**Communication of the Association of Global Custodians’ European Focus Committee**

**Subject to Supplemental Commentary**

**30th January 2015**

**Online:** [**www.esma.europa.eu**](http://www.esma.europa.eu)

**ESMA’s Consultation Paper: Guidelines on asset segregation under the AIFMD**

Dear Sir/Madam:

The members of the Association of Global Custodians’ (the “**AGC**”) European Focus Committee (the “Committee”)[[1]](#footnote-1) are grateful for the opportunity to provide comments in response to the European Securities and Markets Authority’s (“**ESMA’s**”) Consultation Paper: Guidelines on asset segregation under the AIFMD, dated 1st December 2014 (the “**Consultation Paper**”).

We refer to the questions asked in Annex 1 of the Consultation Paper. Responses of the Committee are outlined below, following each question.

**Q.1: Which of the two identified options do you prefer?**

With respect to Options 1 and 2, Option 2 is preferred because Option 1 provides no meaningful benefit over and above Option 2 by delineating accounts at sub-custodians according to depositaries (as Option 1 would require). In insolvency settings, there would be no legal or practical advantage for investors depending on whether assets can be identified at the sub-custodian as held for the AIF clients of a particular depositary or for the AIF clients of all depositaries. Either approach relegates individual AIFs to pools of securities held through the sub-custodian. Whether those pools are smaller and more numerous (which would be the case with Option 1) or larger and amounting to one pool at a sub-custodian (AIF clients of all depositaries, as set out in Option 2) makes no difference in terms of improving investor protection.[[2]](#footnote-2)

However, because Option 1 would result in more complexity in the holding chain, there would be a higher likelihood of error.

**Q.2: Would you suggest any alternative option which is compatible with the AIFMD and its implementing measures? If yes, please provide details.**

The Committee is of the view that Option 4 is compatible with the AIFMD and its implementing measures and therefore should be considered acceptable as an alternative option. We provide the rationale for our view below:

1. Achieving Investor Protection

We understand and agree with ESMA’s contention that the depositary provisions of AIFMD - and, in particular, those on asset segregation – are a “key aspect of the AIFMD framework and are aimed at improving investor protection”.[[3]](#footnote-3)

As we agree that the segregation requirements of AIFMD indeed must ensure investor protection of AIF assets, we point out the following:

* Due to the inherent nature of the indirect enforcement system, AIFs would not have direct claims against any specific property held by the third-party delegate or sub-Delegate. Therefore, from the perspective of an AIF and its investors, it is irrelevant whether the Delegate (or sub-Delegate) has a separate client “omnibus” account containing AIF assets only.
* An omnibus account consisting solely of AIF assets will not provide greater protection for the assets of any individual AIF, as compared to an omnibus account for multiple client categories, as those assets will still be pooled on an omnibus basis with other AIF assets. The segregation of assets by client type, rather than on the basis of other, economic factors – such as taxation status in the relevant jurisdiction – is essentially an arbitrary distinction which we do not believe would provide additional protection to clients inside or outside of the relevant omnibus account.
* Use of omnibus accounts which are not split according to AIF and non-AIF assets reduces operational and structural complexity and thereby reduces the costs which are ultimately borne by clients and the risk of operational error.
* The maintenance of segregated positions throughout the custody chain is generally recognised as providing no meaningful benefit from the standpoint of asset safety, including in the report of the Task Force on Adaptation to Cross-CSD Settlement in T2S. Even if mandatory segregation throughout the custody chain for a category of clients were operationally and safely feasible in the European Union, the imposition of a requirement to segregate beneficial ownership throughout the entire holding chain assumes a holding chain that is entirely subject to the jurisdictional control within the EU or which at least operates in a manner which is amenable to fulfilling such a requirement. This may not be the case in respect of securities held via chains extending outside the EU. In such cases, the imposition of segregation requirements may be frustrated by the operation of law or market practice outside the EU.
* Global custodians undertake rigorous procedures to assure asset safety, including by assessing the suitability of sub-custodians and making arrangements for holding intermediated securities that properly respond to local legal requirements in the jurisdictions where they are held. The usual practice of global custodians is to engage local lawyers to provide information about local insolvency laws and the recognition of segregation arrangements. If segregation of omnibus accounts by client category was a factor that would provide greater security in the case of the default of a sub-custodian, then we are sure that it would have arisen from such reviews, but that has not been our experience.

