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European Securities and Markets Authority
103 rue de Grenelle
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FRANCE

[(submitted via ESMA website)]

Re: CALL FOR EVIDENCE – ASSET SEGREGATION AND CUSTODY SERVICES (ESMA/2016/1137)

Introduction

The Bank of New York Mellon Corporation (BNY Mellon) is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. As one of the world's largest investment services and investment management firms, BNY Mellon welcomes the opportunity to respond to the ESMA Call for Evidence ("Call for Evidence") on Asset Segregation and Custody Services (ESMA/2016/1137).

BNY Mellon operates in Europe through: (i) branches of The Bank of New York Mellon (a New York state chartered bank) and (ii) directly established and duly authorised subsidiaries established in certain EU jurisdictions and branches of those entities operating in core EU member states. BNY Mellon provides services to clients and end-users of financial services globally. It is accordingly keenly interested to ensure financial markets operate fairly and consistently globally and that common standards ensure playing fields are kept level.

In Europe, BNY Mellon is represented as a custodian, depositary, triparty collateral manager and asset manager. As a group, BNY Mellon represents various types of market participants at various levels in the chain of custody. Therefore BNY Mellon has a strong interest in this Call for Evidence.

This is a topic in which we have continually maintained a strong interest. In January 2015, BNY Mellon submitted a response to the ESMA Consultation Paper ("Consultation Paper") on Guidelines on Asset Segregation under the AIFMD (ESMA/2014/1326). We enclose a copy of our response to the Consultation Paper in **Annex 4.** We note that the current Call for Evidence follows on from the Consultation Paper.

The Bank of New York Mellon – Incorporated with limited liability in the State of New York, USA. Head Office: 225 Liberty Street, New York, NY 10286, USA. London Branch registered in England & Wales with FC No 005522 and BR No 000818 and with its Registered Office at One Canada Square, London E14 5AL. The Bank of New York Mellon is supervised and regulated by the New York State Department of Financial Services and the Federal Reserve and authorised by the Prudential Regulation Authority. The Bank of New York Mellon London Branch is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request.

Executive Summary

The topic of this Call for Evidence is of fundamental importance for the custody industry. As the world's largest custodian, BNY Mellon has an integral and important interest in this Call for Evidence. We emphasise that **client asset protection** is and should be the primary objective for regulators and custodians.

Therefore, BNY Mellon has designed our custody operating model with client asset protection as our primary objective.

We dispel the notion that segregated accounts are necessary in order to achieve client asset protection. Omnibus accounts also achieve client asset protection.

We acknowledge that within the EU, there is a fragmented regulatory framework in respect of insolvency law and securities (property) law – with very different regimes and systems in various EU jurisdictions. However, it is important to break the perception that a fragmented regulatory insolvency/securities law framework in the EU (and indeed, globally) means there is insufficient client asset protection. The operating models used by custodians are designed achieve client asset protection on a cross-border basis and regardless of the regulatory frameworks in place.

However, this ties in with a key message that BNY Mellon has delivered for some time – it is necessary to reform and harmonise the EU's insolvency and securities law frameworks. This is, and should be, a key objective of the EU's Capital Markets Union project, which BNY Mellon fully supports.

In our response to this Call for Evidence, BNY Mellon also focuses on **triparty collateral management services**, as this is an area in which we have a unique perspective.

Our view is that proposals in regard to asset segregation need to be carefully designed and implemented so that they do not prevent effective collateral management. Any restrictions (intended or unintended) on the use and management of collateral would contradict the broad public policy objective of the use of collateral to reduce risk in the financial system.

If the use of segregated accounts is required throughout the custody chain, then it will not be possible for BNY Mellon (nor we believe, for any other party) to continue to provide triparty collateral services for AIF and UCITS funds. This would have a severely negative effect on the markets, for the reasons we gave in our response to the Consultation Paper.

European policymakers support the use of collateral as part of the post-financial-crisis recovery path. This is evident in significant components of the EU legislative framework such as CRD IV, CSDR and EMIR, which require or encourage the provision of collateral as an effective risk management tool.

Although this topic can be complex, our position is simple. BNY Mellon is committed to client asset protection, and we take all the necessary measures to achieve this. As mentioned above, this does not mean that segregated accounts must be used at every level in a chain of custody. We do not support any approach that prevents or restricts the use of omnibus accounts at sub-custodian level or below. As custodian, BNY Mellon segregates per client in our own books and records. We strongly recommend that (rather than requiring segregated accounts to be used at various levels in the chain of custody) ESMA takes a permissive approach, whereby it is *possible* for such segregated accounts to be used, but without requiring their use.

In practice, this means that optional segregation should apply at the level of the sub-custodian and below, ie, enabling omnibus accounts to be used where permitted by local law, but using segregated accounts where required by local law or requested by a particular client.

How should this be achieved? Clearly, we must use segregated accounts where necessary to achieve client asset protection, and BNY Mellon does this. However, it is important to note that Options 1 and 2 in the Consultation Paper do not increase client asset protection. What is our solution? ESMA have actually suggested the solution in Question 23 of the Call for Evidence. Question 23 refers to Article 38 of CSDR. BNY Mellon believes this CSDR framework provides the solution. Adapting Article 38 of CSDR for AIFMD and UCITS will result in a consistent legislative framework (horizontal consistency), which is a key objective of Capital Markets Union. BNY Mellon strongly supports the Capital Markets Union, including the goal of horizontal consistency of legislation.

Therefore, we strongly recommend that ESMA follow the approach suggested in Question 23(b). That is, 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. We agree that 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.

BNY Mellon thinks this is a sensible, pragmatic and effective solution. It is consistent with CSDR, and consistent with the public policy objective of the use of collateral to reduce risk in the financial system. It also supports the objective of horizontal consistency of legislation as part of Capital Markets Union.

Our Approach to Responding to this Consultation

In responding to this Call for Evidence, we have worked closely with the Association of Global Custodians ("AGC"). We have also worked with industry associations such as AFME, the European Banking Federation, Irish Funds, and IMMFA. We know that industry associations have also collaborated on this important topic, and you will see from the overall nature of responses that mandating the use of segregated accounts throughout the custody chain has very little support at all.

General Comments – Securities Accounts

We think it would be useful for us to set out our view on what we mean by a "*securities account*", and provide some introductory comments. This concept ties in with several of the questions asked by ESMA in this Call for Evidence.

Definitions/Meanings of "*Securities Account*"

A "*securities account*" is simply another form of account – similar to a bank account as the general public would understand it. A securities account is basically a book and record of securities (shares, stocks, bonds etc).

We note that in 2006, the European Commission's Internal Market and Services DG's Legal Certainty Group considered in detail various questions relating to EU Clearing and Settlement.[1]

One of the questions asked was "What is a Securities Account?", and the Legal Certainty Group looked at this for every EU jurisdiction (as at 2006).

We can extract from this two jurisdictions – the United Kingdom and Belgium – as examples of a common law and civil law approach to the question of what is a securities account.

United Kingdom[2]

"*The regulatory regime established by the Financial Services and Markets Act 2000 imposes a number of requirements on securities custodians operating in the UK, including the general segregation of client assets from house assets and the use of custody agreements.*

Under English law [an] intermediary holding client securities as custodian is generally characterised as a trustee. No formalities are required to establish a valid trust of non-land assets. However, there must be certainty of intention (to create a trust); certainty of beneficiary (i.e. the identity of the client must be known or ascertainable); and certainty of subject matter (i.e. the custody asset must be ascertained). In practice certainty of intention and of beneficiary are satisfied by the execution of a custody agreement in customary form. In previous years there has been an active debate about the requirement for certainty of subject matter in relation to omnibus client accounts (where the like assets of more than one client are held in a single client account by the custodian). Today, the prevailing opinion is that the requirement is either inapplicable in relation to intangible assets and/or satisfied where the client account is segregated from the custodian's house account.

Sections 136 and 53(1)(c) of the Law of Property Act 1925 imposes certain formalities on the transfer of intangible assets. Section 136 is considered to be inapplicable to the transfer of rights in securities held by intermediaries, for two reasons. Firstly, on the basis that the intermediary is a trustee, the transferred asset is equitable and not legal, and therefore cannot be subject to a legal assignment. Secondly, [the] legal effect of book entry transfer is understood to be novation and not assignment.

Section 53(1)(c) requires dispositions of equitable interests to be in writing. While it is theoretically possible that this might apply to book entry transfers of rights in securities held by intermediaries, a number of arguments are available that it is not applicable, and it is not the practice of London custodians to comply with the section.

The UK settlement system, CREST, unlike those of other jurisdictions, is a direct holding system. This means that participants in CREST hold their securities directly from their issuers, and not through an intermediary. Of course, the participants may themselves be intermediaries, holding securities indirectly for their clients."

Belgium[3]

[1] http://ec.europa.eu/internal_market/financial-markets/docs/certainty/background/comparative_survey_en.pdf
[2] ibid, pp.89-90.
[3] ibid, p.70.

"*A securities account is not explicitly defined in Belgian legislation. We consider it as an agreement between the account holder and the intermediary to record in book-entry form assets (generally in fungible form) held by the latter in the name of or on behalf of the former, and for this purpose to submit the entitlement to such assets to a specific law that will govern the correlative rights of the account holder. In fact, in our opinion, a securities account is nothing more than an account agreement which will in fact create, subject to the conditions organised by the law governing the account agreement (which also may impose specific duties on the intermediary in terms of accounting treatment, etc.), the rights and obligations of the parties relating to the securities deposited with the intermediary. For accounting purposes, it records an off balance sheet obligation of the intermediary. For the purposes of Royal Decree 62, it records the entitlement of the client against its intermediary …*

What are the relevant custody, commercial, accounting … laws?

Companies Code, Royal Decree 62, Civil code (deposit contract; see articles 1915 and following); there is no specific accounting law (even if the general accounting legislation is applicable as a rule) except for dematerialized securities held in NBB settlement system (see Royal Decree of 23 January 1991 on Belgian State debt securities), including commercial paper (see Royal Decree of 14 October 1991 relating to billets de trésorerie and certificats de dépôts)."

So although the underlying legal systems (common law, civil law) are different (eg, the extent of codification of the law), when it comes to the concept of a *securities account*, we end up in the same place – a securities account is a book and record setting out the rights and entitlements of parties to securities kept in the account. The securities account establishes a property right (an "*in rem*" right) that is enforceable against all comers.

Characteristics and Usage of Securities Accounts

The characteristics of securities accounts are essentially about what they need to look like. The usage of securities accounts is about how such accounts are opened and why.

In terms of the characteristics, although the finer details may differ from jurisdiction to jurisdiction, the core characteristics of a securities account are books and records that establish the *in rem* rights referred to above – this would generally include some form of account naming convention that would enable the account holder to be identified, and an explanation of how the account works.

The account naming convention is designed to enable the account holder to be identified, and whether the assets in the account are proprietary assets (of the account holder) or client assets. An explanation of how the account works is often set out in contractual terms and conditions, such as a custody agreement, between the account holder and account provider. This may include, for example, a reference to the fungible nature of the securities in the account.

In terms of usage (why such accounts are opened), the accounts are opened precisely in order to establish the *in rem* property rights, which are bilateral rights between the parties concerned, but enforceable against all comers. In terms of how such accounts are opened, please see our responses to Questions 4 and 8.

Status of Securities Accounts

This is about how a securities account is established and recognised. Is it under accounting principles, contract, or other rule or regulation? It depends on the jurisdiction and can be any

or all of these things – but fundamentally, in all markets in which BNY Mellon operates, a securities account is underpinned by a legally enforceable contract, such as a custody agreement, as it is this agreement that establishes the securities account(s), and sets out the rights and obligations of the parties.

Why Securities Accounts Work as a Reflection of a Bilateral Relationship

As we explained in our response to the Consultation Paper, securities accounts work, because they establish *in rem* property rights. When property rights are involved, the cause of action is against the assets, and such rights tend to be effective against all comers. Accordingly, the property rights are enforceable, regardless of the status of any intermediary or counterparty holding the asset.

