

23rd September 2016

The International Securities Lending Association (ISLA) response to ESMA's call for Evidence: Asset segregation and custody services ESMA/2016/1137

Dear Sir,

On behalf of our members, ISLA would like to thank you for the opportunity to comment on the above call for evidence.

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has approximately 120 full and associate members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 clients. While based in London, ISLA represents members from more than sixteen countries in Europe, and the rest of the world. As such, we will restrict our comments to those directly pertaining or impacting the securities finance industry, that is to say, transacting security loans and receiving/managing collateral.

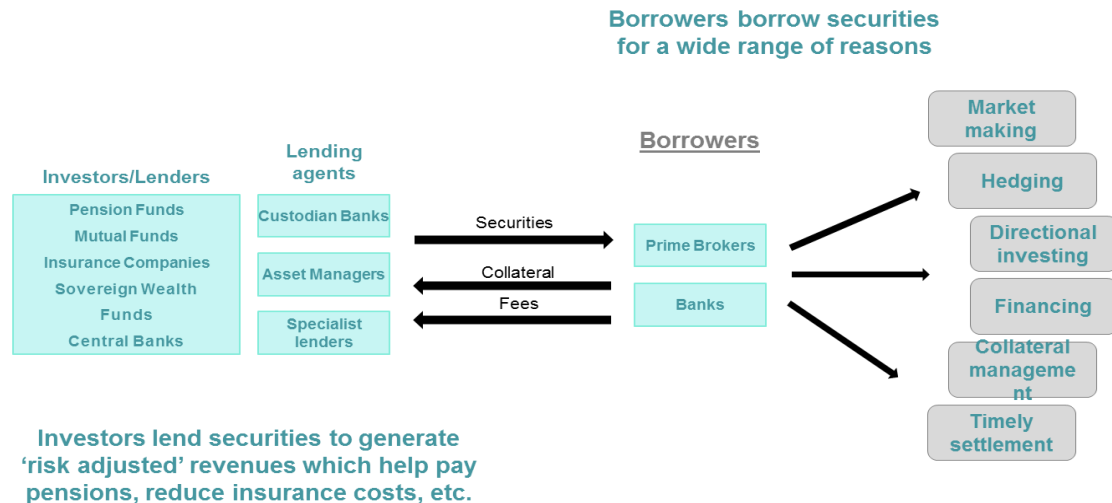
Securities finance is undertaken by AIFs and UCITS as part of their efficient portfolio management strategies. By lending securities these investors generate tangible incremental revenues which have the effect of increasing the returns on their portfolios (thereby helping to meet the needs of investors). The securities that are lent are borrowed by market participants for a variety of reasons, providing liquidity and increasing settlement efficiency in financial markets and also play an increasingly important role in addressing the demand for collateral in the system as regulators seek to improve market infrastructure and mitigate systemic risk.

A number of regulations (such as AIFMD and UCITS V) have impacted AIFs/UCITS ability to maximise returns in recent years, and in particular the adoption of ESMA's Guidelines for ETFs and other UCITS; ESMA/2014/474 (hereafter known as *the Guidelines*) has restricted their ability to utilise term transactions, re-use collateral received or utilise CCPs.

The requirement of these guidelines for the depositary to hold the collateral (paragraph 43 (g)) has led to the adoption of additional oversight and controls around the use of tri-party collateral managers by incorporation into the depositary custody network (or as a delegate) including all the significant controls and oversight this entails.

It should also be noted that a number of regulatory initiatives, such as CASS and MIFID, that seek to improve investor protections have already been introduced to the market, and whilst not specifically aimed at UCITS/AIFs, nevertheless apply. These include, insolvency regimes, single Rulebook and Stay Protocols. Together with recently introduced (the Guidelines) and pending (SFTR and MiFiDII) transparency and reporting requirements, investors have significantly more protection than before.

AIF/UCITS can access the Securities Lending market directly or, more commonly, through an agent. The agent may be the custodian bank, asset manager or specialist third party.



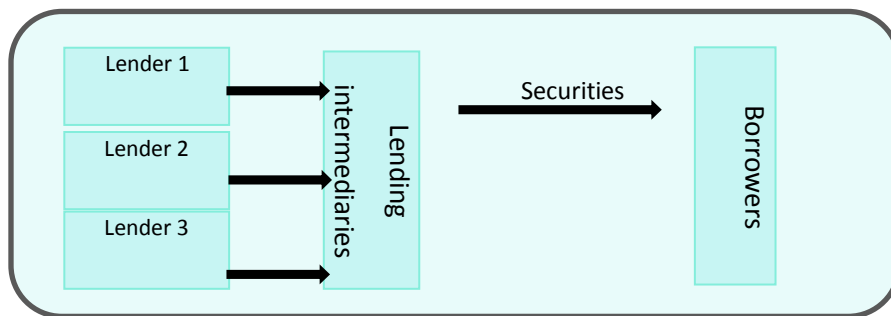
3.1 Mapping of asset segregation models

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).