The Committee therefore disagrees with ESMA’s contention that options 3 and 4 are “sub-optimal” on the basis that they would provide a “clearly lower level of investor protection given that they would have allowed a higher level of commingling of the assets of AIFs which might frustrate the recovery of assets in the event of a bankruptcy of a depositary or sub-depositary.”[[4]](#footnote-4) The Committee is of the view that the above-described approaches to delegation and segregation at the delegate and sub-delegate level as reflected above are valid interpretations of the requirements of the Directive and Level 2 Regulation.

1. Interpretation and Application of Relevant Provisions of the AIFMD and its Implementing Measures

The Committee believes that ESMA is positioned and empowered to provide necessary guidance on interpretation and application of the relevant provisions of the AIFMD and its implementing measures. ESMA’s guidance as to a “baseline scenario” would serve to ensure the minimum requirements necessary to protect investors. We disagree that such an approach would lead to “greater uncertainty” for investors as to whether their interests are adequately protected[[5]](#footnote-5): greater certainty would be achieved if a minimum baseline is established.[[6]](#footnote-6)

The Committee notes that ESMA wrote in the Consultation Paper that “Options 3-5 do not seem to be compatible with the provisions of the AIFMD and its implementing measures (the latter judgement having been based, inter alia, on the provisions of the Impact Assessment accompanying the Level 2 Regulation).”[[7]](#footnote-7) We disagree that options 3-5 may be incompatible for the following reasons:

a. Article 99(1) of the Level 2 Regulation provides in relevant part:

". . . a depositary shall ensure that the third-party [the sub-custodian] . . . acts in accordance with the segregation obligation laid down in [Art 21(11)(d)(iii) of Level 1] by verifying that the third party . . . keeps such records and accounts as are necessary to enable it at any time and without delay to distinguish assets of the depositary's AIF clients from . . . assets held for clients of the depositary which are not AIFs".

b. The proper reading of the above sentence is that the depositary (not necessarily the third-party) must be able - at any time and without delay - to distinguish the assets of its AIF clients from its clients who are not AIFs by using the records and accounts of the third party; i.e., the records and accounts of the third party should support the depositary distinguishing the assets of AIF clients from, among other things, those of other clients of the depositary. The ability to distinguish assets of the depositary’s AIF clients from other clients does not require the third party to put in place account structures that are formally split between AIF clients and non-AIF clients of the depositary.

c. This interpretation coincides with the understanding that records and accounts must be maintained to provide meaningful protection to investors: depositaries must ensure reconciliations are conducted sufficiently and that the sub-custodians maintain accounts which facilitate and do not frustrate the performance of the depositary’s own functions. Any of ESMA's Options will fail to protect investors if the depositary fails to ensure these two things.

d. In particular, the Committee disagrees with ESMA’s conclusion that Option 1 “provides for a high standard in terms of investor protection” on the basis that it would best “limit the exposure of the AIF investors to the risk of the bankruptcy of third parties (such as other depositaries or non-AIF entities)”.[[8]](#footnote-8) None of the cited examples in the Commission’s consultation on hedge funds leads to this conclusion. Indeed, if there is “misuse [of client assets, e.g., to settle obligations of another client] or insolvency of a custodian”[[9]](#footnote-9), none of ESMA’s options would mitigate or obviate the consequences. The risks would be addressed if the depositary “ensures” it can determine and allocate customer (AIF) positions in its own books and records through appropriate reconciliations with the third-party delegates and through ensuring that the third party maintains accounts through oversight and due diligence processes. We similarly question ESMA’s subsequent conclusions regarding the benefits of Option 2 and Option 3.

e. The Committee also is of the view that ESMA's reading of recital 40 of AIFMD Level 1 - which speaks to the delegated third party being able to "hold an account for multiple AIFs" (see para 17 of ESMA's consultation) – is unduly narrow. We suggest that recital 40 as written does not preclude an omnibus account that includes non-AIFs, but refers to AIFs simply because that is the focus of the Directive and the legislators were not making rules for non-AIFs through it.