This is consistent with the PRIMA concept, which recognises that at each level in the custody chain, each person in the chain has a directly enforceable property right against the next person in the custody chain. This maintains a consistent set of property rights throughout the chain, and prevents any attempts by one party to gain an unfair advantage by "leapfrogging" (i.e. trying to enforce property rights directly against further levels in the chain rather than the immediate level).

There is nothing overly complex about this – it simply reflects the bilateral relationship between the "account holder" (client) and the "account provider" (custodian). The contract between the account holder and account provider – in this context represented by a custody agreement – sets out the rights and obligations of the account holder and account provider to each other. This type of relationship is underpinned by and consistent with many other types of bilateral relationships – for example, a bilateral contract whereby each party provides consideration, or an agency-principal relationship.

Limitations on the Status of Securities Accounts (and why this isn't a problem)

Some may say that the nature of securities accounts creates limitations, for example, that it does not recognise third party rights, that it does not "cover the field" of how to deal with all possible eventualities, that there are no detailed overreaching rules, and so on.

However, the fact that securities accounts have limitations is a good thing. Firstly, it keeps the concept of a securities account relatively simple, making enforcement of *in rem* property rights relatively straight-forward. It is rare that parties would need to litigate to determine, for example, who is entitled to enforce the *in rem* property rights, because it is usually beyond doubt. Secondly, there is no need for the custody agreement to contain detailed overarching rules, because the legal system in the relevant jurisdiction already provides whatever overarching rules are needed (such rules are typically codified in a civil law system, and based on judicial precedent and legislation in a common law system), and the legal system provides a court or judicial system for dealing with anything that is not already solved.

Ultimately, the relative simplicity of securities accounts is one of their core strengths. The practical limitations of securities accounts (such as not recognising third party rights) increase legal certainty and therefore the robustness of return of client assets to those who are entitled to them. All of this enhances client asset protection, and the return of assets to clients as soon as possible.

Responses to Specific Questions

BNY Mellon is responding to ESMA using ESMA's "Reply form" document, which we are submitting online. However, for convenience, our responses to questions are also contained in **Annex 1** below.

BNY Mellon looks forward to further engagement with ESMA in regard to this Call for Evidence and any future consultations on this topic.

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List of Annexes

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ANNEX 1 – RESPONSES TO SPECIFIC QUESTIONS

Mapping of Asset Segregation Models

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 – with the use of a chart/diagram – 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 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.

We provide our chart in **Annex 2** of this response. We have endeavoured to keep the chart as simple as possible – a single page – which contains four levels:

- The first level in our chart (labelled "**Depositary**") is the level of the AIF/UCITS-appointed depositary. This shows AIFs and other clients, and depositaries (which may be internal or external to the BNY Mellon group). We have also included a BNY Mellon collateral manager at the same level as depositaries.

- The second level in our chart (labelled "**Global Custodian**") is the level of a delegation to a BNY Mellon intragroup custodian – this sits between the "first level" and "second level" as described in the question (technically not a "third party delegate of the depositary"). We describe the Global Custodian as "Delegate 1", as it is the first delegation from the depositary.

- The third level in our chart (labelled "**Sub Custodian**") is the level of a delegation by the intragroup custodian to an external sub custodian. This level will not exist in some markets, because the intragroup custodian may have direct access to the issuer CSD in those markets. But we include this level here for completeness, as it is a typical scenario for BNY Mellon. We describe the Sub Custodian as "Delegate 2", as it is the sub-delegate of Delegate 1.

- The fourth and final level in our chart (labelled "**CSD**") is the Issuer CSD level. Note that this is not delegation in our view, so we have not labelled this as a level of delegation.

For each level, the chart demonstrates the typical account structures that are used.

Please note we have not identified UCITS separately in this chart.

Detailed description of BNY Mellon's asset segregation model:

First Level

BNY Mellon operates a number of depositaries in the EU, through various legal entities (subsidiaries or branches). For example, BNY Mellon has a depositary in Ireland, Luxembourg, Germany, the UK, and the Netherlands. In our chart, we provide the example of our German depositary and our Irish depositary.

These depositaries maintain individual accounts per fund (or technically, per legal entity that appoints the depositary). These accounts are not omnibus accounts. At this level, all accounts are segregated accounts.

We have highlighted that there could be other external depositaries that choose to appoint BNY Mellon as their global custodian.

In addition to depositaries, BNY Mellon operates its European collateral management business from a distinct legal entity, The Bank of New York Mellon, London Branch ("BNYM LB"). For collateral management purposes, BNYM LB becomes the custodian to multiple "sell-side" clients ("other clients" in the ESMA terminology) and to either AIFs or the depositary of such AIFs and operates individual accounts as indicated.

All BNY Mellon depositary entities use a joint custody platform for securities account keeping purposes. The custody platform is a multi-entity system that links each securities account to a particular depositary via a legal entity code. The legal entity code uniquely identifies the relevant depositary, whether it is a subsidiary or branch.

Via internal delegation arrangements (usually in the form of a custody agreement), the various BNY Mellon depositaries delegate safekeeping (as referred to in AIFMD or UCITS V legislation) to The Bank of New York Mellon SA/NV, a Belgian credit institution which is a global custodian. The depositaries retain responsibility for oversight of the fund, cash flow monitoring, and the other functions that the depositary must perform under AIFMD or UCITS V.

Second Level

As mentioned above, such depositaries and the Bank of New York Mellon, London Branch each appoint The Bank of New York Mellon SA/NV as their global custodian.

Under the internal delegation arrangements, The Bank of New York Mellon SA/NV is entitled to operate the individual client accounts that are maintained on the custody platform. In that sense, Option 5 (Full segregation) is applied at the first level of delegation within BNY Mellon entities.

In addition to that, the system allows The Bank of New York Mellon SA/NV to drive reporting by legal entity code and retrieve at a minimum, 2 distinct records per each of its clients: one “own account” for the client and one “client omnibus” account for the client.

For example, our chart shows that for Depositary 3, the Global Custodian maintains a “Depositary 3 own assets” account, and the Global Custodian maintains a client omnibus account – this account holds all positions of AIF5 and other clients of Depositary 3.

The same approach could be used for Depositary 1 – that is the Global Custodian could maintain a “Depositary 1 own assets account” , and a client omnibus holding all positions of AIF1, AIF2, AIF3 and other clients of Depositary 1.

The Bank of New York Mellon SA/NV will provide each client the option of individually segregated accounts for single underlying clients. It is this scenario which we demonstrate in the chart. In this case, there would be a “Depositary 1 own assets account” (if Depositary 1 has own assets), and there are separate segregated accounts for AIF1, AIF 2, AIF3, and respectively for other clients of Depositary 1.

Third Level

The third level is the local custodian (or sub-custodian) level. The Bank of New York Mellon SA/NV maintains a network of local sub-custodians in many markets around the world, and in such markets the local sub-custodian is a third party delegate appointed by the Global Custodian for that market.

At a minimum, The Bank of New York Mellon SA/NV requires its local sub-custodian to operate 2 securities accounts for The Bank of New York Mellon SA/NV: one account for The Bank of New York Mellon SA/NV’s own assets, and one account for The Bank of New York Mellon SA/NV’s client assets.

In addition to this, BNY Mellon policy is to segregate all own assets of BNY Mellon legal entities. Therefore, The Bank of New York Mellon SA/NV will require its sub-custodian to maintain additional segregated client accounts to segregate the own assets of the various BNY Mellon legal entities. Where local market requirements (e.g. Hong Kong or Japan) require holding segregated client accounts, The Bank of New York Mellon SA/NV will have more than these 2 accounts. Also, optionally, if requested, The Bank of New York Mellon SA/NV will require its local sub-custodian to operate segregated accounts for single clients. For example, an account for The Bank of New York Mellon SA/NV on behalf of Depositary 1 on behalf of AIFx could be set up.

Final Level

The last level in the chart demonstrates the level of the local issuer central securities depository (CSD). Again, depending on local market requirements, at a minimum The Bank of New York Mellon SA/NV's local sub-custodian would operate 2 accounts (one for its own assets, one for its client assets) and would optionally offer to operate segregated client accounts where requested and where supported by the local CSD. As above, own assets of BNY Mellon entities are segregated throughout the whole 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.

Firstly, we would caution against the use of the word "commingled" in the question, as this creates confusion – please refer to the AGC response in this regard.

i) The chart illustrates very clearly: where allowed by local market practice and where not requested differently by individual clients, omnibus accounts would be used on the second level by the global custodian The Bank of New York Mellon SA/NV.

ii) From the perspective of The Bank of New York Mellon SA/NV, the account naming convention for the securities account will demonstrate clearly that the assets held in a client omnibus account belong to the underlying clients of the specific Depositary (eg, through the use of words such as "… for and on behalf of its clients" or "… client account").

iii) BNY Mellon's policies and procedures ensure that restrictions on re-use of assets are observed regardless of whether omnibus accounts or segregated accounts are used. BNY Mellon would not re-use assets unless written client consent has been obtained and provided that re-use is permissible under the relevant regulatory regime.

iv) There is no set or typical percentage of omnibus accounts in a custody chain – this is driven by client demand and will fluctuate over time. BNY Mellon does not have a target percentage in this regard.

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)?

BNY Mellon uses omnibus accounts. For triparty collateral management to work effectively, omnibus accounts must be used (as we explained in our response to the Consultation Paper).

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.

The description of the options in the table under Question 22 and the visualisation of these options in the Consultation Paper give rise to misinterpretation, in particular, because only one level of delegation is described. For this reason, we should be cautious in mapping our model to one of the options described. Based on our interpretation of the options, we believe that on the level of delegation between a BNY Mellon depositary and The Bank of New York Mellon SA/NV as the global custodian, our chart matches with Option 5, as full segregation is applied. In the delegation between The Bank of New York Mellon, London Branch as the collateral manager, and The Bank of New York Mellon SA/NV as the global custodian, Option 4 is applied.

In the delegation from The Bank of New York Mellon SA/NV to the local sub-custodian, our chart matches with Option 4, and provides optional segregation elements as described in Option 5.

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).

BNY Mellon's model does not make any such distinction. In that sense "AIF" and "UCITS" is interchangeable in our chart.

f) **According to a Briefing Note published by ECON in 2011, there are five basic models for holding securities with an intermediary: the trust model, the security entitlement model, the undivided property model, the pooled property model and the transparent model. 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.**

Please see the AGC response.

Investor Protection in the event of Insolvency

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?

We believe that it is constructive to look at the chain of custody in a normal client fund (AIF/UCITS) environment where a depositary is appointed, and who subsequently appoints a Global Custodian (first delegate), who in turn appoints/already has appointed a Sub Custodian (second delegate) network in each of the markets in which the AIF/UCITS will invest. These Sub Custodians will normally work in turn with local Central Securities Depositaries (CSDs) which form part of the local market infrastructure.

Account Names

Firstly, we can start with the initial link in the chain and that is the Depositary. Let's assume that the Depositary is from an independent company to that of the appointed Global Custodian. The books of the Global Custodian, (the first delegate) will show an account in the name of the Depositary for:

1. the Depositary's own proprietary assets (assuming the Depositary appoints the Global Custodian as custodian of the Depositary's own assets)

2. each of the clients of the Depositary (segregated accounts in the name of the Depositary and each client), as well as segregated accounts for all other clients of the Global Custodian

The books of the Sub Custodian (second delegate) will show accounts in the name of:

1. the Global Custodian (first delegate) for the Global Custodian's proprietary assets
2. the clients of the Global Custodian (omnibus account)
3. the Sub Custodian's other clients (omnibus account where the clients are other global custodians on behalf of their clients, and segregated accounts where the Sub Custodian has a direct relationship (first delegate) with the client)
4. the Sub Custodian's own proprietary assets

Scenario 1 – failure of Depositary

If the Depositary becomes insolvent, the Insolvency Practitioner (IP) will look to the records of the Global Custodian and any other party appointed by the Depositary (e.g. prime broker) to establish a picture of the assets that are held on behalf of each client of the Depositary, and what assets may be proprietary assets belonging to the depositary.