Notwithstanding the concerns of members relating to the custody models used (which ISLA is not able to comment on) Securities Lending is utilised using the custody model chosen by the depositary. Most agent models are constructed to deal with segregated accounts, but will use an omnibus structure to minimise the number of transactions in the market and also improve utilisation rates for smaller clients.

In a typical stock loan, a borrower will request to borrow an asset and the agent will select the asset from client accounts according to a fair allocation process. This will ensure each client including AIF/UCITS are treated fairly. However, this may involve the agent utilising assets from a number of clients to construct the value of assets required and so the agent will use an omnibus account to "pool" the assets of a number of clients before meeting the borrower's demand with one delivery. If a borrower is required to accept numerous deliveries from individual segregated accounts, this would lead to additional settlement risk as well as additional transaction costs, making it likely that the borrower would seek to source the asset elsewhere (eg a pool of pension or sovereign wealth fund assets); where a single delivery can be made - the result for the AIF or UCITS being lower securities lending income, in turn reducing the opportunity to offset the total cost of investing.

Example of physical stock movements for a stock loan



The lending intermediate (or agent) receives multiple deliveries from lenders such as AIF/UCITS (or may receive assets from a client omnibus account) but delivers one amount to the borrower

AIF/UCITS funds have already seen a significant drop in demand for stock borrows because of the restrictive and complex collateral requirements of the Guidelines and as a consequence have seen significant reductions in an important alternative revenue/performance source. Recent analysis suggests that AIF/UCITS represent approximately 44% of assets made available to lend but only 17% of assets actually loaned – a significant reduction in loan percentage over the last 18 months¹. Analysis shows that AIFs/UCITS lend on average 7.7% of the assets made available, compared to 12% for non AIF/UCITS assets, illustrating the impact regulation (particularly the Guidelines) have already had on AIF/UCITS ability to generate additional performance from this activity.

If agents for AIF/UCITS funds were unable to use an omnibus account structure to achieve settlement efficiencies in securities lending transactions and instead were required to arrange individual settlements via segregated sub-custodial accounts, then our view is that the revenues for AIFs and UCITS would be even further negatively impacted.

Alongside the impact segregated accounts will have on the AIF/UCITS ability to lend assets, the impact on their ability to efficiently collateralise and, in particular, benefit from the efficiencies, risk reducing practices and cost savings of using tri-party collateral managers will further impact their performance. This is discussed in more detail in our responses in section 3.4.

¹ Source: ISLA market report with data sourced from Markit, FIS, Datalend, BNYM, JP Morgan, Clearstream, Euroclear

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 (depository, 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?

Through-out the lending process the assets in the omnibus account are segregated from the proprietary assets of the Custodian and of its delegate/sub Custodian and the account is recorded as an account containing client assets, and maintained in accordance with the CASS client asset rules in the UK or similar rules in other markets. ISLA’s unequivocal view is that using the omnibus account model for securities financing does not expose asset owners to any additional credit risk to the agent lender, its Custodian (which may be a different entity than its agent lender) or its downstream sub custodians.

In the event of insolvency in the custody chain the Insolvency Practitioner (IP) will look to (and reconcile) the records of the global custodian and any other relevant party to determine which assets are held on behalf of clients and which assets are owned by the defaulting part in a proprietary capacity and as such may be available for distribution to creditors. The IP will reconcile the client statements (issued by the depository to each client) against the accounts held at the global custodian in the name of each of the clients of the depository, and also reconcile the depository’s account containing proprietary assets with the depository’s own record of its proprietary assets.

In the event of insolvency of a client whose assets are comingled with assets of a different client all being held in the omnibus account, the IP would seek to reconcile positions of the omnibus account and it would be the responsibility of the global custodian to provide statements and ultimately ensure the protection of assets belonging to the non-defaulting clients. It is commonly recognized that assets held on behalf of one customer cannot be used to satisfy obligations of another customer, including upon insolvency of such other customer.

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.

It is the view of our members that in the event of a party in the chain becoming insolvent, the time involved in returning any assets that are being held by the custodian, but not yet lent, is unlikely to be any different whether the assets are in an omnibus account or a segregated account.

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.

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.