1. Alternative Options

Because of the Committee’s views expressed above regarding how to achieve investor protection in respect of protecting the safety and integrity of AIF assets through the chain of custody, as well as how to interpret the Level 1 and Level 2 texts of AIFMD, we believe that any of the options presented by ESMA in its Consultation Paper would be permissible under the relevant provisions of the AIFMD Directive and Level 2 Regulation so long as the Depositary’s duties set out in Article 99(1)(a) of the Level 2 Regulation are “ensured”. Option 4 is clearly preferred as providing the most flexibility and efficiency while also ensuring investor protection.

**Q.3: Do you have knowledge of the impact that each of the two options identified would have on your business in terms of restructuring of existing delegation arrangements in Europe and third countries? Please quantify the one-off and ongoing costs as well as the type of costs for each of the two options or any alternative option that you may prefer.**

If Option 1 and/or Option 2 are adopted as the only available options, then this will have a significant impact on custody-related activity. All such costs would ultimately be borne by end investors. These costs would be significant, both in terms of one-off and on-going costs.

Examples of one-off costs in moving to Options 1 and/or 2 only, would include:

* IT re-build or enhancements to cater for a much higher number of accounts and transactions within the chain of custody.
* Contractual renegotiations to cater for the new models.

Examples of on-going costs would include:

* Account opening fees - more accounts required, therefore account opening fees would be higher overall. Account opening fees cover regulatory checks (e.g., AML/KYC) and IT set-up/connectivity testing, the costs of which would increase in a segregated environment.
* Account maintenance fees - more accounts required, therefore account maintenance fees would be higher overall.
* Transaction fees - the more segregated the account set-up is, then there will be more external settlement transactions (including the use of external settlement and messaging infrastructure), as segregation reduces the ability for internalisation of settlement.
* Reconciliation costs - an increased number of accounts will require more work to reconcile all the accounts along the chain. Furthermore, the structure is more likely to result in a higher number of "reconciliation breaks" which will need to be resolved.

Third Country Impacts:

In particular, requiring the use of Options 1 and/or 2 only may inhibit access to markets due to the inability of third country custodians who do not have similar requirements in their own jurisdictions to adapt. Requiring Options 1 and/or 2 in a particular market may have the practical effect of closing off that market to EU investors.

The Committee is of the view that both established and emerging markets would be impacted in these circumstances. As the Committee pointed out in its submission in response to a previous ESMA consultation paper relating to UCITS V technical guidance[[10]](#footnote-10), the laws of some countries[[11]](#footnote-11) require or envision the use of third party delegates that do not segregate customer assets in a manner that would necessarily accord with EU expectations (in this case, Option 1, Option 2 or Option 5).

**Q.4: Do you see merit in foreseeing a specific treatment for certain types of arrangement (e.g. collateral management arrangements)? If yes, please specify how your proposal would ensure compliance with the relevant requirements of the AIFMD and Level 2 Regulation.**

Yes. It should be kept in mind that the AIFM Directive and Regulation provide for the appointment of certain persons as “delegates” of the depositary’s custody function who are not performing a straight-forward custody service. Examples include:

* Investment firms, whose custody function is ancillary to the investment services being performed for an AIF/AIFM, and who hold financial instruments as collateral otherwise than under title transfer collateral arrangements
* Collateral management agents, whose custody function is ancillary to the primary service of calculating margin requirements arising in the context of market transactions between an AIF/AIFM and its counterparty and the movement of margin between accounts to comply with the terms of the relevant transactions.