The IP will reconcile the client statements issued by the Depositary to the clients of the Depositary, against the accounts held at the Global Custodian in the name of each of the clients of the Depositary. The IP will also reconcile the Depositary's account containing proprietary assets with the Depositary's own record of its proprietary assets.

In the event that the Depositary and the Global Custodian were from the same parent entity and the parent entity failed, the IP would follow the same process and look to the books, records and accounts held by each entity (the Depositary and the Global Custodian) to validate which assets belonged to which entity.

Equally, the IP would reconcile the omnibus accounts in the name of the Global Custodian at the Sub Custodians with the records of the Global Custodian to ensure that there was an exact mirror of the total holdings at the Sub Custodian with those of the Global Custodian in aggregate, for each client of the Global Custodian.

In this example, where the Depositary failed, none of its proprietary assets would have been held in an omnibus client account at the Global Custodian, so there is no potential for impact on any other client holdings. All accounts at the Global Custodian (first delegate) are segregated accounts, which facilitate the Global Custodian's reporting to its clients, including the Depositary itself.

Scenario 2 – failure of Global Custodian

Secondly, let's look at a similar situation but this time, where the Global Custodian (first delegate) fails. The IP would firstly reconcile the statements held by the Depositary for each of its clients, with the records of the Global Custodian. Next the

IP would reconcile the records of the Global Custodian with the records of the Sub Custodian to ensure that there was again, agreed holdings across the entire chain from the Sub Custodian, through the failed Global Custodian records and then onto the Depositary's records (if separate from the Global Custodian).

As before, the books of the Global Custodian (the first delegate) will show an account in the name of the Depositary for:

1. the Depositary's own proprietary assets (assuming the Depositary appoints the Global Custodian as custodian of the Depositary's own assets)
2. each of the clients of the Depositary, (segregated accounts in the name of the Depositary and each client), as well as segregated accounts for all other clients of the Global Custodian

Similarly with the example above where the Depositary failed, the books of the Sub Custodian (second delegate) will show accounts in the name of the:

1. Global Custodian (first delegate) for the Global Custodian's proprietary assets
2. clients of the Global Custodian
3. Sub Custodian's other clients
4. Sub Custodian's own proprietary assets

Reconciliation breaks between any of the three parties - Depositary, Global Custodian, Sub Custodian - would need to be resolved before an IP would be confident to release assets to each of the asset owners.

Scenario 3 – failure of Sub Custodian

Finally, we can look at a situation where the second delegate or Sub Custodian fails. The IP would firstly reconcile the statements held by the Global Custodian (first delegate), with the records of the Sub Custodian.

As before, the books of the Sub Custodian, will show an account in the name of the Global Custodian for:

1. the Global Custodian's own proprietary assets
2. the clients' of the Global Custodian in an omnibus account, as well as segregated accounts for any other clients of the Global Custodian who had requested segregated accounts at the Sub Custodian

Similarly with the example above where the Global Custodian failed, the books of the Sub Custodian will also show accounts in the name of the:

1. Sub Custodian's other clients
2. Sub Custodian's own proprietary assets

Reconciliation breaks between the Global Custodian and Sub Custodian would need to be resolved before an IP would feel confident to release assets to the Global Custodian, who would in term release assets to the Depositary.

Other Questions

You have also asked that we look at 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?

Our unequivocal view is that it does not have any impact on other asset owners whose assets may also be held in the same omnibus account.

To look at a simplified example, we could imagine say an insurance company and a sovereign wealth fund were the only two clients of a Global Custodian (which we call ABC Bank). Each of them only invested in say U.S. Treasuries and accordingly there was only one Sub Custodian involved, which we call XYZ Bank.

The accounts at the Global Custodian (ABC Bank) would be as follows:

1. Insurance company account
2. Sovereign wealth fund account

And the Global Custodian would report on each client's account every day.

Now let's assume there is only one client of the Sub Custodian (XYZ Bank), and that is the Global Custodian (ABC Bank). The account structure at the Sub Custodian (XYZ Bank) would be as follows:

1. account in the name of the Global Custodian "ABC Bank" to hold the Global Custodian's proprietary assets, segregated from all client assets
2. account in the name of the Global Custodian "ABC Bank for and on behalf of its clients" (i.e. clients of ABC Bank, the Global Custodian)

Each day, the Global Custodian and Sub Custodian would reconcile both accounts with each other to ensure that the accuracy of positions and balances remains.

However, you have asked us to assume that one of the clients of the Global Custodian fails while its assets are held in an omnibus account of the Global Custodian at the Sub Custodian. We will assume that the insurance company failed, and the IP would therefore be looking to recover the assets of the insurance company from the Global Custodian.

The IP would begin by examining the Global Custodian's account statements issued to the insurance company with the insurance company's own records. The return of the insurance company's assets to the estate of the failed insurance company is the responsibility of the Global Custodian, and not that of the Sub Custodian. The fact that the failed insurance company's assets are kept with the sovereign wealth fund assets in an omnibus account of the Sub Custodian of the Global Custodian is of no consequence.

The IP for the estate of the failed insurance company has no look-through to the Sub Custodian (ie, no "jumping the chain") and must rely on the Global Custodian for the return of the failed insurance company's assets. The IP is not privy to any information or clients in the Sub Custodian omnibus account and no claim could be made against other clients' assets in that omnibus account.

If it were possible for an IP to make a claim against other (surviving) client assets in an omnibus account at the Sub Custodian, no investor would permit their assets to be held in such an account as they would effectively be mutualising their risk on the weakest entity in that omnibus account.

See also the AGC response to this question.

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.

There are obviously different layers in any chain of custody, and we want to be clear that BNY Mellon fully supports the segregation of proprietary and client assets at all levels. This applies to Depositary own assets, Global Custodian and any Sub Custodian, or sub-delegate's own assets. We would always ensure that proprietary and client assets are held in segregated accounts as required.

For our securities financing and triparty collateral management businesses, we operate a segregated client accounts, books and records structure, and client omnibus accounts at the Sub Custodian. Our clients, comprising the world's most substantial investment banks, corporate banks and institutional investment groups, rely on our model which currently holds more than $650bn of their assets, in a books and records environment.

The assets are all held in a client omnibus account at our Sub Custodians, and these holdings are mirrored in our in-house system **RepoEdge** which forms our books and records for our triparty collateral service.

For a triparty collateral manager, the main focus is to ensure that upon insolvency or default of a collateral provider, the non-defaulting collateral receiver can have immediate access to the collateral. This is ensured by either using title transfer agreements (in this case, the assets are held in the name of the collateral receiver) or security interest/pledge mechanisms (in which case, the assets are held in the name of the collateral provider, but with an account control agreement for the benefit of the collateral receiver).

In the event of an insolvency of a participant in the triparty collateral management programme, the insolvency practitioner would look to **RepoEdge** as the BNY Mellon books and records of the failed client's holdings. We would also envisage that the IP would want BNY Mellon to confirm that there were no reconciliation breaks or claims against the assets held in our books and records including any liens/charges that may be in place over the assets of the estate of the failed entity.

In our view, there are no shortcuts to be made in reconciliation of the holdings of a client's account whether the client is solvent or in administration. The records of the service provider need to be appropriately reconciled, any errors resolved, and

charges over the assets determined, before the assets may be returned. Whether the record of a client's holding is in a physical, segregated or omnibus account, or held in an electronic, books and records system, is of no consequence to the IP and ultimate return of the assets. The question is what is the "Golden Record/Source". In BNY Mellon triparty collateral management, it is our books and records platform, **RepoEdge**.

We also refer to **Annex 3** of our response, which is a letter from PwC about the administration of Lehman Brothers International (Europe) ("LBIE"). A number of partners from PwC were appointed as administrators for LBIE, so they have direct experience of the issues raised in this question. The letter confirms that "*… based on the LBIE experience it is not clear that sub-custodian segregated client accounts would make any material difference to the speed of asset recovery to counterparties.*"

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.

As you will note from our response to Question 3, and to our response to the Consultation Paper, we do not believe that segregated accounts provide additional investor protection, nor do segregated accounts expedite the return of client assets in the event of an insolvency of the asset owner, the fund, asset manager, depositary or custody intermediaries.

However, we acknowledge that there are many countries in which segregation *at the CSD level* is necessary for reasons of client asset protection. If segregation at this level is of benefit, then BNY Mellon will ensure that this path is taken. It is important to note that AIFMD and UCITS V do not change anything in this respect.

BNY Mellon is the largest custodian of securitised assets in the world holding $29.5 trillion of client assets in custody. That represents approximately 20% of the world's issued securities. The success of our business is entirely a consequence of the protection we provide to client assets. Notwithstanding that our BNY Mellon depositaries have an obligation of restitution of client assets under AIFMD, we, as a general global custodian of assets outside of AIFMD, could not retain our clients, if we did not provide the highest levels of protection to their assets.

The model we operate as a global custodian, is one where we open segregated accounts in our books in the name of each client. These accounts drive all of the reporting we provide to each custody client every day. In turn, we open an omnibus account at each of our sub-custodians worldwide styled as a "client account in the

name of BNY Mellon". We aggregate all client assets in those accounts and instruct movements to and from the client's segregated accounts in our books and corresponding movements at the sub-custodian from the client omnibus account, according to authorised instructions from the investment manager.

Each day, we reconcile the sub-custodian accounts with our own records of aggregated client holdings and resolve discrepancies, normally within 24 hours. Typically with an AIF, the depositary would reconcile daily records of an AIF's holdings with those of the AIF's asset managers to ensure that all of the links in the investment chain are showing accurate and complete positions and balances.

Such daily reconciliations provide the traceability and assurance that the client's assets are accurately recorded throughout the custody chain.

However, the triparty collateral management services we provide function differently and are reliant upon books and records rather than a physical account structures at the sub-custodian to provide the record of client holdings at any given time.

Now we would like to summarise how the triparty collateral management model works. At its simplest, our client "dealers" also known as "collateral givers" like Goldman Sachs, BNP Paribas, Deutsche Bank who participate in our triparty collateral management programme, send us significant portfolios of assets which qualify as generally eligible collateral in the triparty programme. Those assets form the basis upon which the "dealers" (collateral givers) raise cash from counterparties in the programme. The securities are used as the first leg of the repurchase agreement (repo). The securities we hold in custody now become "collateral", which is assigned to the cash providers known as "investors". Investors make cash available to the dealers, usually on an overnight or short term basis.

BNY Mellon holds the dealers' collateral portfolios in our client omnibus accounts at the relevant sub-custodians. So for example, U.S. Treasuries will be held in our account at the Federal Reserve Bank in New York, Japanese Government Bonds at Bank of Tokyo Mitsubishi, and so on. Because the collateral is required to be moved frequently on the basis that the repo transactions are short term, it is expedient to do all that we can to minimise the physical movement of collateral.

We do this by operating a segregated account, books and records platform known as **RepoEdge** which, at an aggregate level, mirrors the total portfolio provided by the dealers (collateral – which is held unencumbered pending a repo transaction) and is held in our sub-custodian client omnibus account by market. For example, U.S. Treasuries in the U.S., Japanese Government securities in Japan etc.

By way of example, Deutsche Bank and BNP Paribas may provide us with US$1 billion of U.S. Treasuries each, which we will receive into our omnibus account at the Federal Reserve Bank, New York. Those assets ($2 billion in total) will sit in our client omnibus account at the Fed as unencumbered collateral until a repo transaction is done. Simultaneously, we will record the receipt of $1 billion each from Deutsche and BNP Paribas in the segregated accounts of Deutsche Bank and BNP Paribas in our books and records platform, **RepoEdge**. Each day we will reconcile the holdings in **RepoEdge** with those in the sub-custodian client omnibus account.

To continue the example, tomorrow "Bank 1" may wish to raise cash to fund its operations and will enter into a repo with "Bank 2" for $500 million. BNY Mellon already holds the eligible collateral to satisfy the Bank 1/Bank 2 transaction. So on

receipt of $500 million from Bank 2 for the cash leg of the repo, BNY Mellon will move (by book entry) say $510 million of U.S. Treasuries (includes $10 million or 2% collateral margin) in our **RepoEdge** platform from Bank 1's segregated account in **RepoEdge** to Bank 2's segregated account in **RepoEdge**. No movement of these securities occurs at BNY Mellon's sub-custodian in the U.S. The assets remain in the client omnibus account there.

