

OPINION

Asset segregation and application of depositary delegation rules to CSDs

1 Legal basis

1. ESMA's competence to deliver an opinion to the institutions is based on Article 34 of Regulation (EC) No 1095/2010 (the 'Regulation'). In accordance with Article 44(1) of the Regulation the Board of Supervisors has adopted this opinion.
2. In this opinion to the European Parliament, the Council and the Commission ("EU institutions"), ESMA sets out its view on:
 - a) the optimal approach to asset segregation under the framework of both Directive 2011/61/EU ("AIFMD") and Directive 2009/65/EC ("UCITS Directive"), and
 - b) how the depositary delegation rules should apply to central securities depositories (CSDs).

2 Background

3. On 1 December 2014, ESMA issued a consultation paper (CP) on Guidelines on asset segregation under the AIFMD¹ which set out ESMA's proposals for possible guidelines regarding the asset segregation requirements in case of delegation of safe-keeping duties by the appointed depositary of an AIF. Indeed, questions arose in relation to the practical application of the required segregation at the level of the delegated third party (or sub-delegate)².
4. The majority of respondents to this consultation strongly objected to both options on which ESMA consulted and expressed a preference for some of the options which were mentioned in the cost-benefit analysis accompanying the proposal. Those respondents set out a number of supporting arguments, including the operational challenges that

¹ Available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1326_cp_-_guidelines_on_aifmd_asset_segregation.pdf.

² According to the AIFMD, when the safe-keeping duties are delegated to a third party, the asset segregation requirements under Article 21(11)(d) of the AIFMD and Article 99(1)(a) of the Level 2 Regulation apply at the level of the third party. As regards the segregation of assets in case of further delegation, Level 1 imposes the same requirements. However, different interpretations were followed in relation to the practical application of the aforementioned requirements under the AIFMD and the Level 2 Regulation.

would be faced in the custody chain should any of the two proposed options be retained. Various other respondents expressed support for either of the two options on which ESMA consulted.

5. ESMA looked further into the compatibility with the AIFMD legal framework of the various options which were mentioned in the CP and considered that – with the UCITS V Directive having come into force – the issues at stake are not only relevant under the AIFMD.
6. In this context, ESMA made an in-depth review of the relevant documentation³. Based on this review, ESMA identified a number of assertions about the challenges and costs arising from the current EU framework on asset segregation which were mentioned by stakeholders and, on 15 July 2016, launched a second consultation – through a call for evidence (CfE) – in order to gather further input⁴.
7. In its CfE ESMA also sought stakeholders' views on a discrete (but related) issue which relates to any need to provide additional guidance on the notion of custody services and any residual uncertainty on how the depositary delegation rules should apply to CSDs.
8. A summary of the responses to the CfE is included in the feedback statement under Annex I of the present opinion.
9. In the context of its second consultation, ESMA also organised a roundtable on 20 July 2016 to gather views on the topics analysed in the CfE. This roundtable was attended by consumer representatives, asset managers, depositaries, CSDs, prime brokers, collateral managers, T2S and insolvency law experts as well as representatives from national competent authorities. Given the relevance of insolvency-related aspects to the asset segregation requirements, a second roundtable was held on 14 September 2016 gathering insolvency experts and representatives from national competent authorities to discuss the insolvency-related aspects of the CfE. A summary of this second roundtable (“Insolvency Roundtable”) may be found under Annex II.
10. The following policy objective has driven ESMA's work while developing the part of the present opinion relating to asset segregation matters (Section 3.1 below).

Policy objective

11. The policy goal is to provide an EU framework with strong client asset protection, especially in insolvency, for the safe-keeping of assets which are, in accordance with

³ This included not only the responses to the CP, but also, inter alia, a number of responses to the recent Commission Call for evidence on the EU regulatory framework for financial services (available at http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index_en.htm) which touched upon the asset segregation issue.

⁴ The call for evidence (ESMA/2016/1137) is available at https://www.esma.europa.eu/sites/default/files/library/2016-1137_call_for_evidence_asset_segregation.pdf.

both UCITS and AIFM Directives, required to be held in custody. Insolvency and property law are different in all EU jurisdictions. A given type of segregation model intended to provide strong protection in jurisdiction X may in fact offer more, less or no change in protection if imposed on jurisdiction Y or Z.

12. Therefore, in addressing the EU institutions on the optimal approach to asset segregation of financial instruments under the AIFMD and UCITS Directive, ESMA suggests defining a regime which ensures:

- a) assets are clearly identifiable as belonging to the AIF/UCITS, consistent with any reuse (where this is permitted by the applicable legislation), and
- b) investors receive adequately robust protection by avoiding the ownership of the assets being called into question in case of the insolvency of any of the entities in the custody chain.

13. Considering the above policy goal, and on the basis of the feedback received through the consultations it carried out, ESMA came to the conclusion that only **minimum EU-wide segregation requirements** should be prescribed, leaving room for stricter requirements or different account structures if national (ownership, insolvency, tax or fiscal) laws in specific Member States make them necessary.

3 Opinion

14. The present opinion sets out suggestions to the EU institutions for possible clarifications of the legislative provisions under the AIFMD and UCITS Directive relating to the asset segregation requirements and the application of depositary delegation rules to CSDs (see sections 3.1.3 and 3.2.4 below). To put these suggestions into context, each of the aforementioned topics is introduced by specific references to the current legislative framework (see sections 3.1.1 and 3.2.1) and the main arguments brought forward by stakeholders – including respondents to the CfE and participants to the Insolvency Roundtable – are summarised (see sections 3.1.2 and 3.2.2)⁵.

3.1 Asset segregation

3.1.1 Introduction

15. The below is intended to summarise the current provisions on asset segregation under the AIFMD and UCITS Directive. In doing so, the AIFMD provisions are analysed first (section 3.1.1.1) and they are then compared against the provisions of the UCITS Directive.

⁵ For the detailed feedback to the CfE, see Annex I which includes a summary of the responses to the CfE.

3.1.1.1 The legal framework on asset segregation under the AIFMD

16. As a general rule, at the level of the depositary the assets have to be safe-kept on an AIF-by-AIF basis (or on a compartment-by-compartment segregation for AIFs with multiple compartments), which constitutes the maximum level of segregation and allows for prompt identification of the assets belonging to each AIF. This principle, with respect to the financial instruments that can be held in custody and can be registered in a financial instruments account, is set forth by Article 21(8)(a)(ii) of the AIFMD, according to which the financial instruments “[...] are registered in the depositary’s books within segregated accounts in accordance with the principles set out in Article 16 of Directive 2006/73/EC, opened in the name of the AIF or the AIFM acting on behalf of the AIF [...]”.
17. The safekeeping obligations laid down in Article 21(8)(a) AIFMD are further specified in Article 89(1) of Delegated Regulation 231/2013 (“AIFMR”), which sets forth a number of minimum conditions that the depositary shall respect. In summary, the depositary shall ensure that:
 - a) the financial instruments are properly registered according to Article 21(8)(a)(ii) AIFMD;
 - b) records and segregated accounts are maintained in a way that ensures their accuracy;
 - c) reconciliations are conducted on a regular basis between the depositary’s internal accounts and records and those of any third party to whom custody functions are delegated;
 - d) due care is exercised towards the financial instruments held in custody to ensure a high standard of investor protection;
 - e) all the relevant custody risk throughout the custody chain are assessed and monitored, ensuring a flow of information on material risks;
 - f) adequate organizational arrangements are put in place to minimize the risk of loss or diminution of financial instruments or the relevant rights attached to them;
 - g) the AIF’s ownership right (or that of the AIFM acting on its behalf) is verified.
18. The depositary in principle constitutes the first level of the custody chain. However, the depositary may delegate to third parties its custody function pursuant to Article 21(11) AIFMD (second level of the custody chain). This provision outlines the various conditions that shall be fulfilled for the delegation, some of which are directly relevant for the topic discussed in the present Opinion. In particular, the depositary must ensure 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 they can be clearly identified as belonging to clients of a particular depositary” (Article 21(11)(d)(iii) of the AIFMD); furthermore, the depositary shall ensure that the third party “complies with the general obligations and prohibitions set out in paragraphs 8 and 10” of Art. 21 AIFMD (Art. 21(11)(d)(v) AIFMD).

19. The delegation of custody functions is further specified in Article 89(2) AIFMR, according to which the depositary remains subject to the requirements of points (b) to (e) of Article 89(1) AIFMR and it shall ensure that the third party complies with the requirements of points (b) to (g) of Article 89(1) AIFMR (for all these points see the summary in paragraph 17 above) and with Article 99 AIFMR.
20. Article 99(1) AIFMR further specifies the segregation obligations in case of (full or partial) delegation, providing that the depositary ensures that the third party acts in accordance with Article 21(11)(d)(iii) AIFMD (see above) by verifying that the third party, in summary:
 - a) keeps records and accounts that enable at any time and without delay to distinguish assets of the depositary's AIF's clients from its own assets, assets of its other clients, assets held by the depositary for its own account and assets held for clients of the depositary which are not AIFs;
 - b) maintains records and accounts in a way that ensures their accuracy;
 - c) conducts, on a regular basis, reconciliations between its internal accounts and records and those of the third party to whom it has delegated safekeeping functions;
 - d) sets up adequate organizational arrangements to minimize the risk of loss or diminution of financial instruments or the relevant rights attached to them.
21. The requirements above constitute the protection standard that must be consistently followed by the depositary and the third party. However, the AIFMR takes into account circumstances in which the standard provided by Art. 99(1) AIFMR may not be sufficient. Article 99(2) AIFMR states that the monitoring of the third party's compliance with the segregation obligations shall ensure that the financial instruments under custody are protected from any insolvency of the third party. In case, according to the applicable law (including property and insolvency law), the requirements set forth in Article 99(1) AIFMR are not sufficient to achieve such protection, the depositary shall assess which additional arrangements are to be taken to minimize the risk of loss and maintain adequate standards of investor protection.
22. Finally, recital 40 of the AIFMD states that the third party delegate should be able to maintain a common segregated account for multiple AIFs, a so-called 'omnibus account'.
23. For completeness, after clarifying the segregation obligation of the first and second level of the custody chain, the legal framework also foresees the case of sub-delegation down to further levels of the custody chain (third level and following) (Article 21(11) penultimate paragraph AIFMD and Article 99(3) AIFMR). The provisions state that the rules on asset segregation apply "mutatis mutandis" in case of sub-delegation.

3.1.1.2 A comparison between AIFMD and UCITS V provisions on asset segregation

24. Most of the rules on asset segregation provided for by the UCITS Directive and Delegated Regulation 2016/438 (“UCITS V Regulation”) are essentially equivalent (although the wording is not always the same) to those set forth by the AIFMD and AIFMR. Please refer to Annex III for details.
25. It is worth pointing out that UCITS V Regulation, in contrast to AIFMR, details the steps that must be taken by the depositary and the delegated party which is located in a third country to protect UCITS assets from the insolvency of that delegate. As stated in recital 19 of the UCITS V Regulation, the depositary has to “*understand the insolvency law of the third country where a third party is located and ensure the enforceability of their contractual relation*”. This is done, inter alia, by way of a legal opinion confirming that the applicable insolvency law recognizes the “*segregation of the assets of the depositary’s UCITS clients from its own assets and from the assets of its other clients, from the assets held for the depositary’s own account and from the assets held for clients of the depositary which are not UCITS*”.
26. Moreover, under Article 98 (2) of the AIFMR, a depositary for an AIF is to “*exercise all due skill, care and diligence to ensure that entrusting financial instruments to this third party provides an **adequate standard of protection***” and under letter a) to “*assess the **regulatory and legal framework**, including country risk, custody risk and the enforceability of the third party’s contracts. That assessment shall in particular enable the depositary to determine the **potential implication of an insolvency** of the third party for the assets and rights of the AIF. If a depositary becomes aware that the segregation of assets is not sufficient to ensure protection from insolvency because of the law of the country where the third party is located, it shall immediately inform the AIFM.*”
27. In a similar way, Article 15 (2) a) of the UCITS Regulation requires the depositary to “*assess the **regulatory and legal framework**, including country risk, custody risk and the enforceability of the contract entered into with that third party. That assessment shall in particular enable the depositary to **determine the implications of a potential insolvency of the third party for the assets and rights of the UCITS.***”
28. For UCITS and in relation to a third party located in a third country, to whom custody functions are to be or have been delegated, Article 17 (2) a) and b) of the UCITS Regulation specifies further, that legal advice has to be obtained from independent advisors on applicable insolvency laws and their recognition of segregated assets and their unavailability for distribution among creditors of an insolvent entity within the custody chain.