The appointment of such persons as “delegates” of the depositary is to ensure that there is a link between the person charged with the custody obligation for the relevant AIF and the person who, in practice, is holding relevant financial instruments in which the AIF has a beneficial interest. This enables independent oversight of the relevant financial instruments and, of course, provides recourse to the depositary in the unlikely event of their loss.

Due to the nature of the services to be performed by a third party such as a collateral management agent, we do see merit in providing specific treatment for circumstances where the depositary is required to appoint such a person as its delegate for the purposes of its custody obligation. In the case of a collateral management agent, it must be recognised that, in the performance of its services, it will need the flexibility to facilitate a high level of movement of assets between accounts, including on an intra-day basis. To achieve this, it will need to be able to effect movements in a way that takes account of the consequences of transfers between accounts at its own delegates. If a collateral management agent is able to maintain a single omnibus account for client assets at its delegate, then its clients – the parties to the relevant market transaction – will have certainty about their possession and control of securities as they enter or leave their accounts with the collateral management agent; i.e., corresponding movements at the level of the delegate would not need to be made to achieve that result. If a collateral management agent has an AIF client and a non-AIF client who are utilising its services, and if it is forced to maintain separate omnibus accounts on each of their behalf at the level of its delegate, then neither the AIF client nor the non-AIF client will have legal certainty about the transfer of collateral unless and until the corresponding movements have been made at the level of the delegate. This introduces legal certainty risk, as well as attendant operational risk, which is unwarranted given the purposes of the AIFM Directive and Regulation.

If ESMA concludes that only Option 1 or Option 2 is available, due to the nature of the services that are performed by a collateral management agent, we recommend providing for specific treatment for circumstances where the depositary is required to appoint a collateral management agent as its third-party delegate for the purposes of safekeeping the AIF’s assets.[[12]](#footnote-12)

Restrictions on the effective use and management of collateral may contradict policy objectives of the use of collateral to reduce risk in the financial system. Collateral management is systemically important: it plays a vital role in the post-financial-crisis economy by reducing risk in the financial system and increasing liquidity. It also enables additional income for funds, which is of benefit to their investors. The Committee cautions that asset segregation requirements imposed at the level of “third-party delegates” need to be carefully designed and implemented so that they do not prevent effective collateral management.

**Q.5: Do you agree with ESMA’s approach to discarding the third, fourth and fifth options described in Section 5 of the CBA? if not please provide data and information that support your view.**

As indicated above, and for the reasons stated, the Committee disagrees with ESMA's discarding of Option 4. We believe Option 1 and Option 2 would both cause significant disruption to collateral and capital markets transactions.

Omnibus Accounts – background and rationale

In practice, a combination of tradition and operational and legal reasons rather than ease of settlement of transfers are likely to dictate the use of omnibus accounts. Practice has become entrenched, so that where omnibus accounts are common, the law has tended to support their existence.

The technical and operational systems will have grown up domestically in a manner which suits the local legal arrangements, and may be difficult to adapt wholesale. Rather, individual market participants have developed ad-hoc arrangements to cope with local market expectations. The Committee would welcome the opportunity to discuss further with ESMA the legal and other local market factors that would be relevant in particular countries.

In addition to the points raised in our responses to the other questions, the following advantages of using omnibus accounts can be stated:

* Cost. Only one account is needed for many investors. This should reduce fees associated with (a) maintaining the account and (b) transfers, where credit and debit entries offset and the settlement processing technique permits internalised (or net) settlement.
* Voting and corporate actions. Provided that an account provider can gather the voting instructions for the collectively held securities (and contrary voting is permitted - see below) the volume of voting instructions required to be processed by the issuer will be significantly reduced. Likewise, for other corporate actions, the account provider will be responsible for processing the instructions and entitlements for all of the investors under its account, thereby reducing the burden on the issuer.
* Reduced burden for issuers. Issuers do not need to deal directly with large numbers of investors where they are required legally only to recognise the persons who hold directly from them. This shifts the burden of dealing directly with investors to the account providers. Account providers may have more scope to negotiate the level of service provided to their account holders, whereas issuers will generally be required to treat all holders alike.