Now in the event that Bank 1 fails (say two days later) and is unable to repay Bank 2 the $500 million, we can use the $510 million of U.S. Treasuries (eligible collateral) that we are holding in **RepoEdge** for Bank 2 as security to cover the loss to Bank 2. We would sell the U.S. Treasuries from the client omnibus account at the Fed and assuming we sold all of the holding for $510 million, $500 million (plus agreed repo income from the repo transaction) would be repaid to Bank 2 and the balance would be paid to the IP on behalf of the estate of Bank 1.

The IP would always be looking to BNY Mellon's books and records platform **RepoEdge**, as BNY Mellon's statement of the client's holdings, in this case, Bank 1.

To restate, the holdings reflected in the client omnibus account at the sub-custodian are reconciled daily with the aggregate of all segregated client holdings in **RepoEdge**. **RepoEdge** functions as the statement of client holdings in the same way as a normal global custodian segregated account for client assets which are not part of a triparty collateral arrangement.

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?

The answer for a) and b) is no.

Please see our answer to Question 3, the letter from PwC in **Annex 3**, and the response of AGC.

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.

As explained in our response to Question 4, the protection of client assets is of paramount importance to BNY Mellon, and indeed is the primary basis upon which investors appoint us as their custodian.

Testament to that is the fact that we currently hold approximately 20% of the world's securitised assets. Return of client assets in the event of an insolvency, is all part of the process of ensuring that assets are held securely and that adequate records are held at all times so that we at any point in time, and without delay, can attest to a client's positions and balances.

All client accounts are held in our books and records as global custodian and triparty collateral manager on a segregated basis. It is this basis that drives our client reporting and evidencing client holdings.

In the event of our insolvency, an IP would look to our statements of holdings of the clients to determine in the first instance what was due to each client. These statements of holdings would need to be aggregated by client, by market to reconcile back to the consolidated holdings in the client omnibus accounts at each of the local sub-custodians. Any surpluses or shortfalls would need to be reconciled until it was determined to whom or where the discrepancy was attributable.

The same would be true of segregated accounts throughout the custody chain. By that we mean if the global custodian operated segregated accounts at the global custodian level and similarly at the sub-custodian level, the IP would need to reconcile the segregated account at the global custodian level with the segregated account at the sub-custodian level.

The fact that they may reconcile perfectly does NOT mean that the records are a true statement of the ownership of those assets as there may be errors pending reconciliation of postings to the wrong account, reconciliation breaks elsewhere that have an impact on these accounts, pending trades, security charges/liens over the assets that means that the holdings statement is not an accurate record of what the IP may pay out to the investor. A full reconciliation of the entire estate of the failed entity would be essential before any assets were paid away.

The letter from PwC attached in **Annex 3** is confirmation of this.

ESMA references the work that IOSCO has published in their Final Report FR25/2015 entitled Standards for the Custody of Collective Investment Schemes Assets, and seeks a response to the points raised in Paragraphs 29 and 30. IOSCO notes throughout Chapter 3 that there are risks around the custody of CIS assets. Firstly, the risks identified to CIS assets, applies to all other asset owners, not just CIS assets.

But, specifically the risks identified at Chapter 3 A 29 recognise that assets may be held in permissible "omnibus accounts", as if to suggest that this is where the risks arise.

This is misleading, as is it equally true that the assets held in segregated accounts throughout the custody chain could also be commingled with the assets of (i) assets of the responsible entity; (ii) assets of the custodian; or (iii) the assets of other clients of the custodian. Such commingling would only occur in the event of fraud or error.

As we stated earlier, we segregate, as a matter of course, proprietary assets of (a) the depositary (responsible entity), (b) global custodian, (c) sub-custodian, (d) and any other intermediary entity in the custody chain, from client assets.

Secondly, we maintain segregated accounts for our clients on a books and records basis so that we can say at any time and without delay, what the client is holding. For commingling of other client assets with CIS assets or misuse of any client assets, fraud or error has to have occurred.

No custodian can use another client's assets without authorisation, in the same way that we cannot loan a non-lending client's assets without authority, or receive stock dividends for a client when they have elected to receive cash dividends or reinvest the cash. Only fraud or error can cause such misuse. Artificially segregating CIS or any other investors' assets does not prevent fraud or error.

In short, what we are saying is that these risks of misuse of assets, exists whether the CIS is in an omnibus or segregated account throughout the custody chain. To speak directly to fraud and Madoff, the risks of loss in that case are exactly the same across omnibus and segregated accounts. Madoff had authority to move assets from client accounts whether they were styled omnibus or segregated accounts.

Most importantly, we note that the IOSCO Final Report FR25/2015, does not make a recommendation in respect of segregating CIS assets other than as to the industry standard of segregating proprietary assets from clients' assets, which is normal commercial practice.

Complexity / Operational Costs

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

o **Cross-border investments**

- Through CSD Links

- In relation to cross-border investments through CSD links, what are the functions of an investor CSD?

- Through T2S

o **Prime broker services**

o **Tri-party collateral management / securities lending.**

The March 2012 AFME Paper entitled "CSD Account Structure: Issues and Proposals" (available at www.afme.eu/WorkArea/DownloadAsset.aspx?id=5897)

gives on page 9 the following explanation as to why the use of segregated accounts up the chain of custody is more complex than the use of omnibus accounts.

> *"There are two fundamental principles driving the use of omnibus accounts higher up the chain of intermediaries, rather than the use of more segregated account structures. The first is the principle of simplicity, rather than complexity; the second is the principle of data uniqueness (i.e. the principle that data should be stored and maintained in one place only, and not stored in multiple locations, so that – if the data change – there not be the requirement that the update be effected in multiple locations, with the associated risk that not all updates are effected in the same manner, or at the same time).*
>
> *Compared to the operation of multiple segregated accounts, the operation of one omnibus account is simpler, and less complex. The operation of a single omnibus account involves the maintenance of one account, with one account name, one set of static data, one set of securities balances, and one set of securities movements. The operation of multiple segregated accounts involves – at a minimum – the maintenance of multiple accounts with multiple names, multiple sets of static data, multiple sets of securities balances, and multiple sets of securities movements. It should be noted in many cases that the set of static data that is associated with a securities account may well include physical documentation (such as tax documentation).*
>
> *The principle of data uniqueness suggests that the relevant data should be maintained at only one location (i.e. the last intermediary in the chain) and not duplicated up the custody chain.*
>
> *These two principles suggest that the operation of omnibus accounts over segregated accounts is preferable both for reasons of cost (as simplicity is cheaper to manage than complexity) and for reasons of risk (as the maintenance of data in multiple locations creates the risk of inconsistencies between the data locations)".*

We believe that this analysis, and more broadly the entire analysis set out in this AFME paper, is still valid.

The purpose of the analysis, and of the AFME paper as a whole, is not to argue that segregation up the chain should never occur. It is rather to explain that segregation up the chain is a tool of which the purpose is to maintain additional data up the custody chain, and that use of this tool involves costs. If there is a reason for additional data to be held up the chain, then these costs may be acceptable and justifiable. But if there are no reasons for additional data to be held up the chain, then segregation up the chain involves costs without benefits.

The analysis set out in the AFME paper applies generically to all custody chains, and thus it includes custody chains in which CSDs act as intermediaries (i.e. as investor CSDs), in which CSDs use T2S, in which intermediaries provide prime brokerage services, and in which end investors or intermediaries engage in securities lending and/or collateral management.

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.

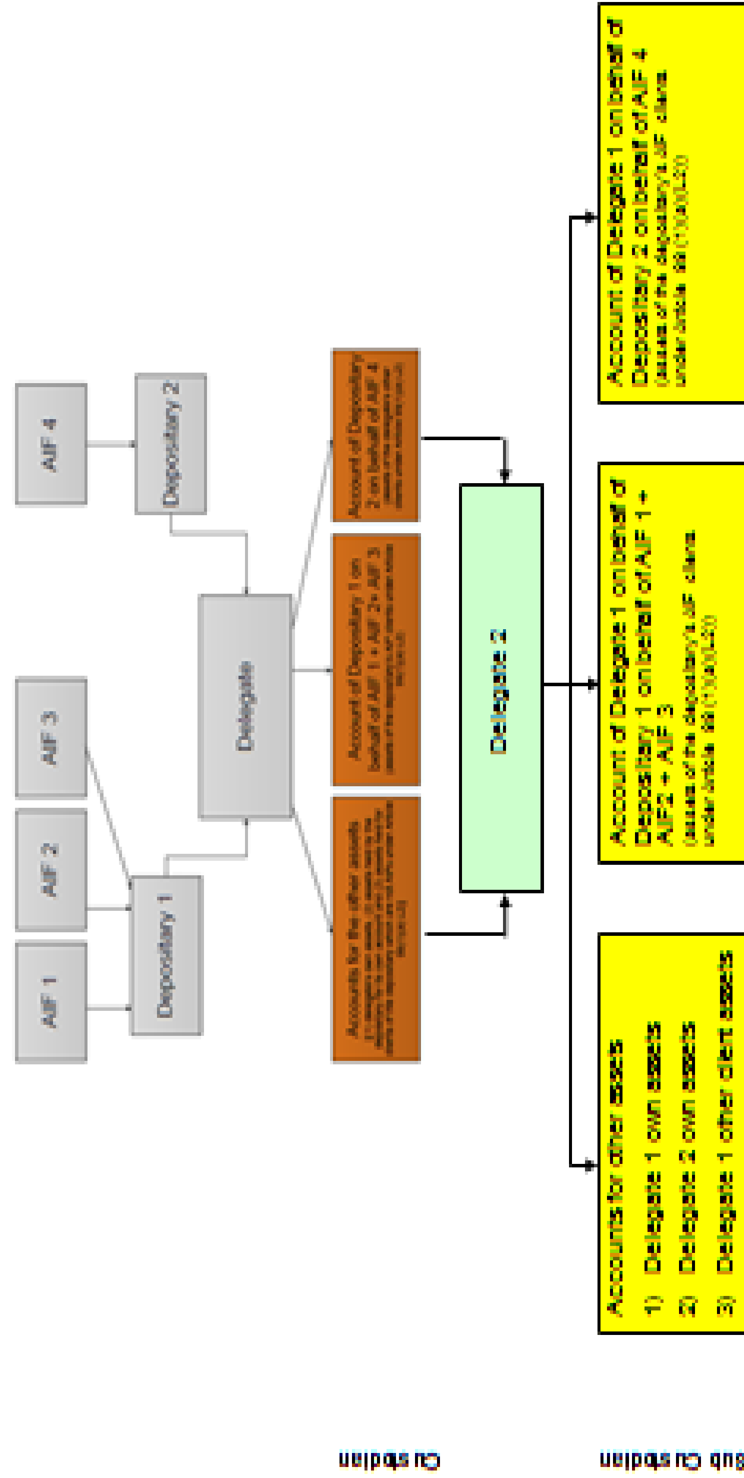
At a minimum, each time there is a new customer, one new account (for that customer) is needed in the books of the depositary. Where omnibus accounts are available, this does not necessarily mean that there will need to be additional accounts at the global custodian, sub-custodian or CSD, because the relevant omnibus accounts may already exist.

However, if segregation is required throughout the custody chain, then this increases the number of accounts needed. If, for example, the new customer invests in securities from 100 markets, then there will need to be a new account at 100 CSDs (ie, 100 new accounts at this level), a new account at 100 sub-custodians (ie, 100 new accounts at this level) and potentially a new account at the global custodian. So we go from the need to have one new account in the chain of custody to at least 200 new accounts. When we multiply this across the number of new customers, we can see that there is an exponentially adverse increase in the number of new accounts required, which creates operational complexity and operational risk, but without any increase in investor protection.

If segregated accounts under Option 1 of the Consultation Paper (which states "*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*"), were to be required, there would be no additional accounts required at the global custodian, but there would need to be a new account at each of the sub-custodians in the markets in which the AIF invested. So 20 countries of investment, would require 20 new segregated accounts on behalf of the AIF depositary.