Whilst ISLA is unable to comment about the existing custodial models, and leaves this to each of our members to comment directly, it should be noted that none of our members believe that segregated accounts provide additional investor protection nor do they expedite the return of client assets in the event of an insolvency of the asset owner, asset manager, depositary or custody intermediaries.

Custodians undertake thorough and robust reconciliations to ensure that all assets are identified including when securities are lent. The securities lending industry actively participates in reconciliations, both between counterparties to the trade and with the underlying custodians and the AIFS/UCITS themselves.

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.

Firstly, we refer to our response to Question 3.

We would also like to highlight the letter provided by BNY Mellon from PWC which clearly states that where a counterparty enters insolvency a full reconciliation of the estate would be required before any assets would be returned. This is clear evidence from an administrator that segregated accounts would not provide improved asset protection nor expedite the return of client assets.

From a securities lending perspective, if a counterparty becomes insolvent, the non-defaulting party will determine the close out amount due by reference to the market value of the deliverable and receivable securities. It does this by (i) selling collateral (receivable securities) in the market or valuing it using quotes and (ii) purchasing securities equivalent to the loaned securities (the deliverable securities)) in the market or using quotes.

In order to minimise market risk, the non-defaulting party typically seeks to determine the default market value by liquidating the collateral and purchasing the equivalent securities as quickly as possible. The inability to utilise omnibus accounts at the custodian/agent level and effect internal settlements to execute these transactions will increase the market risk of the non-defaulting party as more transactions will have to be effected and settled to market in accordance with standard settlement cycles in the relevant jurisdictions. Realigning the settlements to separate segregated accounts for the non-defaulting party (particularly in the case of an agent lender arrangement when there will be multiple affected lenders) will become more complex and time consuming.

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?

Our members believe that segregation at the levels described in option 1 will have a significant and negative impact on AIF/UCITS ability to generate additional revenues through efficient portfolio management techniques such as securities lending, for the reasons discussed above. This in turn will have a direct impact on the investment returns provided to the individual investors and will see the overall cost of investing rise whereby increased custody costs (as a result of their custodian having to open, maintain, reconcile and transact on many more accounts) are passed onto the clients, who can no longer expect to offset a significant portion of these expenses against their securities lending income.

3.4 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;

Triparty collateral management services provide an end-to-end collateral management service to collateral providers and receivers which is widely utilised by the securities financing community. Tri-party agents act upon client instruction, providing highly automated and sophisticated eligibility testing, optimised collateral allocations and substitutions according to the predefined eligibility profiles.

The objective of a triparty agent is to provide operational efficiency to the collateralisation process, helping to mitigate operational risk associated with transactions such as securities finance by offering high degrees of automation, settlement, margining, safekeeping and monitoring services, and to provide tools to efficiently manage the collateral.

In ISLA's recently published market data report, analysis suggests that over 90% of collateral held against securities lending activity is held and managed with a triparty collateral manager.

Segregating AIF and other client assets, including AIF/UCITS at the sub-custodian level prevents efficient collateral management because collateral flows, optimisation and substitutions between AIFs and non-AIFs would have to occur at the market level, rather than at a books and records level on the books of the triparty agent.

The ability to substitute assets (ie replace one collateral asset for another) enables the collateral provider to utilise more of their available assets, in the knowledge that in the event that a sale occurs the assets can be made available without the risk of market fails.

Optimisation is the process of re-allocating available assets across counterparty exposures and ensures that collateral is used in the most efficient manner. This would not be possible if settlement occurred at market level as the costs and increased settlement risk would be prohibitive.

This introduces timing challenges when markets are closed and alignment challenges intraday between the tri-party collateral agent's books and records and the sub-custodian records (unless the sub-custodian can realign on a real time basis intraday) as well as increased settlement risk and cost.

The ability to substitute collateral assets, and optimise all the assets available for collateral across counterparties at a books and records level means collateral can be allocated at any time, rather than being subject to market settlement timeframes, and allows the collateral provider to meet all collateral requirements in the most efficient way. An inability to do this will ultimately impact market liquidity and increase the risks of being left uncollateralised at the end of the day because market settlements have closed.

If it is concluded, 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 (rather than an omnibus account where other lenders assets are pooled) and in all probability will involve multiple deliveries as discussed in our response to Question 1 above.

Further, collateral posted to the AIF/UCITS lenders would also need to be segregated; preventing the use of tri-party agents and this will mean that collateral optimisation and substitution will require a movement of assets at the sub-custodian level into segregated accounts belonging to the AIF. This is patently unattractive to borrowers, who currently are able, due to the omnibus account structure which is common in the market, to optimise and substitute collateral in a low risk/low cost model many times a day within the tri party collateral management environment. If segregated accounts are required for AIFs/UCITS this will increase settlement and operational risk, as well as lengthen the time to collateralise any collateral shortfall the AIF/UCITS may experience due to daily mark to market fluctuations. We believe that requiring segregated accounts would result in a substantial decrease in the amount of AIFs/UCITS assets made available for lending and which currently account for a sizeable part of the European investment market, and which would therefore negatively impact market liquidity.