We would appreciate the opportunity to share our views on the Consultation Paper and any further discussions in relation to the AIFMD. Please do not hesitate to contact the undersigned should you wish to discuss any of the above.

Sincerely,

John Siena

Chair, European Focus Committee

Association of Global Custodians

***ANNEX I***

**Annex 7 of the Impact Assessment accompanying the AIFMD Level 2 Regulation**

**[Extract]**

***Issue 15 – The segregation obligation***

***Article 21, paragraph 10; implementing powers, Article 21, paragraph 15:***

*The depositary may only delegate to third parties provided that, among others, the depositary has ensured that the third party segregates the assets of the depositary's clients from its own assets and from the assets of the depositary in such a way that* 14 *they can at any time be clearly identified as belonging to clients of a given depositary and that it complies with this requirement on an ongoing basis. The third party may, in turn, sub-delegate those functions subject to the same requirements.*

*Delegated acts should specify this segregation obligation.*

***Assessment of IA need***

*Similar rules exist already in MiFID. As there is no obvious reason to deviate substantially from those, there is also no need for a detailed IA. As regards the segregation of assets in case of further delegation, Level 1 imposes the same requirements. In such a case, the delegate of the third party would therefore need to segregate the assets of the third party's clients from its own assets and from the assets of the third party in such a way that they can at any time be clearly identified as belonging to clients of a particular third party.*

*This provides for a clear rule without any obvious substantive alternative option. While one could consider either to impose stronger obligation (e.g. to require individual segregation of assets of depositary's clients) or to impose less strict obligation (e.g. assets would not need to be identified as belonging to clients of a particular third party) but such options would not be consistent with Level 1 that only allows further delegation under the same conditions.*

1. The members of the Association of Global Custodians are: BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and trust Company. [↑](#footnote-ref-1)
2. This aspect is discussed more broadly in our response to question 2, below. [↑](#footnote-ref-2)
3. Consultation Paper, Part 2 (“Background”), para. 5, page 5. [↑](#footnote-ref-3)
4. Consultation Paper, Part 5.2 (“Annex II, Cost-Benefit Analysis”), para. 5.15 (“Option 5”, “Preferred Options”), page 16. [↑](#footnote-ref-4)
5. Consultation Paper, Part 5.2 (“Annex II, Cost-Benefit Analysis”), para. 1.12, page 14. [↑](#footnote-ref-5)
6. Whilst we understand ESMA’s stated goal of not producing any further guidance on “the interpretation and proper application” of Article 21(11)(d)(iii) of the AIFMD and the related implementing measures (Article 99(1)(a) of the Level 2 Regulation), we believe it is consistent with ESMA’s role in ensuring a harmonised approach across the EU to advise on the interpretation and proper application of these provisions. [↑](#footnote-ref-6)
7. The relevant provisions of Annex 7 of the Impact Assessment accompanying the Level 2 Regulation are attached hereto as Annex I. [↑](#footnote-ref-7)
8. Consultation Paper, Part 5.2 (“Annex II, Cost-Benefit Analysis”), para. 6, page 17. [↑](#footnote-ref-8)
9. Ibid. [↑](#footnote-ref-9)
10. Letter of the Committee dated 24th October 2014 regarding ESMA’s technical advice to the European Commission on delegated acts required by the UCITS V Directive dated 26th September 2014 (the “UCITS V Consultation”). [↑](#footnote-ref-10)
11. e.g., U.S. law and market practice relating to broker-dealers and, under the law of the People’s Republic of China, so-called A-shares held via the Hong Kong-Shanghai Stock Connect Scheme. [↑](#footnote-ref-11)
12. Such “specific” treatment would not be required if Option 4 remains permissible. [↑](#footnote-ref-12)