The account structure would be as below (Figure 1):

Figure 1



The ESMA Guidelines in respect of Option 1 state that "*When safe-keeping duties are delegated to a third party (including a prime broker or a collateral manager), the account on which the AIF's assets are to be kept at the level of the delegated third party (or sub-delegate) should only comprise assets of the AIF and assets of other AIFs of the same depositary. Non-AIF assets should not be included in the account on which the AIF's assets are kept at the level of the delegated third party (or sub-delegate). Assets of other AIFs of other depositaries equally should be held in a separate account.*"

Even though it is possible to segregate AIFs by depositary under Option 1, in our view segregating AIFs by depositary at the sub-custodian level from all other assets doesn't make sense in that it does not provide additional protection for AIFs or make it easier to return assets in the event of the depositary, custodian or sub-custodian default.

Before assets are returned from the sub-custodian level, the IP would have to reconcile the entire book of omnibus and segregated accounts to validate that the global custodian's records are equal to the holdings at the sub-custodian level. Doing so means the IP is not exposed to any insolvency estate shortfall.

If segregation at the sub-custodian (sub-delegate) is required by depositary for AIFs and segregated for other assets, securities lending and triparty collateral management will be substantially affected and this will have a major effect on funding and liquidity in Europe.

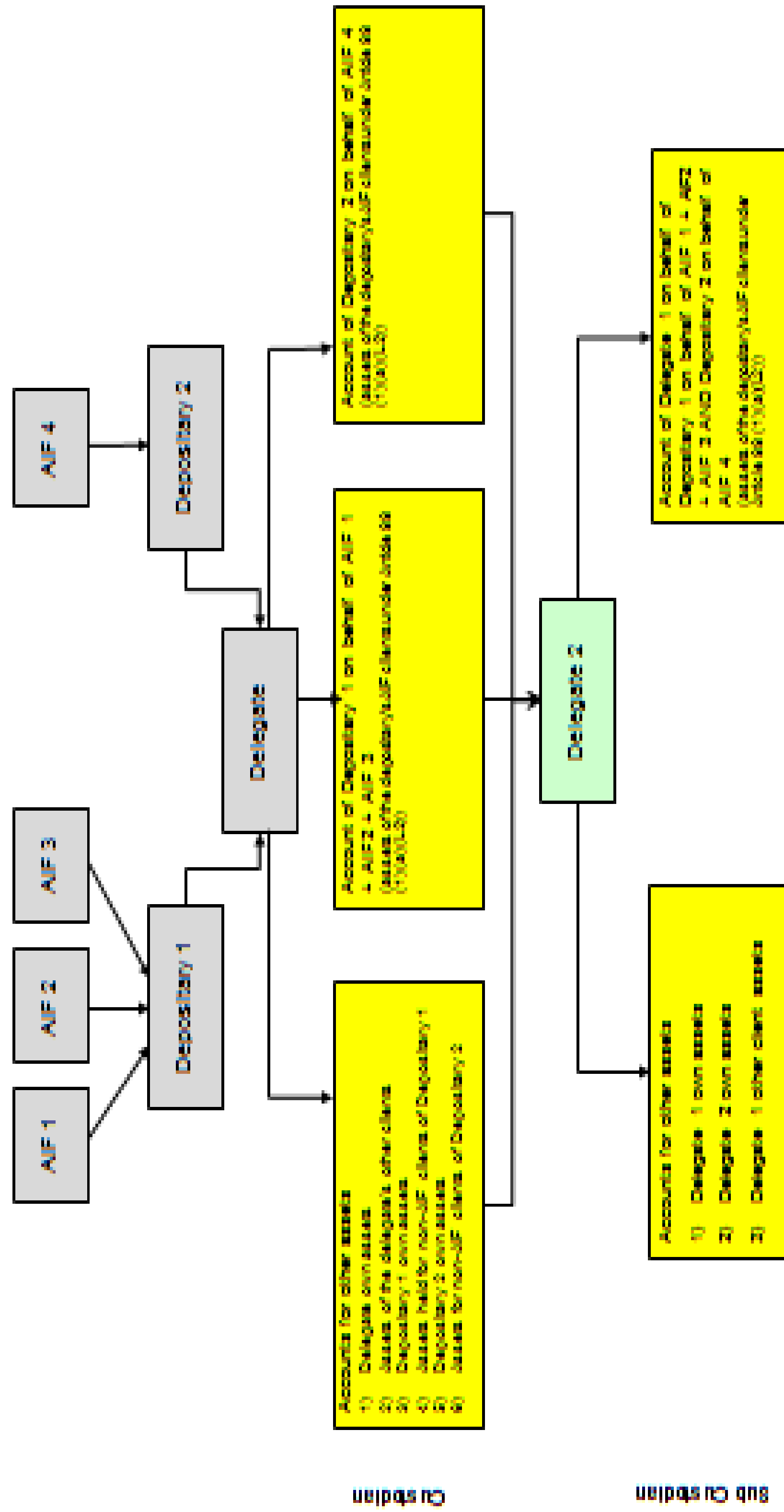
In terms of concerns about differences in re-use provisions between AIFs and UCITS, this protection is managed at the custodian level in the same way that say, one fund may take cash dividends while another elects dividend re-investment, or where one fund accepts Triple A government securities as collateral while another accepts corporate bonds. Custodians would manage "re-use" restrictions across AIFs/non-AIFs in the same way.

Option 2 of the Consultation Paper states that: "*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 sub-custodian level.*"

The ESMA Guidelines for Option 2 state "*When safe-keeping duties are delegated to a delegate (including a prime broker or a collateral manager), the account on which the AIF's assets are to be kept at the level of the delegated third party (or sub-delegate) should only comprise assets of the AIF and assets of other AIFs. Non-AIF assets should not be included in the account on which the AIFs assets are kept at the level of the delegated third party (or sub-delegate). However, the account on which the AIFs assets are kept may include assets from AIFs of different depositaries.*" Under this Option 2, the accounts to be opened would be limited to a segregated account at the level of the sub-custodian by market of investment for all AIF assets.

The account structure would be as follows (Figure 2):

Figure 2



As with Option 1, segregating AIFs, UCITS and all other clients in the books of the global custodian is achievable at the level of the first delegate and it would be normal market practice to open segregated accounts for "Depositary 1 own assets" and "Depositary 1 client assets". The global custodian maintains segregated accounts for its clients in its books to facilitate reporting and asset ownership and the depositary maintains segregated accounts in its books by individual AIF.

The recording of multiple depositaries AIF assets at an account at the sub-custodian level is also achievable. However, segregating AIF assets from UCITS and other client assets at the sub-custodian level is peculiar, and does not provide either group with protections not available already under an omnibus account arrangement at the sub-custodian.

Segregating AIF and other client assets, including UCITS at the sub-custodian level prevents efficient collateral management on the basis that collateral flows, optimisation and substitutions between AIFs and non-AIFs have to occur at the market (sub-custodian) level.

This introduces timing challenges, especially when markets are closed and alignment challenges intraday between the triparty collateral agent's books and records and the sub-custodian records (unless the sub-custodian can realign on a real time basis intraday).

As with Option 1 above, we anticipate a damaging impact on liquidity and funding as collateral movements are restricted, and delayed. Funds will pay more for segregated omnibus accounts but will not benefit from greater asset protection, nor enhanced recoverability of assets in the event of custodian insolvency.

Again it is important for us to stress that fragmenting the securities asset pool at the sub-custodian level will have a negative impact on funding and liquidity and will impair AIF's/UCITS's ability to lend/participate in triparty collateral management.

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)?

As set out in our answer to Question 7, increasing the number of securities accounts up the chain of custody (i.e. segregation of securities positions up the chain of custody) has a broad set of possible consequences.

If one looks only at the efficiency of the settlement process within the settlement engine of the CSD, it is possible to conclude that segregation has little impact; this may be because at the level of the issuer CSD an omnibus account is used, or because the efficiency of the settlement algorithm at the issuer CSD does not depend on whether the securities account to be debited or credited is an omnibus account (holding securities on behalf of multiple end investors) or a segregated account (holding securities on behalf of a single end investor).

However, as soon as one broadens the viewing perspective, the impacts on the settlement process become more apparent.

If one looks not simply at the settlement process, but also at the matching process at the CSD level, then segregation starts to have an impact, as it may affect the content of matching fields. The objective of the use of matching fields is both to maximize the chance of an instruction matching, and to minimise the chance of a cross-match. The

impact of segregation on the matching process is not clear-cut; on the one hand, there is the potential for reducing the possibility of a cross-match, but at the same time there is the potential that the chance of a failure to match is increased. The T2S Cross-Border Market Practices Sub Group (XMAP) has done extensive work on the optimal design and use of matching fields. We believe that this work shows that segregation up the chain is largely irrelevant with respect to the objective of improving matching efficiency.

If one looks not simply at the matching and settlement process as such, but also at the process for generating settlement instructions, then there are more significant impacts. Depending on the underlying business activity, segregation affects both the number and key elements of the settlement instructions that need to be generated. In some circumstances, through the impact on the settlement instructions that would need to be generated, segregation has the effect of rendering the underlying business activity impractical.

Effects of segregation

Increased segregation up the custody chain has two basic effects. First of all, securities positions in the books of entities up the chain are split. Secondly, as the positions are split, a transfer of securities from one client to another client of the same intermediary also requires a transfer of positions in the books of other intermediaries up the chain.

These two effects generate the need for additional processes and messages, and create operational complexity and risk.

Examples of impacts on underlying business activity

The splitting of positions may well impact many different types of business activity.

Our answers to Questions 10 and 14 explain how segregation impacts block trading and collateral management activity.

One additional example of a business activity that is impacted is securities lending activity. In the case of agency securities lending, a borrower may borrow a single amount of securities that is held by the lender on multiple segregated accounts; accordingly, the positions may need to be gathered together before delivery to a borrower; similarly, the collateral that a securities borrower delivers on a bilateral basis to secure its obligation may need to be split into multiple separate positions in order to be credited to the appropriate segregated accounts.

In short, for some types of activity, additional segregation up the chain creates requirements for additional and complex settlement activity, and thereby discourages, and may have the practical effect of prohibiting, some types of activities.

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.

BNY Mellon agrees with both statements a) and b).

The relevant issue is one of efficiency. Block trades and internalised settlements are operationally efficient, compared to individual trades and externalised settlements, because they reduce the amount of processing work that needs to be done, and reduces the number of parties that would otherwise need to play a role in the processing. This reduces transaction costs and enables faster processing times for all parties. Furthermore, block trades and internalised settlements do not reduce investor protection.

Under Option 1, asset managers would no longer have the benefit of block trades nor internalised settlement. This would increase the costs to asset managers and increase processing times (for example, cut-off times for submitting instructions may end up being earlier). So there is a reduction in utility to the asset manager without any increase in investor protection.

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?

The fundamental point is that under Option 1, triparty collateral management would no longer be provided to AIFs/UCITS, with the significant (absolute) cost to the economy as a whole (eg, through reduction in liquidity) that this would result in. We also refer to our response to Question 7.

The *costs of account segregation* in our view are substantial, although relatively insignificant when compared with the *absolute cost* to AIFs/UCITS as a function of the impairment to their attractiveness as a securities financing and collateral counterparty. As AIFs and UCITS funds are wholesale market clients, the costs of account segregation can be "*managed*".

The *costs of account segregation* will also have a bearing on fund performance vis-a-vis other fund types which are not required to be segregated. While at this stage the option for segregation has not been determined, it is difficult to state what the costs will be, since we do not know how many new accounts will need to be opened.

But the process costs of establishing account segregation are not insubstantial and will have an impact on the wider market. Firstly, global custodians will have to work with their sub-custodians to open new segregated accounts at the sub-custodian. Standing settlement instructions with the AIF/UCITS investment managers and brokers will need to be established to ensure that trades settle to the segregated account at the sub-custodian, instead of the client omnibus account.