Even if AIFs/UCITS are still able to lend, the additional cost of managing collateral in segregated accounts without Triparty Services will make the transactions prohibitively expensive and therefore unattractive to market participants.

The alternative for AIF/UCITS would be to manage non-cash collateral on a bilateral basis with each counterparty. This introduces additional settlement risk and the manual processes would lead to significantly reduced collateral eligibility profiles as well as reducing the number of possible substitutions and materially increasing collateral management costs.

An alternative to taking securities as collateral is in some instances accepting cash collateral. In this scenario, the AIF/UCITS needs to re-invest the cash collateral in order to generate a return and protect capital. The Guidelines provide quite descriptive details of acceptable re-investment strategies, and allow the use of short term money market funds (as defined in the Guidelines in paragraph 40 (j)).

Whilst the vast majority of lending from UCITS and AIFs is currently conducted against non-cash collateral, where cash collateral is an option and received, the agent will frequently use high quality short term money market funds as an investment route that meets the Guidelines. Initial cash collateral is received and invested at the start of a loan and then adjusted on a daily basis depending on the mark to market value of the securities lent.

The process will be similarly complicated as for non-cash collateral if the agent is required to hold segregated sub investment accounts for each AIF/UCITS in the money market fund. Rather than making one net payment adjustment per day representing all clients, the agent will need to make individual payments for each AIF/UCITS sub-fund, significantly increasing transactions volume and cost. It should also be considered that money market funds may have minimum investment requirements which may not be met on an individual segregated payment basis, which will reduce re-investment opportunities for AIFs and UCITS and increases the risk of cash collateral being un-invested.

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?

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. This degree of segregation increases settlement and operational risk,
3. There would be additional costs to funds from having to pay for segregated accounts,
4. 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,
5. The removal of that liquidity and funding from the EU market at a time when it is most needed, is counterproductive, and creates a strain in the market as participants are forced to rely on other asset owners, for example Sovereign Wealth Funds (all of whom are outside the EU) for High Quality Liquid Assets,
6. The impact of a segregation requirement would not only be felt by AIFs and UCITS, rather all market participants who need liquidity for smooth operating of their business, including risk mitigating activities such as posting and requiring collateral to cover counterparty credit exposure,
7. Segregation at the levels envisaged by ESMA is inconsistent with certain parts of text within EMIR, MiFID, CSDR, CASS and CMU, which recognise the use of omnibus account structures provided the books and records of the various participants within the Custody chain clearly distinguish the assets of one client from the next,
8. Requiring segregation among AIFs and UCITS would negatively impact investment in EU affected funds and in all probability, result in an increased preference for investment in funds set up in other jurisdictions such as Asia and the US, where segregation is not mandatory.

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 would not solve the problem created by segregating AIF/UCITS assets at the sub-custodian.

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 inform borrowers in the market of which securities are available for loan. Large, consolidated pools of securities are attractive to borrowers who are able to streamline their borrowing activity by sourcing supply from a single omnibus account, thus benefitting a wide range of underlying beneficial owners.

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

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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 would make borrowing securities, commercially unattractive.

The diagrams and examples below show the movements linked to a transaction where omnibus accounts are used compared to what this would look like when segregated accounts are used.

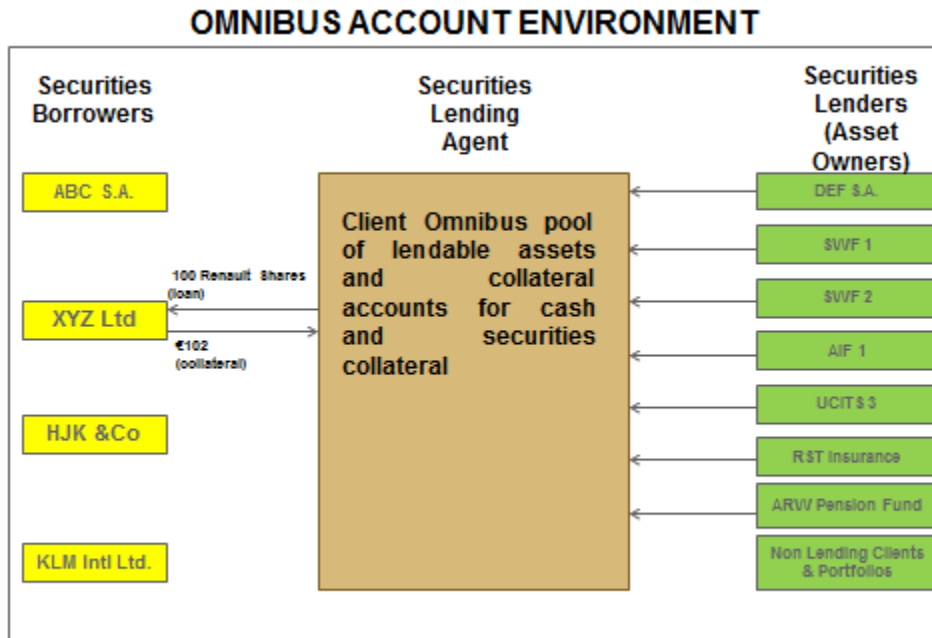
Securities Finance transactions - Omnibus account environment