29. Other existing requirements prescribe the maintenance of accurate books and records and regular reconciliations between the depositary's and the delegate's internal accounts as well as organisational and technical structures, which allow for both.⁶

30. In addition to the provisions which directly refer to asset segregation described above, it should be pointed out that the AIFMD and UCITS Directive contain different rules on the possibility for the depositary to reuse the assets. In particular, according to Article 21(10) of the AIFMD "*The assets referred to in paragraph 8 shall not be reused by the depositary without the prior consent of the AIF or the AIFM acting on behalf of the AIF*". The regime for UCITS assets is different: pursuant to Article 22(7) of the UCITS V Directive, "*The assets held in custody by the depositary shall not be reused by the depositary, or by any third party to which the custody function has been delegated, for their own account.[...]The assets held in custody by the depositary are allowed to be reused only where:*

- a) the reuse of assets is executed for the account of the UCITS;*
- b) the depositary is carrying out the instructions of the management company on behalf of the UCITS;*
- c) the reuse is for the benefit of the UCITS and in the interest of the unit holders; and*
- d) the transaction is covered by high-quality and liquid collateral received by the UCITS under a title transfer arrangement."*

31. It is worth recalling the above rules, in particular to the extent that the ban on the reuse of the UCITS assets for the depositary account should be ensured throughout the chain as it is part of the depositary's due diligence requirements. Indeed, Article 15(3) of the UCITS V Regulation 2 explicitly foresees that "*A depositary shall exercise all due skill, care and diligence in the periodic review and ongoing monitoring to ensure that the third party continues to comply with the criteria provided for in paragraph 2 and the conditions set out in points (a) to (e) of paragraph 3 of Article 22a of Directive 2009/65/EC, and shall at least: [...] (d) monitor compliance with the prohibition laid down in paragraph 7 of Article 22 of Directive 2009/65/EC*".

3.1.2 Arguments against overly prescriptive asset segregation requirements

32. The following arguments made by respondents during the consultation process support stakeholders' view that imposing segregation requirements as envisaged under option 1 of the CP or any other overly prescriptive asset segregation regime is, while technically and operationally possible, not the determining factor in delivering the policy objective.

⁶ For further details please refer to Articles 98 (2) and 99 (1) b) and c) of the AIFMR or Article 16 (1) b) and c) of the UCITS V Regulation.

Investor protection in the event of insolvency

33. The feedback gathered through the various consultations (including at the Insolvency Roundtable) revealed that the account structure described for the level of the delegate under option 1 in the CP and CfE does not necessarily provide additional insolvency protections for clients, which is one of the main objectives of the asset segregation requirements.
34. The feedback received indicates that prescribing a specific model of asset segregation does not necessarily increase investor protection in the event of insolvency. This aim can be achieved by a number of measures used alongside either individually segregated accounts or omnibus accounts.
35. This can be attributed to differences in securities holding systems, national laws on ownership rights or title to securities and the preconditions to their recognition or protection in the case of an insolvency of any party in the custody chain. These parties within the custody chain are subject to national and not harmonised EU laws in relation to insolvency.
36. The majority of respondents to the consultations and roundtables stressed that, in order to determine to what extent account segregation achieves investor protection, it is necessary to look at (1) securities (property) laws, in order to identify the kinds of rights and access (property, beneficial interests etc.) that are attached to the accounts; (2) the structuring and oversight of the sub-custodian network; and (3) the national insolvency regimes that will apply in the event of insolvency of the securities account provider at a given level of the custody chain. However, such regimes are not harmonised and may provide for different models of segregation. These differences make it difficult and undesirable to specify a “segregation model” that would fit every Member State. Such difficulties are further exacerbated when one considers the global nature of custody operations. Respondents also cited the current legislative framework, in particular MIFID and AIFMD, which acknowledge different national models for holding securities.
37. Requirements on segregation under both the AIFMD and the UCITS legal framework are under existing provisions accompanied by specific due diligence requirements to be conducted by the depositary, when selecting and appointing a delegated third party, which aim to provide investors with an adequately robust level of protection by avoiding the ownership of the assets being called into question in case of an insolvency of any entity in a custody chain.
38. Most respondents stated there are no material differences between omnibus accounts and individually segregated accounts in the return of assets in a scenario of potential insolvency or insolvency. Instead, a number of factors are responsible to determining the timing in the return of assets in the event of insolvency including: the operation of insolvency law within the relevant jurisdiction, the accuracy and traceability of securities records, the scale and complexity of the sub-custodian business, problems involved in

reconciliation process such as the existence of security interest or other contracts to which the assets may be subject and the factors leading to the appointment of an insolvency practitioner. Accordingly, there is no single factor, common to all jurisdictions where sub-custodians have been appointed, which guarantees protection of client assets in the event of insolvency.

39. Respondents noted that, in some jurisdictions, separate accounts at the level of the delegate for different types of clients of depositaries are not a prescribed condition for insolvency protection. This is because all levels of the holding or custody chain, i.e. including separate accounts kept at the level of the depositary, would be reviewed in these jurisdictions in order to determine ownership rights and/or protection rights in the case of an insolvency. Respondents have indicated that a requirement to segregate further, i.e. between certain groups of the depositary's clients on the level of the delegate, would cause extensive changes to existing and working structures in these jurisdictions without any benefit for the protection of investors in the case of an insolvency.
40. Legal mechanisms ensuring segregation of a depositary's or depositary delegate's own assets from client assets are widely used to ensure client asset protection. In particular, the existing requirements prescribe the maintenance of accurate books and records and regular reconciliations between the depositary's and the delegate's internal accounts as well as organisational and technical structures, which allow for both.
41. Accurately recording clients' rights and entitlements, or books and records segregation, achieves the policy objective by determining asset entitlements and property rights for each client. In many jurisdictions, an insolvency practitioner would look to the books and records of the insolvent firm as evidence of each client's individual asset entitlement. Individual accounts for clients on their books and records enable the delegate at any time to immediately identify client entitlements and distinguish these from a third party's entitlements or the delegate's own entitlements, including in the event of insolvency.
42. Accordingly, some respondents stated that daily effective reconciliations are a key measure for client assets protection, including in the case of insolvency, by ensuring accurate records and traceability of the client's assets throughout the custody chain. Other measures can include the depositary carrying out due diligence on its delegates, ensuring due diligence on sub-delegates, ensuring contingency arrangements are in place for the appointment of replacement delegates and prompt registration of client securities.
43. Many respondents pointed out that the key factors for investor protection in omnibus accounts are appropriate recording of assets at each layer of the custody chain (e.g. sound record-keeping); accuracy and traceability of securities records and on-going monitoring of the sub-custodian network. MiFID II permits general omnibus client accounts. It requires that (i) the books and records of the investment firm identify the

client for whom it is holding the relevant custody assets and (ii) segregation of client assets from any proprietary assets of the investment firm.

44. Risk of misuse of assets exists whether the assets of AIFs or UCITS are held with a depositary's delegate in an omnibus or individually segregated account. Whether assets are held within omnibus or individually segregated accounts will not prevent fraud by a third party who may misuse or move assets out of either type of account. This risk of misuse or fraud is considered in the IOSCO report⁷ on the Standards for the Custody of Collective Investment Schemes' Assets, IOSCO highlighted the following operational safeguards, which should be undertaken to protect client assets in custody: daily reconciliations; segregation of the assets of the custodian and sub-custodian at all times from client assets; accurate record keeping; and regular monitoring and oversight, including due diligence to ensure asset segregation procedures are being followed.
45. It was also highlighted at the Insolvency Roundtable that additional detailed segregation would not have made a difference in the Lehman Brothers International (Europe) failure. An auditor involved in the Lehman's insolvency proceedings advised that a full reconciliation of the estate was required before any assets would be returned. The auditor concluded that individually segregated accounts are unlikely to make a material difference in the speed of restitution of assets to counterparties in an insolvency.⁸
46. In light of the above views, most respondents disagreed with mandating a detailed individual segregation model, as was previously suggested by ESMA. It is the view of these respondents that detailed individual segregation requirements do not necessarily provide additional investor protection. Accordingly, they recommend that ESMA take a different approach to the use of individually segregated accounts, which should be allowed where required / desired rather than a general requirement for all jurisdictions.

Operational complexity

47. Most of the respondents to the CfE stated that segregation requirements as previously consulted on or any other overly prescriptive individual asset segregation regime would see an increase in the number of accounts in the custodial chain for some market participants.
48. The majority of respondents agreed that both block trades and internalised settlement would become increasingly more difficult or impossible to sustain if option 1 of the CP was to be implemented. This was due to the increase of transactions costs and operational risks, as managers, executing brokers and settlement agents would be required to restructure their operations to accommodate a significantly larger number

⁷ See paragraphs 29 and 30 of the Standards for the Custody of Collective Investment Schemes' Assets – Final Report (FR25/2015): <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD512.pdf>

⁸ See the Feedback Statement in Annex I for further detail.

of trades between accounts. With regard to internalised settlements, several stakeholders argued that the efficiencies derived from this process would be greatly diminished.

49. Respondents indicated that as CSD links and the T2S platform operate through omnibus accounts, the efficiency of cross-border settlement of assets within AIFs and UCITS would be negatively impacted. This was attributed to the complicated reconciliations of securities transfers between accounts which would increase operational risk. Respondents set out that there would be an increased number of mismatched instructions and increased booking errors and also higher transaction costs if account segregation in the manner consulted on was mandated.

Cost Impact

50. In considering the impact of mandating specific models of individual asset segregation, respondents made reference to the capacity constraints; system developments; KYC / AML requirements; and the additional paperwork / administration required as a result of any additional accounts that would be required. The feedback from these parties indicated the significant costs associated with these operational developments would ultimately be borne by investors.
51. Conversely, a handful of respondents that currently operate a custody model akin to option 1 of the CP advise that they have not incurred additional costs from delegates as a result. Notably, these respondents were all from the same jurisdiction.
52. The other participants stressed that omnibus accounts support cheaper, more efficient and profitable operations for EU investment funds. They considered that option 1 of the CP would bring about depository concentration risk as smaller sub-custodians would be unwilling or unable to make the necessary costly infrastructural changes.
53. A number of respondents argued that while the cost of detailed individual asset segregation would be substantial it would be insignificant in comparison to the fundamental impact on AIFs and UCITS and their ability to enter into securities financing transactions.

Tri-party Collateral Management

54. Respondents considered that option 1 would prevent EU investment funds from participating in tri-party collateral management arrangements and make them shift to bilateral arrangements. This is because tri-party collateral management arrangements are also based on the operation of omnibus accounts by the collateral manager. If subject to option 1 of the CP, the collateral manager as a delegated third party, would have to open individual accounts for AIFs or UCITS, leading to individual arrangements and transactions on a bilateral basis. Lending on a bilateral basis complicates the securities lending process as multiple deliveries and receipts of stock and collateral are required with attendant instructions, account movements and reconciliations.

Respondents advise that this removes economies of scale and introduces timing challenges without additional benefits.

55. Stakeholders argued that other securities lending counterparties, such as sovereign wealth funds and non-EU investment funds, which can operate through omnibus accounts, would be preferred to EU investment funds if individual segregation requirements were imposed. EU investment funds would therefore be disadvantaged as counterparties to these transactions, and also reducing the market liquidity which such arrangements provide.
56. Similarly, in relation to prime brokerage, respondents viewed option 1 of the CP as significantly increasing complexity and operational risk arising from delays in identification, reconciliation and release of client assets in an insolvency scenario. Systematic changes would be required in order to facilitate prime brokerage through an individually segregated model.

Third Country Focus

57. Respondents also indicated that depositary delegates based in certain jurisdictions may be unwilling to facilitate the detailed individual segregation requirements prescribed by option 1 of the CP or any other overly prescriptive asset segregation regime because of existing local market practice, rules and infrastructure.
58. Particular mention was made by respondents to the US where prime brokers are subject to specific regulation regarding safe-keeping of client assets and to the market infrastructure in Hong Kong/China. Stakeholders stressed that omnibus accounts were fundamental to the way in which custody models operate in these jurisdictions, in conflict with the segregation model of option 1 of the CP.

3.1.3 The optimal approach to asset segregation as part of a robust investor protection regime for AIF and UCITS clients

59. In view of the existing requirements and insolvency protection provided by different account structures in the various jurisdictions, ESMA came to the conclusion that only **minimum EU-wide segregation requirements** should be prescribed. This approach would on the one hand, leave room for stricter requirements or different account structures, if national laws (on ownership, insolvency, tax or fiscal matters) in Member States, or clients' preferences, make them necessary. On the other hand, this approach would acknowledge insolvency protection provided by some account structures. The proposed approach would therefore deviate from the options discussed in the original consultation and the CfE.
60. As already mentioned in the introduction to the present document, the policy goal when defining the optimal approach to asset segregation is to provide an EU framework for AIFs and UCITS with a strong focus on client asset protection, especially in case of

insolvency, for the safe-keeping of assets which are, in accordance with both UCITS and AIFM Directives required to be held in custody, by:

- minimising the risk of loss of the assets, and
- ensuring efficient and quick return of the assets to their rightful owners in case of insolvency of the party involved in the custody of such assets.