But as we've said consistently, the costs of segregation are relatively minor compared with the impact on the funds and wider industry as a consequence of the

fragmentation of liquidity and segregation of collateral. As an industry, we are clear that:

1. there is an absence of any explained benefit from segregating client assets at all levels in the custody chain;

2. there are additional costs to funds from having to pay for segregated accounts;

3. if AIFs/UCITS assets are segregated at the sub-custodian level, they will suffer a performance drag through not being preferred counterparties to participate in securities lending and repo transactions;

4. the removal of that liquidity and funding from the EU market at a time when it is most needed, is counter intuitive, and forces the market to rely on for example SWFs (all of whom are outside the EU) for HQLA;

5. the impact is not only on AIFs and UCITS but all market participants who need liquidity for their business, including posting collateral to cover their legitimate risk hedging requirements;

6. segregation at the levels envisaged by ESMA is inconsistent with EMIR, MiFID, CSDR, CASS and CMU;

7. this degree of segregation increases settlement and operational risk; and

8. investment in EU affected funds will be impaired and in all probability, move investment to other jurisdictions such as Asia and the U.S., where segregation is not mandatory.

It is for these reasons that we have continued to appeal to all EU regulators to consider this issue very carefully.

What is interesting to us is that we have not found investors or depositaries (on whom the obligation of restitution applies) asking for segregated accounts. Cost is not the driver for them either. But even if they did ask for segregated accounts, we could easily provide them, on the proviso that the investor understood what the implications would be, should their assets be held in segregated accounts at all levels in the custody chain.

But it's not the impact on these funds that we are concerned about. It is principally the removal of the liquidity and connected funding from the market that is the real issue that we are asking regulators to consider.

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

We note that segregation (and a model of using segregated accounts) cannot be generalised so as to cover all investors and all securities. This limitation of segregated accounts is an advantage of using omnibus accounts.

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 (including if this may raise any operational difficulties)? Should you consider that there is any impact, please explain why.

EMIR Article 39 provides for optional segregation models and requires the central counterparty (CCP) to offer to clearing members "omnibus client segregation" (Article 39(2)) or "individual client segregation" (Article 39(3)). It also requires the clearing members to offer the choice of these two segregation models to its clients (Article 39(5)).

As mandated by EMIR and corresponding Technical Standards, EMIR segregation shall be achieved "in accounts with the CCP", it does not require implementing the segregation of financial collateral in accounts held at the CSD or held at the custodian level.

So it requires the CCP to distinguish in accounts with the CCP the assets (and positions) of the clearing member (own collateral), from the clearing member's clients (omnibus segregation) and from the clearing member's individual client (individual segregation).

To achieve this operationally, in particular for the individual segregation model, the CCP needs to obtain from the client's custodian, information of the assets that belong to this specific client. This requirement can be combined with the different segregation options contemplated in the table under Question 22.

How this can be achieved operationally may differ depending on the specific implementation of the CCP and the collateral location of the CCP (i.e. the Securities Settlement System that is appointed by the CCP to hold the collateral).

Collateral Management / Prime Brokerage

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;

Segregating AIF and other client assets, including UCITS at the sub-custodian level, prevents efficient collateral management on the basis that collateral flows, optimisation and substitutions between AIFs and non-AIFs have to occur at the market level.

This introduces timing challenges especially when markets are closed and alignment challenges intraday between the triparty collateral agent's books and records and the sub-custodian records (unless the sub-custodian can realign on a real time basis intraday).

In addition to the impact on triparty collateral management, if it is concluded by ESMA, notwithstanding the above, that the regulation requires segregation of AIF/UCITS assets at all levels in the custody chain, we have determined that AIFs/UCITS will immediately become unattractive counterparties to the securities

finance and repo market. This is on the basis that any securities borrowed from an AIF/UCITS will have to be delivered from a segregated account at the sub-custodian (rather than an omnibus account where other lenders assets are pooled) and because that pool of assets will be smaller than the omnibus pool, in all probability will involve multiple deliveries, especially if Option 1 is mandated.

Further, collateral posted to the AIF/UCITS lenders will need to be segregated and this will mean that collateral optimisation and substitution will then become a function of movement of assets at the sub-custodian level (T+X). This is patently unattractive to borrowers, who optimise and substitute collateral many times a day in the tri party collateral management environment. Substitution and optimisation of collateral at the sub-custodian level is not possible intraday since it becomes the subject of "physical" movements in the local markets. Even if there was to be only two segregated accounts at each sub-custodian, one for non AIFs/UCITS and one for AIFs/UCITS, dealers would not be able to substitute/optimise their portfolios intraday across those two accounts.

This essentially means that AIFs/UCITS which currently account for a sizeable part of the European investment markets, will have their assets and cash removed from the generally accessible market liquidity.

There are two issues here.

Firstly, fragmentation of asset/liquidity pools is counter-intuitive at a time when liquidity and collateral mobility is needed more than ever as a function of new regulation like EMIR which requires freely available eligible collateral and access to HQLA to reduce market risks for all investors.

Secondly, since AIFs/UCITS are subject to competitive performance benchmarks, impairing their attractiveness to other counterparties in the market and thereby reducing fund performance at a time when yield is low, doesn't seem sound. The initial reason AIFs/UCITS become less attractive counterparties to the dealer community is because their funds tend to be smaller than the large institutional and sovereign wealth funds. So if a group is looking to borrow say 1 million Vodafone shares, they will today generally be able to source all of those shares from one omnibus account at ourselves as an agent lender.

A similar request from a segregated pool of AIFs/UCITS (even if say Option 2 was deployed) would potentially mean that the order could not be filled in one delivery and would need to be sourced from multiple pools. Equally, there would need to be separate collateral deliveries which adds expense, fragments collateral and adds operational/settlement risk. If Option 1 is deployed the problem becomes much worse as multiple deliveries/receipts could be required. This then has the significant additional potential to make the transaction uncommercial for the dealer/borrower.

We caution again that segregated accounts increase operational and settlement risk with no apparent benefits.

In terms of impairment to AIF and UCITS fund performance through account segregation, we already see that AIFs/UCITS on loan balances are currently around 7.7% of available securities while non AIF/UCITS average balance on loan is more than 12%. This in part reflects securities borrowers' concern about loan collateral having to be segregated in the future and therefore AIFs/UCITS have become unattractive from a loan perspective already.

The delta in terms of revenue between AIF/UCITS revenue from loaned securities and those that a non AIF/UCITS currently generates in our securities lending programme is substantial at $13 million. We recognise that not all of that delta is attributable to the concern of potential segregation, but there is a strong element of that and it will only increase as counterparties refuse to deal with AIFs/UCITS, if segregation at the sub-custodian is deemed to be mandatory.

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?

BNY Mellon does not provide prime broker services, but we are one of the largest triparty collateral managers. Accordingly, we will focus our response on the **impact to collateral management**.

As set out in our responses above and particularly Question 14, implementing Option 1 from a triparty collateral management perspective is technically and operationally possible. But the model would never be used because of the fragmentation of assets into multiple sub-custodian accounts. BNY Mellon would simply withdraw from providing triparty collateral management services to AIFs/UCITS. AIFs/UCITS could lend their assets but it would be on a bilateral basis and that is not typically what borrowers want.

We would not expect to incur significant costs from segregating AIFs/UCITS at Option 1 level from a collateral management perspective, since we would cease to provide triparty collateral management services under such a model.

The market impact though would be substantial as described in our responses above to Question 8 and Question 14, and as we have previously submitted in our response to the Consultation Paper.

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?

Legal certainty risk

In regard to legal certainty risk, this is the risk that Option 1 will reduce legal certainty, because of the additional complexity in account structures that this would introduce. It would take longer for relevant parties to clearly identify and enforce their *in rem* property rights.

Attendant operational risk

Whenever there is a change in settlement arrangements and new accounts to open/settle with/reconcile to, there is an inevitable increase in risk of errors. In brief, the more accounts there are, the more opportunities there are to post transactions to incorrect accounts or to issue settlement instructions etc. to incorrect accounts.

Mitigating such risks is in part the responsibility of the custodian, but equally has an impact on the asset manager and brokers who are responsible for issuing and

executing instructions. Risk control is a part of the industry's responsibility, but deliberately increasing operational risk with no benefits elsewhere from doing so, is at odds with good regulation and best market practice.

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.

Adaptation to IT systems does not solve the problem created by segregating AIF/UCITS assets at the sub-custodian. The clearest way of showing the unintended consequences and impact from segregation of AIF/UCITS, is by transactional example showing a simple securities finance transaction.

Investment firms borrow securities to cover failed trade receipts/deliveries and to support market trading strategies. Securities lending agents (typically custodians) combine lending client portfolios to broadcast to borrowers. Large, consolidated pools of assets are attractive to borrowers as they can source supply from "one" omnibus account.

Segregating AIF/UCITS portfolios as proposed, fragments the pool of available stock to borrow, and will dissuade borrowers from accessing AIF/UCITS portfolios because multiple receipts of borrowed stock and multiple deliveries of collateral to each AIF/UCITS/depositary will be required to satisfy the borrowing transaction.

Multiple deliveries and receipts of stock and collateral with attendant instructions, account movements and reconciliations make the transaction, commercially unattractive.

The diagrams and examples on the following pages show the movements linked to a transaction in omnibus and segregated account environments.

Securities Finance transactions - Omnibus account environment

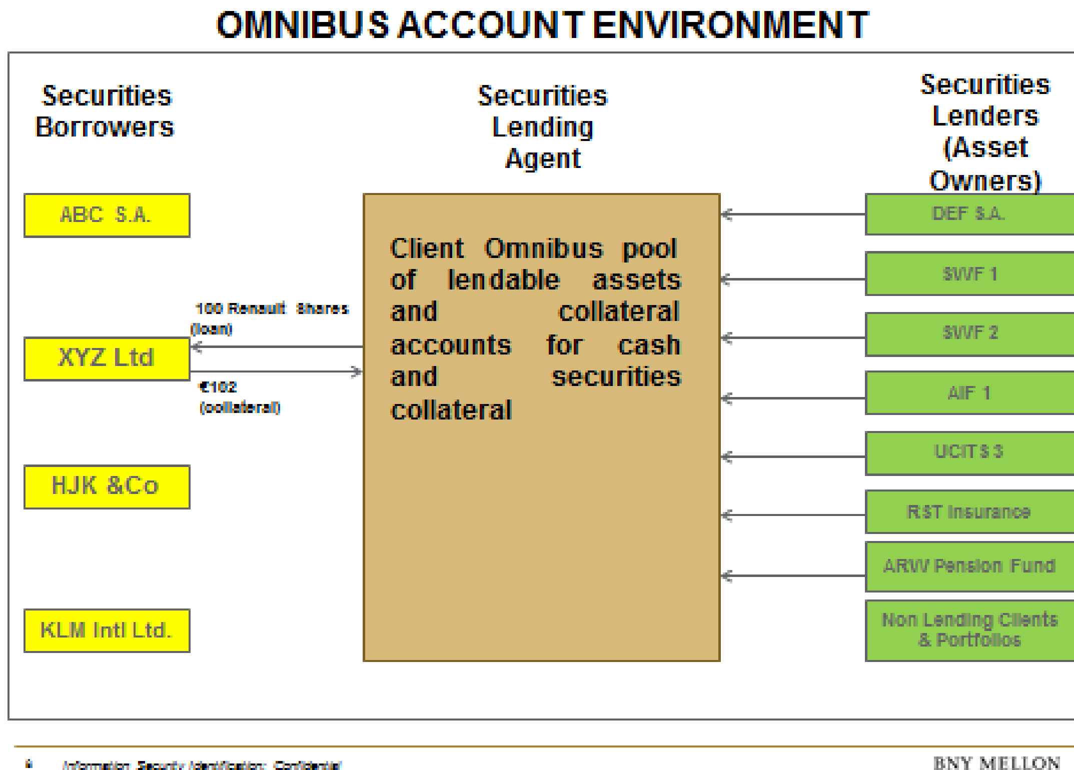
A single borrower (XYZ Ltd in this example) may wish to borrow 100 Renault shares versus 102% collateral margin. Under an omnibus model the borrower will receive 100 Renault shares from the agent lender against €102 collateral to the lending clients' account at the agent lender.

