respective Directives.

At the present, AIFMD, clearly states that CSDs, as operators of Security Settlement Systems (“SSS”), are outside the scope of Article 21 (11) which applies to third-party delegates,

The uncertainty relates to the reading of the UCITS Directive in respect of Recital 21 of the same legislation and the ESMA Q&A issued on 1 October 2015 in respect of the AIFMD. It is ambiguous in respect of the dual roles that CSDs can play, either as “issuer CSDs” or “investor CSDs”, although both provide the same level of asset protection towards the CSD participant. Two fundamental questions arise:

a) Should CSDs be considered “third parties to whom custody is delegated” and if so, would these include all CSDs or just certain CSDs – such as CSDs maintaining certain types of links to provide access to securities held at other CSDs?

b) If there is a loss of securities by a CSD (or a third-party within its network), should such loss be considered due to "external events"?

We also noted that there is a potential mismatch of liability standards between depositaries and their delegates on the one hand and, on the other hand, CSDs.

For the industry to operate on a level playing field, we are of the view that clarifications need to be made to recognise the dual role CSDs can play as either "issuer" or "investor" CSDs. However, we also note that relying solely on the "issuer" CSD / "investor" CSD distinction might be problematic. We are concerned that the "investor" CSD definition might capture more than what it is aimed at as some CSDs transactions should not be treated as delegates, such as CSDs that provide access to other CSDs using direct links between SSS entities. Those linked CSDs should be classified as market infrastructure and not as delegates[14]. Finally, CSDs that provide access to other CSDs using links that are intermediated by entities that are not Securities Settlement Systems should be classified as well as falling within the scope of depositary delegation arrangements under the UCITS/AIFM Directives, although again, here it should be noted that CSDs as operators of SSSs are differentiated from custodian banks as they offer a single fungible environment for their participants with among others:

- the same level of asset protection regardless of whether a security is held "domestically" or "cross-border",
- where all activities are controlled and measured against PFMI-IOSCO standards (not the case for custodians) and reviewed by the NCAs with the IMF/World Bank
- where CSD-R obligations will be transitioned in over the coming months.

Any changes in this regard should be thoroughly investigated with a view to measuring against CMU objectives and existing direct requirements on custody operations for custodian banks, therefore we doubt that changes can be triggered via Level 3 without due considerations to the respective Level 1 regulations for funds, CSDs as well as the potential impact if any on the operations of T2S.

<ESMA_QUESTION_CE_ASCS_29>

[14] Examples: Target2Securities (T2S), Shanghai-Hong Kong Stock Connect programme, as operated jointly by the Hong Kong Securities Clearing Company Limited (HKSCC) and China Clear. Article 7 of the China Securities Regulatory Commission (CSRC) Stock Connect Rules mandates both China Clear and HKSCC to perform their functions effectively as joint CSDs, together acting as a "top tier level" CSD function as described under Recital (21) of the "UCITS V" Directive.