61. Insolvency and property law are different in all EU jurisdictions. A given type of segregation model intended to provide strong protection in jurisdiction X may in fact offer more, less or no change in protection if imposed on jurisdiction Y or Z. Therefore the EU framework regulating asset segregation regime shall focus on:

- ensuring that assets are clearly identifiable as belonging to the AIF or UCITS, and
- ensuring that investors receive adequately robust protection by avoiding the ownership of the assets being called into question in case of the insolvency of any of the entities in the custody chain.

62. In view of all material received in response to the original CP, CfE, industry roundtable and Insolvency Roundtable, it appeared that mandating one specific model of individual asset segregation throughout the chain cannot guarantee in itself investor protection. The responses of a vast majority of the respondents (as described under section 3.1.2 of the present opinion) call for flexibility and the consideration of different factors such as local market regulations, prevailing custodial practices and available insolvency protections of the local markets. Given the range of factors to be taken into account, there can be no “one model fits all” approach.

63. In this context, it must be highlighted that, based on the feedback received – including from insolvency experts – an individual account segregation structure is not necessarily the critical element in ensuring the policy objective, but rather the enforcement of the ownership rights of a client through accurate recordings of those rights, an effective reconciliation process, and the recognition under the laws of the relevant jurisdiction that rights of the holder or owner of the assets are insulated from the claims of any creditor of the relevant intermediary.

64. Against this background the following sections set out ESMA’s proposals for possible legislative clarifications on the asset segregation rules under the UCITS Directive and AIFMD.

i) *Alignment of the insolvency-related provisions under the UCITS Directive and AIFMD*

65. An alignment of the UCITS Directive and the AIFMD regimes on client asset protection is recommended, in order to ensure a consistent regime across the EU for collective investment undertakings. As the UCITS V Directive is a later piece of legislation than

the AIFMD, it offers additional hindsight with respect to safe-keeping of assets, providing for more precise provisions on some aspects that should be mirrored in the AIFMD.

66. Article 22(8) of the UCITS Directive notably requires Member States to ensure that in the event of insolvency of the depositary and/or of any third party located in the Union to which custody of UCITS assets has been delegated, the assets of a UCITS held in custody are not available for distribution among, or realisation for the benefit of, creditors in case of insolvency of such a depositary and/or third party.
67. Article 22a(3)(d) of the UCITS Directive further requires that in case of delegation of safekeeping duties to a third party, that third party at all times during the performance of the tasks delegated to it *“takes all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among, or realisation for the benefit of, creditors of the third party”*.
68. In case of delegation of tasks to a third party located outside the EU, Article 17 of the UCITS V Regulation concurrently places a similar responsibility on the depositaries, by requiring them to ensure that the third party takes all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among, or realisation for the benefit of, creditors of the third party. In that context, the depositary shall ensure that the third party notably receives independent legal advice confirming that the applicable insolvency law recognises the segregation of the assets.
69. These provisions are a cornerstone for enabling protection of investors’ assets irrespective of the various insolvency and property laws across the different EU jurisdictions.
70. Taking the above into consideration, ESMA is of the view that the EU institutions should consider mirroring such provisions in the AIFMD in order to harmonise protection of these types of assets for AIF and UCITS investors across the different Member States.

ESMA is of the view that the EU institutions should consider mirroring Articles 22(8) and 22a(3)(d) of the UCITS Directive and Article 17 of the UCITS V Regulation in the AIFMD framework in order to harmonise protection of these types of assets for AIF and UCITS investors across the different Member States.

ii) Asset segregation requirements at the first level (i.e. depositary level)

71. Some issues of interpretation in relation to the segregation requirements applying at the first level of the custody chain were mentioned by some of the respondents to the CfE. Therefore, ESMA sees merit in suggesting clarifications in this respect.

72. ESMA considers that a fund-by-fund segregation (or a compartment-by-compartment segregation for funds which have multiple compartments) should apply in any event at the level of the first link in the custody chain (i.e. the appointed depositary), even when the depositary delegated its custody functions⁹. This is based on the provisions under Article 21(8)(a)(ii) of the AIFMD (and the equivalent rules under Article 22(5)(a)(ii) of the UCITS Directive).
73. However, feedback from the consultation raised some issues of interpretation with respect to Article 89(2) of the AIFMR. This article provides for implementing measures relating to the safekeeping duties with regards to assets held in custody. Article 89(1) of the AIFMR provides for a list of detailed minimum requirements with which a depositary has to comply with respect to financial instruments to be held in custody. These include the requirement to ensure that “*the financial instruments are properly registered in accordance with Article 21(8)(a)(ii)*” of the AIFMD (Article 89(1)(a) of the AIFMR). Article 89(2) of the AIFMR provides for situations where a depositary has delegated its custody functions to a third party. It lists (a) the requirements the depositary shall remain subject to and (b) the requirements the depositary shall ensure that the delegated third party complies with, in these circumstances. Article 89(2) does not refer to the aforementioned requirements under Article 89(1)(a) of the AIFMR.
74. For this reason, some respondents noted that the wording of this article seems to exempt depositaries from the requirements under Article 21(8)(a)(ii) of the AIFMD when the depositary has delegated its custody functions to a third party in accordance with Article 21(11) of the AIFMD. More specifically, there seems to be some uncertainty on the full set of obligations of the delegate: on the one hand, Article 21(11)(d)(v) of the AIFMD states that the delegate must comply with paragraph 8 of the same article, which is further specified by Article 89(1) of the AIFMR (and thus all the points from (a) to (g) listed thereby); on the other hand, as mentioned above, Article 89(2) of the AIFMR states the delegate shall respect the conditions of Article 89(1) AIFMR points from (b) to (g). It is therefore unclear whether the delegate must respect Article 89(1) point (a) AIFMR. Similar interpretative doubts may be raised in relation to the corresponding provisions under Article 13(2) of the UCITS V Regulation.
75. ESMA is of the view that it shall remain the responsibility of the depositary to ensure that all those financial instruments that can be registered in a financial instruments account are first registered in the depositary’s books, even when such duties are further

⁹ This does not apply in situations where an AIF depositary falls under the category described under Article 21(3)(c), first subparagraph of the AIFMD or a UCITS depositary falls under the category described under Article 23(3) of the UCITS Directive (and in the latter case only until 17 March 2018) because the depositary will not generally provide safekeeping functions for assets which must be held in custody. Indeed, these depositaries may not provide safekeeping functions for assets which must be held in custody and hence not be in a position to comply with the requirements under Article 21(8)(a)(ii) of the AIFMD and Article 22(5)(a)(ii) of the UCITS Directive (i.e. to open and register in their books within segregated accounts in accordance with the principles set out in Article 16 of Directive 2006/73/EC those financial instruments that can be registered in a financial instruments account). In these cases, ESMA considers that the requirements to open accounts in accordance with the principles in Article 21(8)(a)(ii) of the AIFMD and Article 22(5)(a)(ii) of the UCITS Directive should be applied at the level of the entity to whom the safekeeping of the assets has been delegated.

delegated to a third party, notably in order to enable the depositary to comply with its other duties as set under Article 21 of the AIFMD and Article 22 of the UCITS Directive¹⁰.

76. While this approach is the one followed by depositaries in practice, where books and records are effectively kept at the first level of the depositary chain before further delegation, some structures do however tend to open securities and cash accounts of fund clients directly at the level of the delegate of the depositary, notably when the delegate in question is the parent entity of the appointed depositary.
77. In such cases the responsibility for ensuring that the financial instruments are properly registered in accordance with Article 21(8)(a)(ii) of the AIFMD (and Article 22(5)(a)(ii) of the UCITS Directive) set forth by Article 89(1)(a) AIFMR (and Article 13(1)(a) of the UCITS V Regulation), seems to be neither the responsibility of the depositary nor that of the third-party delegate according to the wording of Article 89(2) of the AIFMR and Article 13(2) of the UCITS V Regulation, which seem to allow such a structure.
78. Taking the above into consideration, ESMA is of the view that the EU institutions should clarify that the depositary shall ensure that the financial instruments are properly registered in its books and records in accordance with article 21(8)(a)(ii) of the AIFMD and Article 22(5)(a)(ii) of the UCITS Directive at all times.

In order to ensure that financial instruments are properly registered in the depositary's books and records even in case of delegation of the safe-keeping duties¹¹ ESMA is of the view that the EU institutions should consider the following:

- **adding references to the requirements under Article 89(1)(a) in Article 89(2) of the AIFMR, and**
- **adding references to the requirements under Article 13(1)(a) in Article 13(2) of the UCITS V Regulation.**

iii) Asset segregation requirements at the second level (i.e. delegate level)

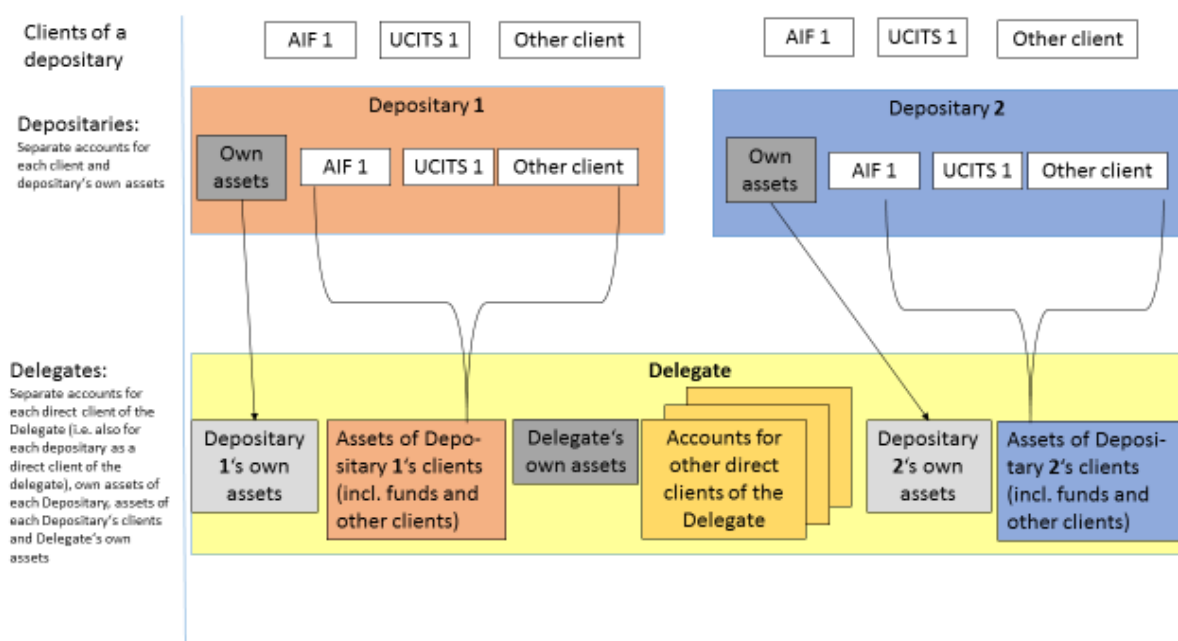
79. ESMA considers that the minimum requirements to be prescribed for the level of the delegate should consist of a minimum of **3** segregated accounts **per depositary** at the level of the delegate as follows: **(1) own assets** of the **delegate**, **(2) own assets** of **depositary** and **(3) assets** of **depositary's clients**, so that with every additional depositary, who delegated safe-keeping functions to the delegate, two more accounts – one for the depositary's own assets and one for the respective depositary's clients' assets – would have to be added as illustrated and framed in light yellow for the level

¹⁰ See, however, the exception mentioned in the previous footnote.

¹¹ Except for the cases described in the second-last footnote.

of the delegate in the chart below. Additionally, for each other direct client of the delegate a minimum of one account per direct client would be opened on the level of the delegate as illustrated by dark yellow boxes in the chart below.

80. It should be noted that the requirements above and the chart below only reflect the suggested approach for the UCITS and AIFMD requirements and are without prejudice to any additional segregation requirements stemming from any other European or national legislation (e.g. commingling assets of depositary's clients other than UCITS or AIF clients with UCITS and AIF clients may be prohibited by, for instance, the MiFID rules in case these depositary's clients are MiFID investment firms).