Many asset owners (lenders) may participate in that loan of Renault shares but only one movement of stock and cash collateral is made in the market.

The agent lender allocates the collateral across the lending clients' accounts in the proportion of the amount of stock loaned from their account.

The diagram (Figure 3) shows the loan and collateral flow in an omnibus environment.

Figure 3



Securities Finance transactions - Segregated account environment

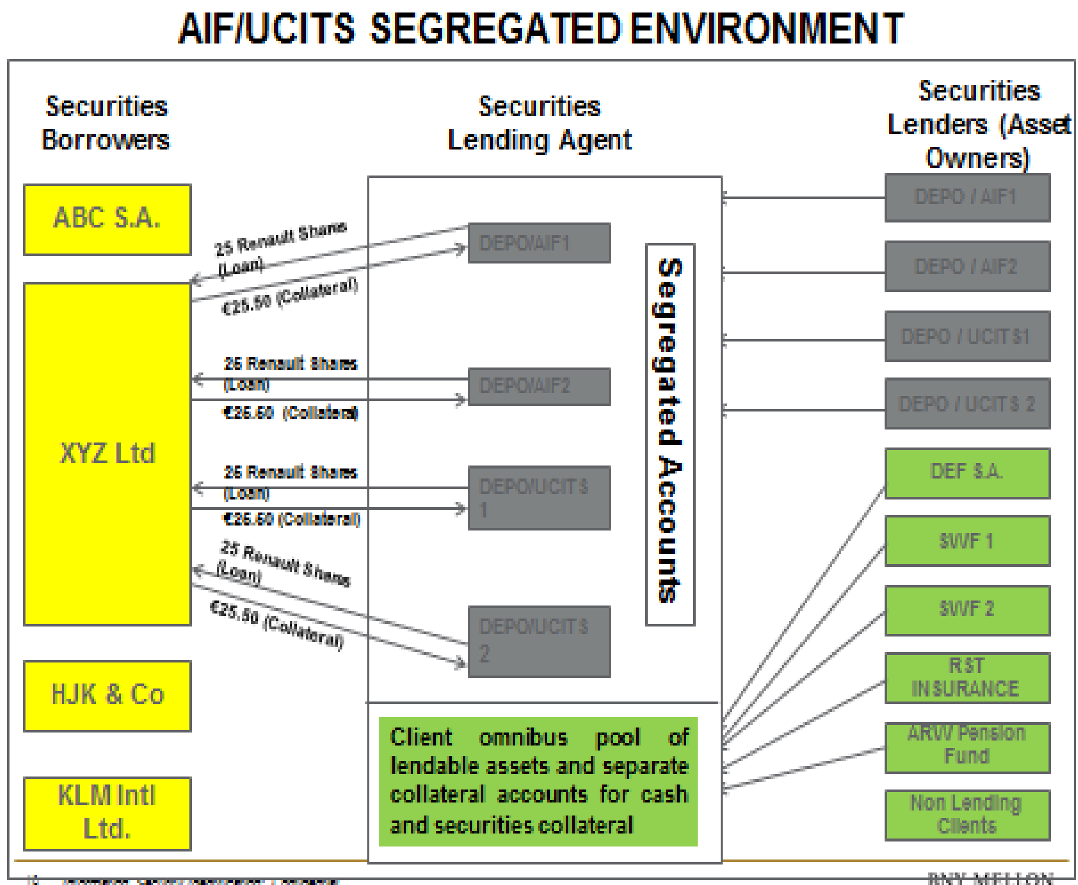
A single borrower (XYZ Ltd in this example) may wish to borrow 100 Renault shares versus 102% collateral margin as in the previous slides. Under a segregated account model, the borrower will ask the agent lender if he has 100 Renault shares available for loan.

The agent lender will look into the pool of lendable assets and each segregated AIF/UCITS account and confirm that there are 100 Renault shares available to borrow. In this example, there are 25 Renault shares in Depo/AIF 1 account, 25 Renault shares in Depo/AIF2 account, 25 Renault shares in Depo/UCITS 1 account and 25 Renault shares in Depo/UCITS 2 account.

If the agent lender offers 4 separate deliveries and 4 collateral calls to the borrower, the borrower will immediately ask, do you have a consolidated holding of 100 Renault shares and if so, may we borrow that. In all likelihood, the shares will then be delivered from the client omnibus account containing the non AIF/UCITS portfolios. This is because AIFs/UCITS funds tend to be much smaller than other investment funds such as Sovereign Wealth Funds for example, and also today AIFs/UCITS are a composite of an omnibus account anyway, which by definition will be larger.

The diagram (Figure 4) shows the loan and collateral flows, as if the loan was made against the 4 segregated accounts.

Figure 4



Segregation of AIFs/UCITS will force them out of triparty collateral management arrangements into a bilateral environment, which we know is unattractive to the major dealers and market generally. Segregation will therefore limit the revenues that AIFs/UCITS can generate through securities loans and repo transactions creating an unnecessary performance drag on those funds.

This schematic clearly shows that technology is not the issue here. It is the artificial segregation of AIFs/UCITS. Technology is not something that can solve that problem and even if we were to place a technology overlay on the segregated accounts and consolidate them into an omnibus books and records account, we would present a confusing cocktail of reporting to any IP who would see a consolidated omnibus AIF/UCITS position, and a segregated AIF/UCITS position at the global and sub-custodian levels from which any movements would be made. The technology wouldn't facilitate the loan delivery nor collateral receipts.

T2S

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.

The answer is yes. There is the possibility that requirements under option 1 create operational challenges for the functioning and efficiency of T2S.

The specific impact on T2S depends critically on the following factors:

a/ the degree to which the custody chain is located on T2S;
b/ the degree to which segregation requirements apply to that part of the custody chain located on T2S; and
c/ the degree to which the segregation requirements under AIFMD and UCITS V also apply to assets held on behalf of other categories of investor.

Explanation of factors

a/ degree to which the custody chain is located on T2S

If only the securities accounts provided by the issuer CSD are located on T2S, and all other securities accounts provided by intermediaries in the custody chain are located outside T2S, then the technical impact on the functioning of T2S will be negligible or non-existent.

This is for two reasons. The first is that the AIFMD and UCITS V segregation obligation does not apply with respect to accounts provided by the issuer CSD. This is because issuer CSDs are not, cannot, and should not be, delegates.

The second is that in any event T2S needs to allow an issuer CSDs to provide large numbers of accounts to its participant; T2S needs to provide this possibility as CSDR Article 38 places an obligation on CSDs to give its participants the possibility to use large numbers of accounts.

However, if securities accounts provided by several intermediaries in a custody chain are located on T2S, then, as explained below, there is the possibility of a technical impact on the functioning of T2S.

b/ degree to which segregation requirements apply to that part of the custody chain located on T2S

If securities accounts provided by several intermediaries in a custody chain are located on T2S, and if those intermediaries (investor CSDs) are not under obligations to segregate (i.e. are not considered delegates of the depositary), then the technical impact on the functioning of T2S will be negligible or non-existent.

The same conclusion applies if investor CSDs are considered delegates of the depositary (and thus are under obligations to segregate), and if there is only one investor CSD in a custody chain.

The reasoning behind this conclusion for these two cases is largely the same as the reasoning set out with respect to issuer CSDs under point a/ above.

However, if investor CSDs are considered delegates (and thus are under obligations to segregate), and if there are two or more investor CSDs in a custody chain, then there may well be a technical impact on the functioning on T2S.

This technical impact arises out of the fact that the full account structure for AIF/UCITS holdings in the books of the first investor CSD on T2S will need to be replicated in the books of all other investor CSDs in the custody chain before reaching the issuer CSD; such replication will involve not only opening up the relevant inter-CSD accounts on T2S, but also opening up the appropriate mirror accounts on T2S.

We cannot give an estimate of the size of the technical impact on T2S of the opening, maintenance and use of these additional accounts (and mirror accounts),
The answer to this question depends on whether investor CSDs are considered delegates

c/ degree to which the segregation requirements under AIFMD and UCITS V also apply to assets held on behalf of other categories of investor

Even if the technical impacts on T2S of segregation requirements placed on AIF and UCITS assets are limited, it is important to consider the consequences for T2S if these segregation requirements are generalised so that they apply to assets held on behalf of all types of investor.

The point is that if public authorities take the view that segregation requirements up the chain of custody give additional protections to holders of UCITS and AIF then there is the significant possibility that public authorities will in due course take the view that all categories of investor should benefit from these additional protections.

Although again we cannot give an estimate of the size of the technical impact on T2S, we would believe that it is significant.

Final comments

We, of course, believe that we need to segregate to the extent necessary, but *additional* segregation up the chain of custody does not provide additional protections, and in fact creates cost and risk.

We also believe that T2S provides a good example of why this is the case.

The argument is simple. Segregation up the chain for a part of a custody chain that is located on T2S involves opening up additional technical accounts on a common IT infrastructure. Opening up these additional technical accounts gives no apparent additional protections, but it does very clearly create the possibility for additional cost and complexity, with a reduction in the efficiency and capabilities of the IT infrastructure.

Impact on 3rd Countries

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.

This is simply a matter of asking for a segregated account at each sub-custodian and agreeing the terms under which such an account will be provided. We always inform clients of the account structure that they face in each market.

<u>The Optimal Asset Segregation Regime for achieving a Strong Level of Investor Protection without imposing Unnecessary Requirements</u>

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.

In our view, the policy objective should be to achieve an adequate or sufficient level of investor protection (by way of client asset protection). The phrase "*strong level of investor protection*", with the emphasis on "*strong*", is misconstrued. If there is sufficient client asset protection (and investor protection), then any additional requirements are by definition unnecessary. In fact, additional requirements may actually reduce investor protection by increasing operational complexity and operational risk.

All five options outlined above achieve the policy objective of investor protection. However, **Option 4 provides a sufficient level of investor protection and is the only option that maintains the policy benefits arising from triparty collateral management.** Option 3 does not increase investor protection above Option 4, and would cause some damage to triparty collateral management. Options 1 and 2 would mean that triparty collateral management would no longer be available, with a significant negative impact on liquidity and funding. Furthermore, Options 1 and 2 do not increase investor protection and increase operational risks and costs. We note that mandating Option 5 (which would also mean that triparty collateral management would no longer be available) was already ruled out by ESMA in its Consultation Paper.

We do not believe that the EU regulators' intention is to damage jobs, investment, growth, liquidity and funding in Europe. However, notwithstanding the markets' response and the sincere doubts expressed by various national competent authorities (NCAs), our concern remains from the tone in the questions in this Call for Evidence, the Industry Roundtable, original Consultation Paper and some interpretations of the Level I and II text, that there is a real potential to mandate segregation of AIF/UCITS assets at the sub-custodian level in the custody chain.

It is essential that the individual market regulators and funds understand that if segregation becomes mandatory down to the sub-custodian/CSD level, the consequences for the EU funds industry will be very serious.

Equally, affected counterparties including the broker-dealer and fund community would need to understand that they will have to establish many new segregated accounts at all levels in the custody chain, develop in-house collateral management capabilities, acquire technology and collateral management specialists to support their needs, novate all of their collateral management agreements removing triparty collateral agents, and set up operational models including standing settlement instructions (SSIs) and reconciliation protocols to support the new account structures.

This could take more than 12 months to achieve market ready status.

AIFs/UCITS would be much less attractive from a securities lending perspective, on the basis that the securities lending agent will (on almost every loan) be delivering loaned securities from multiple sub-accounts to borrowers. Borrowers would not want multiple deliveries because of the additional transaction costs and efforts required to reconcile receipts.

The securities borrowing community (collateral givers) would be required to post collateral to segregated accounts (for AIFs/UCITS) resulting in increased delivery costs and more importantly, they would not be able to efficiently manage their collateral positions, perform substitutions, conduct optimisation of their collateral inventory, on the basis that the collateral inventory would be fragmented across multiple sub-accounts.

There are currently four triparty collateral management agents: BNY Mellon, Clearstream, Euroclear and JP Morgan. In our view, no triparty collateral management agent would be able to perform triparty collateral management services for AIFs/UCITS, on the basis that all collateral movements would occur at the sub-custodian level. This would introduce market settlement delays (e.g. T+2) and would mean that intraday books and records movements of collateral, on which the market relies, could not occur. The non-AIF/UCITS market would continue to operate under a triparty collateral management model, but would have fewer counterparties with whom they could transact and this will also impact liquidity and funding.