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 shows the loan and collateral flow in an omnibus environment.



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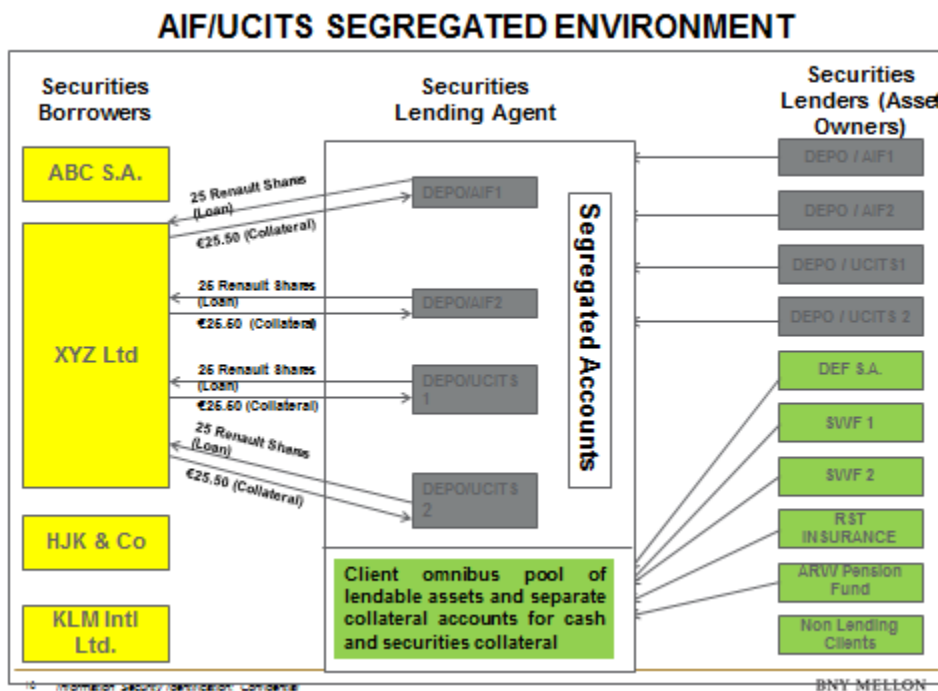
Securities Finance transactions - Segregated account environment

A single borrower (XYZ Ltd in this example) may wish to borrow 100 Renault shares versus 102% collateral margin as in the previous slide. 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, due to cost, timing, and risk considerations, likely request a consolidated holding of 100 Renault shares instead of the 4 separate lots. If available, the agent lender will then deliver the shares from the omnibus account they hold for clients 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 on the following page shows the loan and collateral flows, as if the loan was made against the 4 segregated accounts.



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Segregation of AIFs/UCITS will force them out of tri-party 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 and increasing both cost and risk.

It is not possible through IT adaptations to facilitate segregated accounts for AIF/UCITS in the existing tri-party model.

3.6 Impact on 3rd countries

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

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

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

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

Whilst ISLA will not comment on the changes in investment strategies that segregation might cause, it should be noted that AIF/UCITS invest globally and a number of 3rd countries would be inaccessible if option 1 is mandated.

From a securities lending perspective the Guidelines have already forced AIF/UCITS to withdraw from providing liquidity in markets where the use of CCPs, potentially not receiving title to collateral is compulsory, such as Brazil. However numerous other markets will become inaccessible such as Hong Kong where Hong Kong Stock Connect is based on an omnibus account structure.

[END]

Once again, on behalf of our members, I would like to thank you for the opportunity to comment. If you require any further detail or clarification, please do not hesitate to contact me.

Yours sincerely,



Andrew Dyson
Chief Executive