81. As a consequence, omnibus accounts, i.e. those comprising assets of different clients of depositaries, but excluding own assets of the delegate or of the depositary, would be admissible at the level of the delegate subject to

- (1) ensuring that assets are not available for distribution to creditors of the failed entity;
- (2) accurate accounting and reconciliation systems allowing the depositary to verify that – for each of its UCITS and/or AIF clients – the number and type of financial instruments registered in the accounts opened in its books matches with the number and type of financial instruments belonging to its UCITS and/or AIF clients which are recorded on the financial instruments accounts of the delegate (where instruments belonging to other clients may also be kept);
- (3) reconciliation measures under (2) being conducted as often as necessary depending not only on the dealing frequency of the relevant UCITS or AIF, but

also on any trade which would occur even outside the dealing frequency (e.g. a UCITS or AIF with weekly dealing frequency which trades on a daily basis would require daily reconciliations). Moreover, reconciliation measures would also need to be conducted depending on any other transaction happening in relation to any of the other client assets kept in the omnibus account;

- (4) processes ensuring that reuse of securities is only allowed if provided for in the relevant contracts and permitted by the relevant legislation¹²;
- (5) a written contract being concluded between the depositary and the delegate¹³; and
- (6) the contract between the depositary and the delegate providing for:
 - a) the depositary's right of sufficient information, inspection, admittance and access, to enable the depositary to have oversight of the whole custody chain in order to ensure that its arrangements satisfy the policy objective and to enable the depositary to fulfil its oversight and due diligence obligations; and
 - b) respective rights to be agreed on between the delegate and the sub-delegate in the event of a sub-delegation.

82. Such a structure is in line with both, Article 21 (11) d) (iii) of the AIFMD and Article 22a (3) (c) of the UCITS Directive, respectively, which both demand a segregation between **(1) assets of the depositary's clients, (2) own assets of the delegated third party and (3) own assets of the depositary** and do not comment on direct clients of the delegated third party as additional layers.

83. However, it is noted that recital 40 of the AIFMD¹⁴, on the one hand, allows so-called "omnibus accounts" where different AIFs' assets can be aggregated, while on the other hand, appears to rule out the possibility to commingle in a same account AIFs, UCITS'

¹² In this respect, Article 21(10) of the AIFMD provides that AIF's assets "shall not be reused by the depositary without the prior consent of the AIF or the AIFM acting on behalf of the AIF". Article 22(7) of the UCITS Directive provides the following on the reuse of UCITS' assets: "The assets held in custody by the depositary shall not be reused by the depositary, or by any third party to which the custody function has been delegated, for their own account. Reuse comprises any transaction of assets held in custody including, but not limited to, transferring, pledging, selling and lending.

The assets held in custody by the depositary are allowed to be reused only where:

- (a) the reuse of the assets is executed for the account of the UCITS;
- (b) the depositary is carrying out the instructions of the management company on behalf of the UCITS;
- (c) the reuse is for the benefit of the UCITS and in the interest of the unit holders; and
- (d) the transaction is covered by high-quality and liquid collateral received by the UCITS under a title transfer arrangement.

The market value of the collateral shall, at all times, amount to at least the market value of the reused assets plus a premium".

¹³ This written contract should be in addition to the written contract relating to the appointment of the depositary to be concluded between the latter and the manager of the fund or the fund itself as prescribed under Article 21(2) of the AIFMD and Article 22(2) of the UCITS Directive and further detailed in the relevant implementing measures (i.e. Article 83 of the AIFMR and Article 2 of the UCITS V Regulation).

¹⁴ Recital 40 states the following: "A third party to whom the safe-keeping of assets is delegated should be able to maintain a common segregated account for multiple AIFs, a so-called 'omnibus account'".

assets and, possibly, assets of other clients. Interpretative doubts may also arise on whether, under the UCITS Directive, omnibus accounts may contain only UCITS' assets or, alternatively, UCITS and assets of other clients.

84. Both, Article 99 (1) a) of the AIFMR and Article 16 (1) a) of the UCITS V Regulation, respectively, seem to foresee a further possible segregation between the depositary's clients by demanding "*records and accounts as are necessary to enable the depositary¹⁵ at any time and without delay to distinguish*

- ***assets of the depositary's AIF or – in the case of UCITS – UCITS clients from***
- *its own assets,*
- *assets of its other clients,*
- *assets held by the depositary for its own account and*
- ***assets held for clients of the depositary which are not AIFs or – in the case of UCITS – UCITS***".

85. In order to reflect the minimum account structure arrangements described above, ESMA recommends to revisit the provisions in Article 99(1)(a) of the AIFMR and Article 16 (1)(a) of the UCITS V Regulation as per one of the following two options:

- 1) deleting these provisions and refraining from detailing Article 21 (11)(d)(iii) of the AIFMD and Article 22a(3)(c) of the UCITS Directive in the AIFMR and UCITS V Regulation, or
- 2) to amend

➤ Article 99 (1)(a) of the AIFMR as follows:

"Where safekeeping functions have been delegated wholly or partly to a third party, a depositary shall ensure that the third party, to whom safekeeping functions are delegated pursuant to Article 21(11) of Directive 2011/61/EU, acts in accordance with the segregation obligation laid down in point (iii) of Article 21(11)(d) of Directive 2011/61/EU by verifying that the third party:

(a) keeps such records and accounts as are necessary to enable ~~the~~ the depositary at any time and without delay to distinguish assets of the depositary's AIF clients from ~~the~~ the third party own assets, assets of ~~its~~

¹⁵ For purposes of clarification ESMA is of the opinion that under Article 99 (1) a) of the AIFM Regulation and in line with the wording of Article 16 (1) a) of the UCITS Regulation it is the depositary, who must be able to distinguish between the assets mentioned therein.

~~the third party's other clients, and assets held by the depositary for its own account and assets held for clients of the depositary which are not AIFs~~, and

Article 16 (1)(a) of the UCITS V Regulation as follows:

“Where safekeeping functions have been delegated wholly or partly to a third party, a depositary shall ensure that the third party to whom safekeeping functions are delegated pursuant to Article 22a of Directive 2009/65/EC acts in accordance with the segregation obligation laid down in point (c) of Article 22a(3) of Directive 2009/65/EC by verifying that the third party:

(a) keeps all necessary records and accounts to enable the depositary at any time and without delay to distinguish assets of the depositary's UCITS clients from ~~its~~the third party own assets, assets of its ~~the third party's other clients, and~~ assets held by the depositary for its own account ~~and assets held for clients of the depositary which are not UCITS~~”.

86. Should the legal advice obtained in relation to third parties located in a third country or the due diligence conducted pursuant to Article 15 (2) (a) of the UCITS V Regulation or Article 98(2) of the AIFMR prior to the delegated party's appointment reveal that the policy objective is jeopardized by the minimum asset segregation requirements described above, necessary changes and additional safeguards should be implemented in agreements between depositaries and delegates. For example, the following safeguards may be considered: more detailed segregation required to mitigate a specific risk (e.g. separating assets of collective investment undertakings from assets of other clients) or declarations by the delegate confirming its knowledge, that certain assets are not own assets of the depositary as well as waivers of rights possibly hindering an execution of ownership rights, thereby reflecting the relevant legal situation. This is in line with the already existing requirement pursuant to the second sentence of Article 99(2) of the AIFMR, in accordance with which the depositary – if, according to the applicable law, including in particular the law relating to property or insolvency, the requirements laid down in Article 99(1) – including segregation requirements under letter a) of the AIFM are not sufficient to achieve that objective – shall assess what additional arrangements are to be made in order to minimise the risk of loss and maintain an adequate standard of protection.

87. In this respect, ESMA considers that the text in Article 99(2) of the AIFMR could be reinforced by requiring not only to “*assess what additional arrangements are to be made in order to minimise the risk of loss and maintain an adequate standard of protection*”, but also to ensure that appropriate arrangements (including further segregation of accounts) are put in place.

88. As the approach in this opinion would not generally prohibit the use of omnibus accounts on the level of the delegate as defined above, but would even allow them to be used under the described circumstances and conditions in many cases, it would have the additional advantage that there would be no need for a specific ‘carve out’ or exemption for prime brokerage or tri-party collateral management.¹⁶ I.e. they could be subject to the same requirements as any other delegate. In cases where the use of omnibus accounts affects the policy goals in a given jurisdiction, arrangements between depositaries and delegates may be adapted to meet the requirements, where possible. This does not exclude cases, in which the policy objective – depending on the relevant national law - can only be reached by further segregated accounts. The latter may lead to an exclusion of some assets held on behalf of specific collective investment undertakings from services of a prime broker or tri-party collateral management services.

89. The same requirements should apply to collective investment undertakings irrespective of whether these are marketed to professional or retail investors.

ESMA invites the EU institutions to consider legislative clarifications in the UCITS and AIFMD framework in order to prescribe the following minimum requirements at the level of the delegate:

- **a minimum of 3 different segregated accounts per depositary should be required at the level of the delegate as follows:**
 - 1) own assets of the delegate,**
 - 2) own assets of depositary, and**
 - 3) assets of depositary’s clients**
- **the use of omnibus accounts (i.e. those comprising assets of different clients of depositaries, but excluding own assets of the delegate or of the depositary) should be subject to the following conditions:**
 - (1) ensuring that assets are not available for distribution to creditors of the failed entity;**
 - (2) accurate accounting and reconciliation systems allowing the depositary to verify that - for each of its UCITS and/or AIF clients – the number and type of financial instruments registered in the accounts opened in its books matches with the number and type of financial instruments belonging to its UCITS and/or AIF clients**

¹⁶ For issues in connection with an application of option 1 to these services, please refer to paragraphs 54 to 56 above.

which are recorded on the financial instruments accounts of the delegate (where instruments belonging to other clients may also be kept);

- (3) reconciliation measures under (2) being conducted as often as necessary depending not only on the dealing frequency of the relevant UCITS or AIF, but also on any trade which would occur even outside the dealing frequency (e.g. a UCITS or AIF with weekly dealing frequency which trades on a daily basis would require daily reconciliations). Moreover, reconciliation measures would also need to be conducted depending on any other transaction happening in relation to any of the other client assets kept in the omnibus account;**
- (4) processes ensuring that reuse of securities is only allowed if provided for in the relevant contracts and permitted by the relevant legislation¹⁷;**
- (5) a written contract being concluded between the depositary and the delegate¹⁸; and**
- (6) the contract between the depositary and the delegate providing for:
 - a) the depositary's right of sufficient information, inspection, admittance and access, to enable the depositary to have oversight of the whole custody chain in order to ensure that its arrangements satisfy the policy objective and to enable the depositary to fulfil its oversight and due diligence obligations; and****

¹⁷ In this respect, Article 21(10) of the AIFMD provides that AIF's assets "shall not be reused by the depositary without the prior consent of the AIF or the AIFM acting on behalf of the AIF". Article 22(7) of the UCITS Directive provides the following on the reuse of UCITS' assets: "The assets held in custody by the depositary shall not be reused by the depositary, or by any third party to which the custody function has been delegated, for their own account. Reuse comprises any transaction of assets held in custody including, but not limited to, transferring, pledging, selling and lending.

The assets held in custody by the depositary are allowed to be reused only where:

- (a) the reuse of the assets is executed for the account of the UCITS;
- (b) the depositary is carrying out the instructions of the management company on behalf of the UCITS;
- (c) the reuse is for the benefit of the UCITS and in the interest of the unit holders; and
- (d) the transaction is covered by high-quality and liquid collateral received by the UCITS under a title transfer arrangement.

The market value of the collateral shall, at all times, amount to at least the market value of the reused assets plus a premium".

¹⁸ This written contract should be in addition to the written contract relating to the appointment of the depositary to be concluded between the latter and the manager of the fund or the fund itself as prescribed under Article 21(2) of the AIFMD and Article 22(2) of the UCITS Directive and further detailed in the relevant implementing measures (i.e. Article 83 of the AIFMR and Article 2 of the UCITS V Regulation).

b) respective rights to be agreed on between the delegate and the sub-delegate in the event of a sub-delegation.