The AIF/UCITS and their counterparties would be forced to move to a bilateral collateral management world in which counterparty, credit, settlement and operational risk would be increased.

If AIFs/UCITS become less attractive counterparties to the dealer borrowers, liquidity will be diminished, funding in Europe will stall and AIFs/UCITS performance will drop, as they are no longer able to generate revenue from securities lending/repo. This would result in fund investment potentially moving to Asian and U.S. funds which are not required to operate under a segregated regime.

Groups who need to source eligible collateral to post as margin to satisfy their EMIR obligations would not be able to efficiently and cost-effectively source inventory, as a result of required collateral being held in multiple segregated accounts.

Many thousands of accounts within T2S are likely to be required, to support the segregated structure at the domestic CSD, which would be exported on to T2S. We understand that this is not currently possible as the T2S platform was not designed to support thousands of additional accounts, given that the development of T2S (which has been underway for some years) reasonably assumed that omnibus account structures would continue to be widely used.

Of all the options offered, ONLY Option 4, does not damage the industry while preserving the benefits of the policy objective.

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.

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

Yes. Such a regime (which is in effect Option 4 from the Consultation Paper) would contribute to achieving the policy objective described in the introduction.

We believe that replacing the existing requirements under AIFMD and UCITS V for segregation up the chain of custody (such as, for example, Options 1 and 2 from the Consultation Paper) by new requirements based on the principles of the regime set out in CSDR Article 38 will be a helpful and positive step towards achieving this policy objective for the following three reasons.

The first reason is that the existing AIFMD and UCITS requirements for segregation up the custody chain (such as, for example, Options 1 and 2 from the Consultation Paper) do not actually help achieve this policy objective.

The second reason is that the existing AIFMD and UCITS requirements for segregation up the custody chain do not cover the most prominent, and possibly only, example within the European Union of a case in which segregation up the custody chain does indeed increase asset protection. This is the case of the Greek equity CSD Helex. In Greece, and at the Greek equity CSD, but not at the Greek bond CSD (Bank of Greece), the entity in whose name a securities account is opened is recognised as the owner of the assets on that account. This means that for asset protection purposes there is a significant benefit for accounts opened at Helex to be segregated by end investor. However, the existing AIFMD and UCITS requirements for asset segregation up the chain do not impose requirements for segregation by end investor in the books of Helex. This is because Helex is an issuer CSD, and thus is not, and cannot be, a delegate, and the existing AIFMD and UCITS requirements for asset segregation up the chain apply only to delegates.

The third reason is that the regime of Article 38 CSDR is based on important principles to which we subscribe fully. These are the principles of maximising choice (by giving market participants options, rather than minimising choice by mandating a particular set-up), and of transparency (by giving market participants information as to the consequences and implications of their choices).

We would believe that the proposed CSDR Article 38 regime would in theory apply with respect to the accounts provided by all entities in the custody chain, including the issuer CSD, but excluding the depositary itself (i.e. the last intermediary in the custody chain) for which the existing AIFMD and UCITS V segregation rules would apply.

We would support this approach, as it has the benefit of completeness.

However, any implementation of an Article 38 regime must take into account the case of non-European securities. Specifically, depositary banks may not be able to offer their clients a full choice as to account structures up the custody chain with respect to those parts of the custody chain that are located outside of the European Union. This is because non-EU CSDs and account providers do not fall under European law, and may be constrained by their own system capabilities and national regulatory obligations. This means that the obligations on European depositaries to provide options should be limited to those cases where they really can provider options; the application of the Article 38 regime should not have the unintended consequence of preventing AIFs and UCITS investing in certain categories of non-EU securities, as depositaries are unable to fulfil their Article 38 regime obligations for those categories of securities.

Some additional commentary with respect to this proposal:

(i) we, of course, presume that the existing MiFID rules mandating segregation between client and proprietary assets will continue to apply;

(ii) we would note that any Article 38 regime does not in itself guarantee strong asset protection; there are many other measures contained in AIFMD and UCITS V and other pieces of legislation that also help increase asset protection; our argument is that an Article 38 regime will help improve asset protection compared to the existing AIFMD / UCITS V rules with respect to segregation up the custody chain;

(iii) we take the opportunity of pointing out that this discussion of appropriate rules for segregation up the custody chain highlights the critical distinction between the delegation of the custody function as such, and the use of a sub-custodian; if a depositary delegates the custody function as such so that it no longer acts as custodian, and so that it is not the last intermediary in the custody chain, then the AIFMD/UCITS V segregation rules should apply to the delegate; but using a sub-custodian is a very different activity; this is why the AIFMD/UCITS V segregation rules are not appropriate for the use of a sub-custodian up the custody chain; we have given more information on this point in our response to the European Commission's Call for Evidence on the Regulatory Framework.

Accordingly, we recommend that funds (AIFs/UCITS) be given the flexibility to request segregation or not, on the proviso that the depositary/custodian has the obligation to inform the fund of the pros and cons of segregation (including cost and potential impairment to securities lending/repo revenues and participation in triparty collateral management arrangements). We would add that we believe that the fund should retain the right to request a change of segregation/omnibus status at any time during the period of the contract, subject to reasonable notice.

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.

We do not believe that applying a regime similar to that of Article 38 of CSDR would raise any particular concerns in terms of investor protection.

As set out in our answer to Question 23(a), we believe that replacing Options 1 or 2 by an Article 38 approach will actually improve asset protection for investors in the fund.

We, of course, agree that any individual fund will make one choice as to the degree of segregation up the chain of custody per category of securities purchased by the fund, so that individual investors in a fund will not be able to make individual choices. We do not see this as a particular problem.

As a matter of general policy, we support the principle of transparency, and believe that any concerns could be alleviated by appropriate disclosures.

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

Such a regime has no implications for the account related provisions under EMIR Article 39.

EMIR Article 39 is very much in line with CSDR Article 38(5) – it provides for optional choice between omnibus segregation and individual segregation. The choice has to be offered by CCPs to clearing members and by clearing members to their clients.

It may be the case that an asset manager that chooses individual segregation at the CCP level would also have a preference for individual segregation up the custody chain. However, there is no need to combine individual segregation at the CCP level with individual segregation up the custody chain; for more information on this point, please see our answer to Question 13.

In general, CCP segregation models have been put in place prior to the AIFMD/UCITS segregation discussion, so that the models have been developed on the assumption of the use of omnibus accounts up the custody chain.

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

We remain confident that Option 4 is the right option for all market participants, on the basis that it:

- does not remove from funds the opportunity to generate incremental revenue to improve fund performance;
- does not damage market funding and liquidity; and
- gives investors the flexibility to decide which account structure they believe gives them the best benefit and levels of investor protection.

Provision of Custody Services

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

We do not see a specific need for detailing and further clarifying the concept of "*custody*" for the purposes of the AIFMD and UCITS Directive.

This is because we believe that CSDs are not, and should not be considered, delegates of the depositary with respect to the provision of custody services.

From a strict, functional perspective, CSDs do indeed provide custody services. However, and as set out in our answer to Question 29, CSDs cannot, and should not be considered delegates.

For the purposes of AIFMD and the UCITS Directive, we suggest that there is a more urgent need to clarify the meaning of "*delegation*". As set out in our answer to Question 23 above, one major problem with both AIFMD and the UCITS Directive is that a single term "*delegation*" is used to refer to two very different concepts.

From a more general (rather than AIFMD/UCITS specific) perspective, we agree that this is a need for a better definition of the word "*custody*" – please see our response to Question 26 below.

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');

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?

Although our answer to Question 25 was "no", we nonetheless believe that there would be a benefit in clarifying the concept of custody.

From a functional perspective, the concept of custody relates to a part of the chain of entities that connect issuers with investors.

In such a chain, the issuer CSD operates as a key point of connection between multiple issuers and multiple investors; an issuer CSD provides services both to issuers (or their agents) and to investors (or their agents).

The core concept of custody is the provision of a securities account on which securities are held, and the provision of related services that allows an investor to be able to exercise the rights associated with the securities held on the account.

From this perspective, custody services relate to the custody chain, which is that part of the chain that extends from the issuer CSD to the end investor. In this part of the chain, each entity, apart from the end investor, does provide custody services.

Based on the above analysis, service (b) is a custody service. Service (c) is necessarily indistinguishable from service (b), and so also falls under the concept of custody services. Service (a) is not in itself a custody services. Services (d) and (e) are not necessarily custody services – the question is not sufficiently precise in respect of (d) and (e) in order to give a clear view, and requires further clarification and discussion in our view.

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) and Article 22(5) of the UCITS Directive (as well as Article 13 of the UCITS V Level 2).

From a very general functional perspective, we would understand safe-keeping as being largely synonymous with custody. "*Safe-keeping*" refers to the provision of securities accounts and, in particular to the exercise of the right of disposal of a securities position; the term "*custody*" refers to both the provision of a securities account, and also more generally to the exercise of all rights associated with a securities position (including rights dividends, corporate actions, etc).

However, from an AIFMD perspective, the distinction is clear, and is set out in Article 21(8). Safekeeping covers both custody as such, and also a process of verification of ownership of assets that cannot be held in custody.

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.

BNY Mellon's view is that the provision of any services by a CSD should not be considered a delegation of the custody function.

From a formal legal perspective, the situation appears clear. Specifically, both AIFMD (Article 21(11)) and UCITS V (Article 22a(4)) explain that the use of a securities settlement system (SSS) shall not be considered a delegation of the custody

function. In this context, SSS means CSD, as CSDR states that all CSDs must be SSSs, and non-CSDs cannot operate SSSs.

The apparent confusion arises from Recital (21) of UCITS V, which seems to suggest that under some circumstances, use of a CSD could be considered a delegation of the custody function.

As set out in our answer to Question 23, the underlying problem is that AIFMD and the UCITS Directive use a single term "*delegation*" to refer to two very different concepts. Fundamentally, the right way forward is for AIFMD and the UCITS Directive to use the term "delegation" to refer to the delegation of the function of last intermediary, and to use another term, and another set of rules, to refer to the use of a sub-custodian or a CSD.

However, using the current definition of "*delegation*", our views are as follows as to whether CSDs should be considered delegates.

As a matter of fundamental principle, use of an issuer CSD cannot be a delegation of the custody function; this is because a loss at an issuer CSD cannot be considered to be an internal event.

So, the question that remains relates to the use of investor CSDs.

We believe that there are four main aspects to this discussion:

a/ whether there is a change to the restitution obligation of a depositary in the case of a loss at an investor CSD. We believe this to be unlikely – this is because loss at an investor CSD is unlikely to meet the requirements of AIFMD Article 21(12) and of the equivalent text in UCITS V.

b/ whether the AIFMD and UCITS V segregation requirements also apply up the chain of custody. If they do, then there is a strong argument for the segregation requirements also to apply to investor CSDs (for level playing field reasons), but it is clear from our response to this Call for Evidence that we do not believe that these segregation requirements should apply up the chain – so this aspect is redundant.

c/ whether there is a rationale to overlay regulation, so that on top of CSDR rules relating to CSD-to-CSD links, there are also AIFMD/UCITS V rules relating to the use of a sub-custodian. In general, we believe there is little justification for such overlay.

d/ whether there are legal, operational and risk management complexities and obstacles in an intermediary holding securities on a securities account with a CSD and, depending on the particular securities position, that CSD is functioning both as a delegate and not as a delegate.

Based on these considerations, we believe that a clear and understandable outcome would be use of a CSD not to be considered as delegation. Expressed differently, and assuming that this Call for Evidence has a satisfactory outcome with respect to the segregation discussion, we see no major benefits for a CSD to be considered a delegate, and we see the potential for risk and legal and operational complexities.

ANNEX 2 – CHART

ANNEX 3 – PwC LETTER

ANNEX 4 – BNY MELLON RESPONSE TO CONSULTATION PAPER (ESMA/2014/1326)