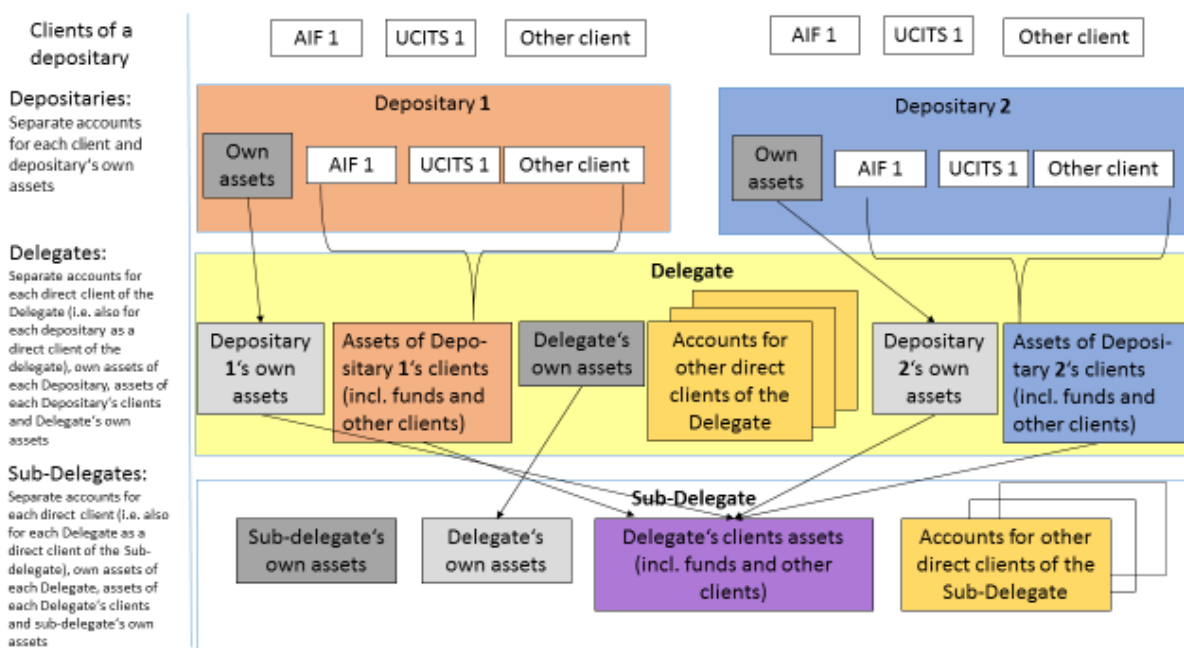
iv) Asset segregation requirements at the third and further levels

90. Pursuant to the AIFMR and the UCITS V Regulation, both, (1) the requirements on asset segregation and (2) due diligence and process related provisions shall apply “mutatis mutandis” when the safe-keeping functions delegated to a delegated party are sub-delegated.¹⁹
91. As to the “mutatis mutandis” requirement down the chain, after the second level, ESMA holds the view that this principle should be maintained in relation to both the segregation related and the due diligence and process related provisions.
92. With respect to the **due diligence and process related provisions** the delegate would have to fulfil the **same requirements** in relation to the sub-delegate as the depositary in relation to the delegate.
93. In relation to the segregation requirements – and in line with the reasoning under subsection ii) above – ESMA is of the opinion, that accounts prescribed as minimum requirements for the delegate level would not necessarily have to be identical or repeated on the level of the sub-delegate when such a structure is not a precondition to recognition of ownership rights in insolvency scenarios in relevant jurisdictions.
94. This is because the finding, that security holding systems, national laws on ownership rights or title to securities and the preconditions to their recognition or protection in the case of an insolvency of any party within the securities holding chain differ and are subject to national and not harmonised EU laws, also applies on the sub-delegate level.
95. In particular, in some jurisdictions separate accounts at the level of the sub-delegate for different depositaries or different clients of the depositary, for whom they indirectly hold assets, are not a precondition to insolvency protection. This is because all levels of the holding or custody chain, i.e. including separate accounts kept on the level of the delegate or depositary, would be reviewed in these jurisdictions in order to determine ownership rights and/or protection rights in the case of an insolvency. A requirement to segregate further, i.e. between certain groups of the depositary’s clients or different depositaries on the level of the sub-delegate, would cause extensive changes to existing and working structures in these jurisdictions without any benefit for the protection of investors in the case of an insolvency. Similarly, as on the delegate level, the “mutatis mutandis” application of due diligence and process related existing

¹⁹ For **segregation requirements**, please refer to Article 99 (3) of the AIFM Regulation and Article 16 (2) of the UCITS Regulation. For **due diligence and process** related provisions, please refer to Article 98 (4) of the AIFM Regulation and Article 16 (2) of the UCITS Regulation.

regulation in relation to the delegate and the sub-delegate additional safeguards exist, because the due diligence related provisions pursuant to Article 15 (2) (a) of the UCITS Regulation and Article 98 (2) of the AIFMR and the process related provisions pursuant to Articles 98 (2) and 99 (1) (b) through (e) of the AIFMR or Articles 16 (1) (b) through (e) of the UCITS Regulation also apply in the two-party custody or client relationship between the delegate and the sub-delegate.

96. With respect to the segregation requirements, it is also important to note, that the phrase “mutatis mutandis” should not be interpreted as meaning an identical application. Instead it should mean “with appropriate changes”.
97. This allows for the adjustment of the minimum segregation arrangements proposed for the delegate level as follows for the sub-delegate level.
98. On the level of the sub-delegate there should be a minimum of **3** segregated accounts **per delegate** on the level of the sub-delegate as follows: **(1) own assets** of the **sub-delegate**, **(2) own assets** of the **delegate** and **(3) assets of delegate’s clients**, so that with every additional delegate, who delegated safe-keeping function to the sub-delegate, more accounts would have to be added: one for the delegate’s clients’ assets and, as necessary, one for the delegate’s own assets (if there are any) as illustrated for the level of the sub-delegate in the chart provided below. The sub-delegate should not record the delegate’s own assets and the delegate’s client assets in the same account. Again, for each other direct client of the sub-delegate a minimum of one account per direct client would have to be opened on the level of the sub-delegate as illustrated by dark yellow boxes in the chart below.



99. As a consequence, omnibus accounts comprising assets of different clients of a delegate – including different depositaries, but excluding own assets of the sub-delegate or the delegate – would be admissible at the level of the sub-delegate subject to

- (1) ensuring that assets are not available for distribution to creditors of the failed entity;
- (2) accurate accounting and reconciliation systems allowing the delegate to verify that – for each of the UCITS and/or AIF clients of the depositary – the number and type of financial instruments registered in the accounts opened in its books matches with the number and type of financial instruments belonging to its UCITS and/or AIF clients which are recorded on the financial instruments accounts of the sub-delegate (where instruments belonging to other clients may also be kept);
- (3) reconciliation measures under (2) being conducted as often as necessary depending not only on the dealing frequency of the relevant UCITS or AIF, but also on any trade which would occur even outside the dealing frequency (e.g. a UCITS or AIF with weekly dealing frequency which trades on a daily basis would require daily reconciliations). Moreover, reconciliation measures would also need to be conducted depending on any other transaction happening in relation to any of the other client assets kept in the omnibus account;
- (4) processes ensuring that reuse of securities is only allowed if provided for in the relevant contracts and permitted by the relevant legislation²⁰; and
- (5) a written contract being concluded between the delegate and the sub-delegate;
- (6) the contract between the delegate and the sub-delegate providing for:
 - a) the delegate's right of sufficient information, inspection, admittance and access, to enable the delegate to have full oversight of the levels of the custody chain further down and to pass on relevant information to the depositary to enable the depositary to ensure that its arrangements satisfy the policy objective and to enable the depositary to fulfil its oversight and due diligence obligations, and
 - b) respective rights to be agreed on between the sub-delegate and further sub-delegates in the event of a further delegation by the sub-delegate.

²⁰ See footnote 12 above.

100. Should - *mutatis mutandis* - the legal advice obtained in relation to third parties located in a third country or the due diligence conducted pursuant to Article 15(2)(a) of the UCITS V Regulation or Article 98(2) of the AIFMR prior to the appointment of the sub-delegate reveal, that the policy objective is jeopardized by the minimum asset segregation requirements described above, then appropriate changes and additional safeguards should be implemented in agreements between depositaries and delegates, e.g. specifics further segregated account structures or other means.
101. On further levels down the chain the above minimum requirements should be adjusted accordingly subject to the same principles.

ESMA invites the EU institutions to consider legislative clarifications in the UCITS and AIFMD framework in order to prescribe the following minimum requirements at the level of the sub-delegate:

- **a minimum of 3 different segregated accounts per delegate should be required at the level of the sub-delegate as follows:**
 - 1) **own assets of the sub-delegate,**
 - 2) **own assets of the delegate, and**
 - 3) **assets of delegate's clients**
- **the use of omnibus accounts (i.e. those comprising assets of different clients of delegates, but excluding own assets of the sub-delegate or of the delegate) should be subject to the following conditions:**
 - (1) **ensuring that assets are not available for distribution to creditors of the failed entity;**
 - (2) **accurate accounting and reconciliation systems allowing the delegate to verify that – for each of the UCITS and/or AIF clients of the depositary – the number and type of financial instruments registered in the accounts opened in its books matches with the number and type of financial instruments belonging to its UCITS and/or AIF clients which are recorded on the financial instruments accounts of the sub-delegate (where instruments belonging to other clients may also be kept);**
 - (3) **reconciliation measures under (2) being conducted as often as necessary depending not only on the dealing frequency of the relevant UCITS or AIF, but also on any trade which would occur even outside the dealing frequency (e.g. a UCITS or AIF with**

weekly dealing frequency which trades on a daily basis would require daily reconciliations). Moreover, reconciliation measures would also need to be conducted depending on any other transaction happening in relation to any of the other client assets kept in the omnibus account;

(4) processes ensuring that reuse of securities is only allowed if provided for in the relevant contracts and permitted by the relevant legislation;

(5) a written contract being concluded between the depositary and the delegate; and

(6) the contract between the delegate and the sub-delegate providing for:

a) the delegate's right of sufficient information, inspection, admittance and access, to enable the delegate to have oversight of the whole custody chain in order to ensure that its arrangements satisfy the policy objective and to enable the depositary to fulfil its oversight and due diligence obligations; and

b) respective rights to be agreed on between the sub-delegate and further sub-delegates in the event of further delegation by the sub-delegate.

3.2 The application of depositary delegation rules to CSDs

3.2.1 Introduction

102. Recital 41 of the AIFMD provides that *“Entrusting the custody of assets to the operator of a securities settlement system as designated for the purposes of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems or entrusting the provision of similar services to third-country securities settlement systems should not be considered to be a delegation of custody functions”*.

103. The enacting terms of the AIFMD reflect these provisions under Article 21(11), last sub-paragraph, which states that *“[...] the provision of services as specified by Directive 98/26/EC by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement systems shall not be considered a delegation of its custody functions”*.

104. Questions arose on the interpretation to be given to the aforementioned provisions given the alleged inconsistency between, on the one hand, the enacting terms of the AIFMD which provide for an exemption from the depositary's delegation rules in relation to "*the provision of services*" by securities settlement systems and, on the other hand, recital 41 which refers to entrusting the custody of the assets to the operator of a securities settlement system.
105. A common approach on the interpretation of the above mentioned provisions of the AIFMD was sought, in particular following the adoption of Directive 2014/91/EU ("UCITS V Directive") which introduced depositary rules similar to those of AIFMD under Directive 2009/65/EC ("UCITS Directive"). The UCITS V Directive introduced a new Article 22a(4) of the UCITS Directive which mirrors the provisions of the above mentioned Article 21(11), last sub-paragraph, of the AIFMD. Recital 21 of the UCITS V Directive accompanies these provisions and states the following: "*When a Central Securities Depository (CSD), as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council, or a third-country CSD provides the services of operating a securities settlement system as well as at least either the initial recording of securities in a book-entry system through initial crediting or providing and maintaining securities accounts at the top tier level, as specified in Section A of the Annex to that Regulation, the provision of those services by that CSD with respect to the securities of the UCITS that are initially recorded in a book-entry system through initial crediting by that CSD should not be considered to be a delegation of custody functions. However, entrusting the custody of securities of the UCITS to any CSD, or to any third-country CSD should be considered to be a delegation of custody functions*".
106. Against this background, ESMA felt it was appropriate to ensure convergence on how to apply the provisions under Article 21(11), last sub-paragraph, of the AIFMD. On 1 October 2015 ESMA issued a Q&A aimed at providing guidance on the extent to which the provisions on delegation by depositaries under the AIFMD apply to CSDs²¹. The Q&A stated that whenever assets are provided to a CSD in order to be held in custody in accordance with Article 21(8) of the AIFMD, the AIFMD delegation rules should apply.
107. Following the release of the Q&A, residual uncertainties seem to remain on how to interpret the relevant provisions and, in particular, in relation to which services the exemption applies, including in the context of the distinction between issuer CSD and investor CSD roles.

²¹ See Q&A 8 under Section VI of the Questions and Answers on the Application of the AIFMD (ESMA/2016/568), which states the following: "**Question 8 [last update 1 October 2015]:** *When assets of an AIF held in custody by the depositary of the AIF are provided by that depositary to a CSD or a third country CSD as defined under Regulation (EU) No 909/2014 (CSDR) in order to be held in custody in accordance with Article 21(8) of the AIFMD, does the CSD or third country CSD have to comply with the provisions on delegation set out under Article 21(11) of the AIFMD?* **Answer 8:** Yes".

3.2.2 *Feedback from consultation*

108. Many respondents to the CfE ask for the acknowledgment of the dual role of CSDs as “investor CSDs” and “issuer CSDs”²² and a clarification of their responsibilities in relation to the AIFMD and UCITS V Directive.
109. Several respondents (mainly CSDs) were of the opinion that CSDs should never be considered a delegate and that the provision of CSDR core or ancillary services should never result in a CSD being considered as a delegate under AIFMD or UCITS V Directive. They argued that custody of securities is included in the service of operating securities settlement systems and add that CSDR as the regulatory framework under which CSDs are active includes organizational requirements and conduct of business rules pursuing the protection of clients’ assets. In addition, they stated that being subject to the segregation rules under AIFMD, in addition to those already included in CSDR, would be too costly and lead to significant market disruption and settlement fails as a result of the increased complexity related to their links arrangements.
110. Other respondents (custodians and fund associations) were of the opinion that CSDs should be considered delegates when they act in a capacity of investor CSDs. They underlined that “investor CSDs” are in commercial competition with global custodians and must compete on equal terms. Moreover, these respondents were concerned about the absence of a comparable and harmonized liability regime for CSDs. Some respondents further explained that the fund depositary may avail itself of the opportunity to prove that such loss has resulted from an external event beyond its reasonable control, while other consider that the depositary is always liable. In this context, it was however specified that the CSD is a party over which the depositary has no control.
111. Other respondents deemed that CSDs should be considered delegates when they act in a capacity of investor CSD but only in the case of indirect links, whereas direct links to other CSDs should be classified as infrastructure access and not as delegation arrangements. The reason is that local CSDs are often used to get access to local market infrastructures, such as trading venues.

3.2.3 *CSDR regulatory framework*

112. When considering the question whether and which kind of CSDs should be subject to the AIFMD or UCITS Directive delegation requirements, it appears relevant

²² The EC Delegated Regulation on CSD Requirements defines the issuer CSD and the investor CSD in Art.1 (e and f) as follows: “‘issuer CSD’ means a CSD which provides the core service referred to in point 1 or 2 of Section A of the Annex to Regulation (EU) No 909/2014 in relation to a securities issue;” - “‘investor CSD’ means a CSD that either is a participant in the securities settlement system operated by another CSD or that uses a third party or an intermediary that is a participant in the securities settlement system operated by another CSD in relation to a securities issue”.

to analyse their role in the securities markets in general, and in the custody chain in particular.

113. On 28 August 2014, Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories (“CSDR”) was published in the Official Journal of the European Union. ESMA drafted regulatory technical standards and implementing technical standards on CSD requirements, which have been endorsed by the European Commission.

114. The goal of CSDR is threefold: (1) to enhance the settlement framework by improving cross-border settlement discipline and harmonising settlement periods, (2) to introduce consistent rules for CSDs across Europe by harmonising the licensing framework, the prudential and organisational rules, and the authorisation and supervision regimes of CSDs, and (3) to remove barriers of access to/from CSDs. The latter refers to both access between issuers and CSDs as well as between the CSDs themselves and between CSDs and other market infrastructures.

115. CSDs are key financial market institutions in the post-trading area, operating securities settlement systems designated under the Settlement Finality Directive, and playing an important role in the securities holding systems, controlling the integrity of an issue and thus contributing to maintaining investor protection and confidence. CSDs are therefore systemically important for the market they operate in, and are becoming more interconnected, due to the increase in cross-border transactions in Europe and the outsourcing of the settlement function by most of the CSDs in the EU to the T2S platform (a project launched by the Eurosystem that provides a common platform for securities settlement in Europe).

Protection of securities of participants and those of their clients

116. CSDR imposes strict asset segregation requirements upon CSDs. Specifically, Article 38(1) on the protection of securities of participants and those of their clients stipulates that, for each securities settlement system it operates, a CSD shall keep records and accounts that shall enable it, at any time and without delay, to segregate in the accounts with the CSD, the securities of a participant from those of any other participant and, if applicable, from the CSD’s own assets.

117. Furthermore, Article 38(2) of CSDR stipulates that a CSD must keep records and accounts that enable any participant to segregate the securities of the participant from those of the participant’s clients. This implies that a participant of a CSD is obliged to segregate its own securities from those of its clients.

118. In addition, Article 38(3)-(4) enables participants of a CSD to choose between holding the securities that belong to different clients in one securities account (omnibus client segregation) or segregate the securities of any of its clients (individual client segregation). Thus, the participant chooses the level of asset segregation. In this

respect, CSDs and their participants are required to provide for both omnibus client segregation and individual client segregation (as clarified by recital 42 of CSDR).

119. Moreover, Article 38(6) of CSDR stipulates that CSDs and their participants shall publicly disclose the levels of protection and the costs associated with the different levels of segregation that they provide and shall offer those services on reasonable commercial terms. Details of the different levels of segregation have to include a description of the main legal implications of the respective levels of segregation offered, including information on the insolvency law applicable in the relevant jurisdiction.

120. Article 38(7) of CSDR states that a CSD shall not use for any purpose securities that do not belong to it. A CSD may however use securities of a participant where it has obtained that participant's prior express consent. The CSD shall require its participants to obtain any necessary prior consent from their clients.

121. As highlighted by the majority of respondents to the CfE, factors other than asset segregation are crucial for determining whether investor assets are adequately protected in various insolvency scenarios. The national insolvency regime in particular determines how and under which timeframe assets can be returned to their legitimate holders. Article 41 of the CSDR requires CSDs to disclose and regularly test their rules and procedures as regards participant defaults. Article 20(5) of the CSDR foresees that a CSD shall establish, implement and maintain adequate procedures ensuring the timely and orderly settlement and transfer of the assets of clients and participants to another CSD in the event of a withdrawal of authorisation.

Reconciliation requirements

122. In addition to stringent segregation requirements, CSDs are subject to strict reconciliation requirements. Article 37 of CSDR on the integrity of the issue requires a CSD to take appropriate reconciliation measures to verify that the number of securities making up a securities issue or part of a securities issue submitted to the CSD is equal to the sum of securities recorded on the securities account of the participant of the securities settlement system operated by the CSD and, where relevant, on owner accounts maintained by the CSD. Such reconciliation measures must be conducted at least daily.

123. Article 65 of the EC Delegated Regulation on CSD Requirements stipulates that where the reconciliation process reveals an undue creation or deletion of securities and the CSD fails to solve this problem by the end of the following business day, the CSD must suspend the securities issue for settlement until the undue creation or deletion of securities has been remedied.

Record keeping requirements

124. On top of the segregation and reconciliation requirements, Article 29 of CSDR on record keeping obliges a CSD to maintain, for a period of at least 10 years, all its

records on the services and activities, including on the ancillary services, so as to enable the competent authority to monitor the compliance with the requirements under CSDR.

125. Article 53 of the EC Delegated Regulation on CSD Requirements adds that the record keeping system shall ensure that all of the following conditions are met: (a) each key stage of the processing of records by the CSD may be reconstituted, (b) the original content of a record before any corrections or other amendments may be recorded, traced and retrieved, (c) measures are put in place to prevent unauthorised alteration of records, (d) measures are put in place to ensure the security and confidentiality of the data recorded, (e) a mechanism for identifying and correcting errors is incorporated in the record keeping system, and (f) the timely recovery of the records in the case of a system failure is ensured within the record keeping system.

Operational risk management

126. CSDs are subject to very stringent operational risk management requirements. According to Article 45(1) of CSDR, a CSD shall identify sources of operational risk, both internal and external, and minimise their impact through the deployment of appropriate IT tools, controls and procedures, including for all the securities settlement systems it operates.
127. According to Article 78(1) of the EC Delegated Regulation on CSD Requirements, a CSD shall have in place arrangements to ensure the continuity of its critical operations in disaster scenarios, including natural disasters, pandemic situations, physical attacks, intrusions, terrorist attacks, and cyber-attacks. Those arrangements shall ensure: a) the availability of adequate human resources; b) the availability of sufficient financial resources; c) the failover, recovery and resuming of operations in a secondary processing site.

Capital requirements

128. In accordance with Article 47(1) of CSDR, capital, together with retained earnings and reserves of a CSD, shall be proportional to the risks stemming from the activities of the CSD. It shall be at all times sufficient to ensure that the CSD is adequately protected against operational, legal, custody, investment and business risks so that the CSD can continue to provide services as a going concern. Strict capital requirements are further specified in the EC Delegated Regulation on prudential requirements for CSDs.
129. According to Article 54 of CSDR, a CSD that provides banking-type ancillary services needs to be authorised as a credit institution as provided for in Article 8 of Directive 2013/36/EU and needs to comply with the prudential requirements referred to in Article 54 of CSDR.

CSD links

130. In order to facilitate cross border settlement, CSDs set up links with each other, which represent an arrangement between CSDs whereby one CSD becomes a participant in the securities settlement system of another CSD in order to facilitate the transfer of securities from the participants of the latter CSD to the participants of the former CSD or an arrangement whereby a CSD accesses another CSD indirectly via an intermediary. The CSDR identifies the following types of links:

- standard link: means a CSD link whereby a CSD (the 'investor CSD') becomes a participant in the securities settlement system of another CSD (which can be the 'issuer CSD' or another 'investor CSD') under the same terms and conditions as applicable to any other participant in the securities settlement system operated by the latter.
- customised link: means a CSD link whereby a CSD (the 'investor CSD') that becomes a participant in the securities settlement system of another CSD (which can be the 'issuer CSD' or another 'investor CSD') is provided with additional specific services to the services normally provided by that CSD to participants in the securities settlement system.
- interoperable link: means a CSD link whereby CSDs agree to establish mutual technical solutions for settlement in the securities settlement systems that they operate.
- indirect link: means an arrangement between a CSD (the 'investor CSD') and a third party other than a CSD, that is a participant in the securities settlement system of another CSD (which can be the 'issuer CSD' or another 'investor CSD'). Such link is set up by a CSD in order to facilitate the transfer of securities to its participants from the participants of another CSD.

131. The EC Delegated Regulation on CSD Requirements defines the issuer CSD and the investor CSD in Article 1 (e and f) as follows:

- 'issuer CSD' means a CSD which provides the core service referred to in point 1 or 2 of Section A of the Annex to Regulation (EU) No 909/2014 in relation to a securities issue;
- 'investor CSD' means a CSD that either is a participant in the securities settlement system operated by another CSD or that uses a third party or an intermediary that is a participant in the securities settlement system operated by another CSD in relation to a securities issue.

132. With regard to link arrangements, there are specific and strict regulatory requirements for the establishment of those links. Such requirements aim at avoiding all potential sources of risk for the CSDs themselves and their participants. For instance, when a CSD sets up a link, Article 48 of CSDR requires that the CSD verifies that the asset protection regime in the country of establishment of the CSD, or that of

the intermediary and of the CSD when the link is indirect, is comparable to the asset protection regime of its own jurisdiction. Also for each link it opens, a CSD needs to undertake legal due diligence. Specific requirements for indirect links are included in Article 85 of the EC Delegated Regulation on CSD Requirements regarding the monitoring and management of additional risks resulting from the use of indirect links or intermediaries to operate CSD links.

133. CSDs that intend to establish links shall submit an application for authorisation to the competent authority of the requesting CSD as required under point (e) of Article 19(1) of the CSDR or notify the competent and relevant authorities of the requesting CSD as required under Article 19(5) of the CSDR.
134. Before establishing a CSD link and on an ongoing basis once the CSD link is established, all CSDs concerned shall identify, assess, monitor and manage all potential sources of risk for themselves and for their participants arising from the CSD link and take appropriate measures to mitigate them.
135. A CSD established and authorised in the Union may maintain or establish a link with a third-country CSD in accordance with Article 48 of the CSDR.

3.2.4 ESMA's proposal for legislative clarifications under the AIFMD and UCITS Directive

136. As highlighted in the introductory paragraphs above (101-106), the intended policy approach to depositary delegation requirements under AIFMD and UCITS Directive seemed to be to appropriately acknowledge the role of CSDs as market infrastructures. The depositary delegation requirements therefore were not to apply where the depositary's use of the CSD was mandatory for the holding of particular securities, both within and outside of the EU. At the same time, residual uncertainties remained as to the application of this exemption, especially under the new regulatory framework for CSDs provided by CSDR. As UCITS V is a later Directive it is reasonable to look to the text in that Directive for guidance and Recital 21 from UCITS V is more descriptive than Recital 41 of AIFMD when it says: "*When a Central Securities Depository (CSD), as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council (1), or a third-country CSD provides the services of operating a securities settlement system as well as at least either the initial recording of securities in a book-entry system through initial crediting or providing and maintaining securities accounts at the top tier level, as specified in Section A of the Annex to that Regulation, the provision of those services by that CSD with respect to the securities of the UCITS that are initially recorded in a book-entry system through initial crediting by that CSD should not be considered to be a delegation of custody functions. However, entrusting the custody of securities of the UCITS to any CSD, or to any third-country CSD should be considered to be a delegation of custody functions.*"

Depository delegation requirements in the case of Issuer CSDs

137. On the basis of this analysis, it is reasonable to conclude that depository arrangements with issuer CSDs should not be subject to depository delegation rules, whether the CSD is domiciled inside or outside the EU, because the use of the issuer CSD is mandatory for the holding of securities in a particular jurisdiction. An issuer CSD should therefore not be a delegate as mentioned in Article 21 (11), last subparagraph of AIFMD and Article 22a(4) of UCITS Directive.

Depository delegation requirements in the case of Investor CSDs

138. Recital 21 of UCITS V contemplates that the holding of securities at the investor CSD is a delegation of custody functions and it would seem therefore that depository delegation requirements should apply in this instance.

139. In considering how to satisfy the depository delegation requirements where an investor CSD is used, the existing regulatory framework for CSDs is important. As set out above, investor CSDs authorised under CSDR are subject to detailed regulatory requirements which address some of the matters set out in the depository delegation requirements. On the basis of the regulatory regime, it could be reasonable for the depository to rely on the CSD's authorisation under CSDR to satisfy some of the depository delegation requirements.

140. Annex IV of this opinion sets out the depository delegation requirements and how provisions under the CSDR can contribute to satisfying some of these requirements.

ESMA invites the EU institutions to consider legislative clarifications in the UCITS and AIFMD framework in order to prescribe the following regime for the application of depository delegation rules to CSDs:

- 1) Depositories should not be required to apply the delegation rules under the AIFMD/UCITS Directive to CSDs, in their capacity as Issuer CSDs. As consequence and for the avoidance of doubt:**
 - a) There would be no specific segregation requirements at the level of the Issuer CSD;**
 - b) *Due diligence*: A depository would not have to perform any due diligence under Article 21(11) AIFMD or under Article 22a of the UCITS Directive on an Issuer CSD; and**
 - c) *Liability*: In the case of a loss of a financial instrument at the level of the Issuer CSD, this loss is to be regarded as an external event beyond the reasonable control of the depository, since the loss is attributable to the**

Issuer CSD. Any liability by the CSD will be subject to the relevant law to which the CSD is subject.

2) Depositories should be required to apply the delegation rules under the AIFMD/UCITS Directive to CSDs, in their capacity as Investor CSDs. This means the following:

a) *Segregation requirements at the Investor CSD:* Investor CSDs would be subject to the revised asset segregation requirements in line with the suggestions made under Section 3.1 of the present opinion (see also Annex IV) which are compatible with Article 38 CSDR;

b) *Due diligence:* In appointing the Investor CSD as a delegate, the depository should comply with the due diligence requirements under the AIFMD and UCITS Directive. However, while appointing an Investor CSD authorised or recognised under CSDR, a depository should do the following:

➤ rely on the CSD authorisation or recognition while assessing the ex-ante due diligence requirements under Article 21(11)(a) to (c) of AIFMD (as implemented by Article 98(2) of the AIFMR) and Article 22a(2) of UCITS Directive (as implemented by Article 15(3) of the UCITS V Regulation), and

➤ assess the ongoing due diligence requirements under Article 21(11)(d) of AIFMD (as implemented by Article 98(3) of the AIFMR) and Article 22a(3) of UCITS Directive (as implemented by Article 15(3) of the UCITS V Regulation); and

c) *Liability:* A depository delegating to an Investor CSD would remain subject to the standard liability regime, in line with the provisions under Article 21(12) and (13) AIFMD and Article 24(1) to (4) UCITS Directive. For the avoidance of doubt, this implies the following:

➤ in the case of a loss of a financial instrument at the level of the Investor CSD, the standard strict liability regime as per the AIFMD/UCITS Directive would apply to a depository, i.e. the depository remains liable unless it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary; and

➤ a transfer of liability from the depository to the Investor CSD would only be allowed under the strict conditions set out under Article 21(13) AIFMD, while no transfer of liability would be

allowed for UCITS, as per the provisions of Article 24(2) and (3) UCITS Directive.

141. ESMA may reconsider the approach proposed above on the application of the depositary's delegation rules under the AIFMD and UCITS Directive to Investor CSDs in case any legislative changes were to be introduced in the CSDR framework providing for a harmonized liability regime for CSDs at EU level.

Annex I

Feedback statement on the call for evidence

1. ESMA received 44 responses to its Call for evidence on asset segregation and custody services ([ESMA/2016/1137](#)). Responses were submitted by asset managers, depositaries, prime brokers, collateral managers and their associations. The non-confidential responses were published on the ESMA website.
2. The following sections set out (1) a summary of the general comments made by the respondents which is followed by (2) the key findings for each of the 29 questions included in the call for evidence (for some of the questions, the key findings are preceded by a short summary of the feedback received, while for the majority of the questions the short summary and the key findings are merged together).

1) General comments

Summary

3. Some respondents have argued that this CfE broadens the scope of the CP, covering certain aspects of the safekeeping and custody of securities, which go beyond the application of UCITS and AIFMD and are under discussion in other European initiatives, such as EMIR and CSDR, which are the result of different and independent negotiations.
4. The majority of respondents underlined that ESMA should be focused on the underlying aim of asset segregation, namely investor protection (i.e. asset segregation is not an end in itself). In this framework, it is firstly noted that a higher level of segregation does not necessarily increase investor protection while, on the contrary, further segregation could have a negative influence on the possibility to use assets in order to engage in repurchase and securities landing transactions.
5. Secondly, these respondents stress that, in order to determine to what extent account segregation achieves investor protection, it is necessary to look at (1) securities (property) laws, in order to identify the kinds of rights (property, beneficial interests etc.) attached to the accounts; and (2) the insolvency national regimes that will apply in the event of insolvency of the securities account provider at a given level of the custody chain. However, such regimes are not harmonized and provide for different levels of segregation; consequently, such differences do not allow to find a “segregation model” that would fit every Member State.
6. Another argument which was presented is that the aim of investor protection can be achieved either by using physically segregated accounts or omnibus accounts; indeed, books and records and the related reconciliation procedures enable the depositary to identify its clients’ assets and to distinguish them from its own and other assets. At the same time, omnibus account facilitate the use of tri-party collateral and support broader market liquidity.

7. Finally, most of the respondents underline that a number of regulatory initiatives (such as MIFID I and II, Stay Protocols and SFTR) enhancing investor protection have already been introduced to the market; consequently, investors have significantly more protection than before the crisis. In this context, it should be also considered that custody chains may involve non-EU depositaries that are not subject to mandatory segregation. From a market perspective, such circumstance should be taken into account to avoid imposing undue barriers on the use of these non-EU entities.
8. In view of the above, most of the respondents disagreed with imposing mandatory segregation and consequently recommended that ESMA take a flexible approach in the use of segregated accounts. In this respect, they also noted that both MIFID II and the MiFID I implementing Directive (Directive 2006/73/EC) are flexible as regards the national models for holding securities and also recognize the use of omnibus accounts. Consequently, since local laws and practices may differ, these respondents suggested that the intermediaries choose the model of asset segregation that best suits the goal of protecting investors. In this regard, one respondent proposed to follow the approach of Article 38 of the CSDR.
9. In case ESMA decided to impose mandatory segregation, the majority of respondents expressed their preference for Option 4 of the CP, which apparently represents current best practice among AIFs, prime brokers and custodians. Moreover, for these respondents, the AIFMD allows the approach under Option 4 in the understanding that, pursuant to Article 99(2) of the AIFMD Level 2 text, participants are required to employ additional actions and procedures including, if required, individual segregation in those jurisdictions where this is necessary to ensure client asset protection.
10. These respondents argue that the other options do not lead to greater investor protection but rather increase operational complexity, risk of error and rate of settlement failure, which would ultimately result in higher costs for end-investors.
11. In contrast, some respondents supported Option 1 of the CP on the basis that it achieves the right balance by providing an appropriate level of transparency to the depositary, enabling it to monitor its delegates while at the same time only requiring a limited increase in the number of accounts.
12. Regarding T2S, some of the respondents noted that it is a technical platform designed to accommodate high volumes of transactions and number of accounts: it follows that it is neutral with respect to the degree of segregation of the accounts.
13. Finally, many respondents sought acknowledgement of the dual role of CSDs as “investor CSDs” and “issuer CSDs” and a clarification of their responsibilities. In particular, for those respondents that are not CSDs, “investor CSDs” should fall within the scope of depositary delegation arrangements under UCITS and AIFMD; in other words, there are no justifications for a distinct regime in favour of investor CSDs versus global custodians. Instead it should be clarified that “issuer CSDs” are not delegates of the depositary, as opposed to “investor CSDs”.

2) Responses to the individual questions

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).

14. ESMA received 33 responses to Q1, 23 of which were public and 10 of which were confidential. Some respondents only made general remarks or referred to the general statement in the introduction and did not answer Q 1 specifically.

15. As far as ESMA received detailed responses on the sub questions of Q1, these are separated out and summarized below. Responses and comments which are more of a general nature are summarized in paragraphs 76 to 79 below.

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,

16. For charts/diagrams provided by single respondents who accepted to make their responses public, please refer to the individual responses to the CfE published on the ESMA website²³.

17. In general, respondents pointed out or illustrated in their charts that at the depositary level, a separate account is opened for each investment fund and each sub-fund so as to ensure the segregation of assets and liabilities between investment funds and sub-funds such that there is no confusion with the own account of the depositary nor any other client of the depositary. The creditors of a given investment fund or sub-fund can only seize the account corresponding to such investment fund or sub-fund. The record keeping follows the same logic. A key task of the depositary is to ensure that the records of entitlements and holdings per investment fund or sub-fund are accurate on an ongoing basis.

18. To this end, according to one stakeholder the depositary bank must understand the structure of the custody chain down to investor CSD and execute its obligations accordingly in order to understand the risks at each level.

19. Furthermore, three respondents referred to prime brokerage arrangements and indicated that any such accounts are not true custody accounts (the depositary having delegated its custody obligations to the prime broker), but generally are rather opened for the purposes of oversight. In such case, the depositary has ‘view’ access to the prime brokers’ accounts for the purposes of fulfilling its oversight obligations, and, according to these stakeholders,

²³ The responses are available at: <https://www.esma.europa.eu/press-news/consultations/call-evidence-asset-segregation>.

both parties have robust procedures to ensure the same. The same mechanism was mentioned by another respondent in relation to global custodians.

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

20. Regarding the second level, five respondents explained that at the level of the delegate, the depositary complies with the regulation or Option 1 and opens 5 different types of accounts in order to segregate (1) its own assets, (2) the own assets of the depositary, (3) the assets of the delegate's other clients, (4) the assets of the depositary's other clients, and (5) the assets of UCITS or AIF clients. These two last types of accounts are omnibus in the name of the depositary that group UCITS or AIF clients managed, for instance, by different asset managers, except if specifically required to individualize the accounts at the level of the delegate (which is unusual according to these respondents).
21. According to two other stakeholders, at the second level in the custody chain the depositary will open at least 3 accounts, namely one omnibus account for own financial instruments, one omnibus account for UCITS and/or AIF financial instruments and one omnibus account for the financial instruments of other customers. The (global) sub-custodian must separate own transferable financial instruments from the above referenced accounts. In terms of entitlement, the creditors of the (global) sub-custodian can potentially get hold of the (global) sub-custodian own financial instruments but typically not of the other financial instruments. Similarly, the creditors of the depositary can potentially get hold of the own financial instruments of the depositary but not of the other ones. The investment funds and their creditors can, however, not directly claim against the (global) sub-custodian and get hold of the financial instruments on the omnibus accounts opened for UCITS and/or AIF and the omnibus accounts for other customers. They have to claim against the depositary that then, in turn, must claim against the (global) sub-custodian. Consequently, it is of lesser importance whether separate omnibus accounts are opened for UCITS, AIF and other customers. For a variety of reasons, the market practice appears to be to have at least separate accounts for UCITS and AIF (collective asset management) on the one hand and other customers on the other hand. However, the most important is to ensure that there is segregation between own account and clients' assets.
22. There may be a(n intra-group) Global Custodian, Global Sub-Custodian, prime broker, security lending agent or a country specific Sub-Custodian or local agent at level 2 or a mixture, depending on the circumstances and preferences. Finally, one stakeholder mentioned that the second level is the level of a delegation to an intragroup custodian which sits between the "first level" and "second level" as described in the question (technically not a "third party delegate of the depositary").
23. In the case of a prime broker, there exists a custody agreement with the Depositary as well as a direct contractual relationship with the prime broker, who segregates and opens for all clients individual accounts in its internal books and records.

24. According to some respondents, the preference is to use omnibus accounts, but local rules, clients' preferences or tax regulation may demand segregated accounts.
25. According to a couple of respondents, the second level is the level of the third party-delegate of the depositary. This respondent indicated that assets coming from different depositaries should not be commingled. AIF and UCITS assets from the same depositary can be commingled in the account. Depositary's proprietary assets should be segregated from its clients' proprietary assets.

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.

26. Two respondents stated that from this level until the CSD the prevailing standard is segregation between own assets and customer assets. According to another respondent, if no other sub-custodians are appointed, the third level should be the CSD. In the view of one respondent, CSD participants must distinguish proprietary and third party assets at the level of the CSD and can opt for omnibus or individual client segregation.
27. Another respondent confirmed that on a CSD level, one pooled account (omnibus) is being held for all clients. The assets in the omnibus accounts are separated from the assets of the sub-delegate and the CSD.
28. Three other respondents explained that at the level of the sub-delegate, there is a further segregation that stems from the regulation, which foresees that the sub-delegate must separate (i) its own account, (ii) the own assets of the delegate, (iii) the assets of UCITS or AIF in the name of the delegate per depositary, (iv) the assets of the sub-delegate's other clients, (v) the asset of the delegate's other clients (vi) the own assets of the depositary in the name of delegate (vii) the assets of the depositary's other clients in the name of the delegate. These respondents considered this to be a meaningful segregation model, to get a more detailed review and ask the sub-delegate to keep the structure that exist at the preceding level and segregate UCITS in several omnibus accounts, one for each of the clients of the delegate.
29. A stakeholder using an intragroup custodian explained that the third level is the level of the 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. The fourth and final level for this stakeholder is the issuer CSD level. According to the view of this stakeholder this is not delegation.
30. A CSD asked to distinguish between a sub-delegate of the delegate third party and SSSs/CSDs and argued that such entities should represent a separate 4th level in the custody chain, which could be connected at the second or third level.

Q1, a): General remarks

31. Several respondents referred to recital 21 of the UCITS V Directive: an issuer CSD is not a delegate /sub-delegate of the depositary for the purposes of the AIFMD and UCITS Directive. Some stakeholders suggested that the issuer CSD should segregate its own assets (or its delegate's/sub-delegate's assets) from the assets of its clients (or its delegate's/sub-delegate's clients) in a nominee omnibus account and stated that this minimum segregation level is the one imposed by MIFID in the EU.
32. According to two stakeholders accounts are of lesser importance in this respect. The following hypothetical example was provided by these stakeholders: an investment fund can establish proof to be entitled to a given financial instrument, then the depositary must normally provide such financial instrument, regardless of whether such financial instrument is or is not in the financial instruments account of such investment fund. The same is true vice versa. The fact that a given financial instrument is in a given account does not necessarily mean that the relevant investment fund is entitled to such financial instrument. It can be in such account by error.
33. One respondent indicated that in parallel to the accounts, records are kept at each level. Such records permit to follow and establish the entitlement of each investment fund throughout the whole chain of custody, sub-custody and CSD. In terms of entitlement, the investment fund would be able to claim at level 1 a given financial instrument from the depositary. At level 2 it is the depositary who can claim against the Sub-Custodian or the Global Sub-Custodian, as the case may be. At level 3 it is then the (Global) Sub-Custodian who can claim against the CSD. Such proof typically takes the form of records and hence proper record keeping and re-conciliations are of paramount importance.
34. Other stakeholders indicated that the overriding consideration should be ensuring that books and records of intermediaries are accurate and remain so throughout the various transactions carried out for clients/investors and are reconciled once any transaction is completed. The apparent historic failures in the use of omnibus accounts and their process arose from failures in record-keeping and not because of the use of omnibus accounts per se, according to these stakeholders.
35. Three other stakeholders mentioned that the model of asset segregation used by prime brokers is consistent with Option 4 (Omnibus Model) in the CP.
36. Another respondent did not describe any particular custody chain, but set out common practice among custodians. According to this respondent account structures in the custody chain have five main features. (1) There is always full segregation by end investor at the level of the first intermediary in the custody chain (i.e. at the level of securities accounts provided to the end investor; this is the level of the securities accounts provided by the AIF/UCITS-appointed depositary). (2) There is always appropriate segregation between proprietary assets and client assets so as to ensure that the assets of clients of an intermediary are clearly distinguished from proprietary assets of that intermediary and from proprietary assets of the account provider of that intermediary. (3) In the absence of other

considerations, custodians will choose to hold client assets in omnibus accounts at higher levels in the custody chain up to the issuer CSD. (4) There may well be operational reasons why - for some types of activity and for some types of end investors (and sometimes at the investors' request) - custodians choose to use segregated accounts further up the custody chain. The reasons may, for example, be linked to processing of corporate actions, tax reclaims or securities settlement. Such segregation further up the chain may identify individual end investors or categories of investor (such as, for example, by country of residence for tax purposes). (5) There may also be legal and asset protection reasons that mandate the use of segregated accounts. The most important legal and asset protection reasons for segregation further up the custody chain are driven by the legal environment in the country of the investment (i.e., the country of the issuer CSD); these reasons may require some degree of segregation in the securities accounts provided by the issuer CSD, or in the securities accounts provided by a local sub-custodian (which in most cases would be located in the same country as the issuer CSD), or both.

37. This respondent also described the features in particular countries which might be relevant for legal factors. (1) There are countries where local investors are obliged to hold their securities directly in the CSD/issuer so the need for omnibus accounts only arises in respect of foreign investors who already use a global account provider to hold their securities. (2) In countries where the person who is registered at CSD/issuer level is regarded as the owner of the securities, to the exclusion (in most circumstances) of other claimants, there may be obstacles to recognition of custodial arrangements. The operational set-up is likely to have been created historically in a way which does not envisage that a CSD participant would need multiple accounts or delegate the operation of its accounts to third parties. In order to operate a separate account for each investor, the account provider would have to persuade the higher-tier intermediary to operate multiple accounts for the account provider, and pay (or charge investors for) the additional fees associated with many accounts. (3) In countries where omnibus accounts are common (where direct holdings are not compulsory and indirect holdings are standard practice), there may be operational influences on account structures. A higher-tier intermediary may be unwilling to agree to a single-investor-per-account holding pattern, for example because the higher-tier intermediary is constrained by systems limitations on scaling up to the degree implied by each of its account provider clients having multiple accounts. Another factor is the need to have separate identifiers for each account. Where an omnibus account is used, the task of allocating securities received by buyers is carried out by the account provider. A settlement system may (but may not) be able to supply the account provider with identifiers to facilitate the allocation of securities received to the sub-accounts maintained by the account provider for its clients. Where a stock exchange operates a straight-through processing system linked into the relevant CSD, the choice of account structure may be affected by the amount of detail that the various systems can support.

38. According to a respondent, the most important elements of end investor asset protection are the following: (1) on the own books of the custodian (as account provider), assets from different end investors/account holders are clearly segregated from each other and from the assets of the custodian itself; (2) when the custodian in turns holds assets with another

account provider (e.g., a sub-custodian or a CSD) further up the custody chain, it is acting as an “account holder”. The custodian will ensure that on the books of its account provider, the assets of its clients are segregated from: (a) its own assets, (b) the assets of any other client of the account provider (the sub-custodian or CSD), and (c) the assets of the sub-custodian.

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.**

39. A detailed response to this sub question was given by 21 respondents. Two of the respondents cautioned against the use of the word “commingled” in the question, as this creates confusion since custodial agents such as global custodians and sub-custodians are almost always both an “account holder” and an “account provider”. According to these respondents, “commingling” would mean that all customers’ cash or property would be combined in one common account or investment fund in return for an allocation of an interest (usually on a pro rata basis) in the combined cash or property. These respondents state that no “commingling” occurs because individual end investors’ assets held with each of their account providers are considered segregated and protected in compliance with national law obligations falling on account providers.

40. All respondents stated that omnibus accounts are often used at the interface of the second level of the chain and almost always at the third level. However, depending on specificities of national markets and clients’ preferences individually segregated accounts are also offered. One participant explicitly stated that all depositaries use omnibus accounts depending on the market, some more than others. Another respondent stated that, even in markets with end investor segregation at the level of the CSD, omnibus accounts are used for CSD links in relation to cross-border investments. Furthermore, two respondents stated that own assets and customer assets are always segregated. In principle the

standard at the first level is to open segregated accounts for each investment fund or sub-fund and hence omnibus accounts are not the entry point.

41. Two respondents pointed out that the typical chain of entitlement is, for example, investment fund/sub-fund – depositary, depositary – global sub-custodian, global sub-custodian – sub-custodian and finally sub-custodian – CSD. From this results that, whatever the account structure, the record keeping is paramount because ultimately it determines the entitlements to the specific financial instruments. The account structure model in a given market is in particular driven by a combination of local settlement and safekeeping practices in the specific market concerned, systemic and reporting capabilities of the local agent and CSDs and the local regulatory requirement, established market practices or clients' preferences.
42. One respondent explained that accounts are governed by the contractual provisions agreed between the account provider and account holder. The features of an omnibus account are a function of the law applicable to the particular omnibus account. In most cases, omnibus accounts are regular securities accounts, used for settlement, tax and asset servicing. To optimize tax processing, sometimes 'tax pooling' accounts are used whereby assets of different clients with similar tax profiles are aggregated.
43. Furthermore, three respondents gave a detailed description of the different models of the custody account structure and referred to the prime brokerage arrangements described above under paragraph 19. These respondents added that the same applies to the contractual relationship with global custodians. The depositary will fulfil its oversight function by means of (among other things) reconciliations with the accounts of the prime broker. Typically, a depositary does not actually hold AIF assets in custody (having delegated that function to the prime broker) and therefore the accounts on the depositary' books and records have no bearing on the degree of asset protection provided to AIF assets held in custody by the prime broker. The delegate (i.e. prime broker) will also establish on its books and records, individual securities accounts for each of its clients. The client of the delegate will be the AIF or UCITS fund rather than the depositary. The delegate will have a sub-custody (delegation) agreement in place with the depositary pursuant to the requirements under the AIFMD and UCITS Directive. However, the delegate holds and recognizes the assets as belonging to its client (AIF/UCITS).
44. Regarding the restriction on reuse of client assets, two respondents mentioned that the segregation by type of funds is a powerful instrument to make sure that there will never be any misuse of assets, for example re-hypothecation or reuse when forbidden. Three other respondents stated that, according to EU Directives, reuse of the assets by depositaries and delegates is subject to restrictions and therefore no reuse can be carried out without the prior authorization by the legitimate owner, while in other jurisdictions reuse restrictions are normally contractually agreed, regardless of the existing legal provisions. The latter was also confirmed by other respondents, some of whom referred to the right of the prime broker to reuse assets held in custody that must be agreed by the client and depositary in the relevant contract between the prime broker and the client. According to four respondents, the terms of the agreement limit the amount of such assets that may be

reused or re-hypothecated and are respected when such assets are held in omnibus accounts at the sub-delegate level by the prime broker/delegate. Another respondent explained that assets of clients who agreed to reuse will be kept in special purpose accounts, so commingling with assets of those who did not would be prevented. One respondent mentioned the delivery management of the custodian, referencing of trade and transfer orders or hold and release mechanisms as tools to avoid unpermitted use or reuse. At the sub-custodian level there is, according to some participants, no right to reuse assets. Another respondent stated, that UCITS and AIF assets are flagged as exempt from reuse. It also stated, that in general, prime brokers do not keep assets in custody for UCITS funds. According to another respondent, a depository would not be allowed to send an instruction for a reuse of UCITS or AIF assets held in an omnibus account. Some respondents argued that in respect of a UCITS fund, there is no contractual right of re-hypothecation granted to the prime broker and therefore those assets are excluded from the re-hypothecation process. Another respondent stated that reuse of financial instruments is not permitted, but could – unintentionally – be possible if omnibus accounts are used on the second or third level of the custody chain. However, in the view of this respondent, such unintentional use would be detected, so the depository and sub-custodian could take relevant actions to assign to each client the relevant financial instrument.

45. Regarding the number or percentage of omnibus accounts versus separate accounts used in the custody chain, one respondent cautioned ESMA that any data it received in this respect should be treated with care. It explained some of the reasons why such data may be deceptive namely (1) mandatory segregation (including the use of ‘separate’ accounts) further up the custody chain has the effect of restricting market access, and thereby of reducing the total numbers of accounts and (2) segregation requirements further up the chain “propagate” the total number of accounts; such “propagation” has the effect of increasing the total numbers of “segregated” or “separate” accounts. Another respondent pointed out that the use of omnibus accounts and separate accounts depends on the perspective of each intermediary at its own level. In relation to accounts that are only kept in Germany (German accounts), for instance, 100 % separate accounts are used for direct clients, but looking at the next level of the custody chain, almost 100 % of the client assets are held in omnibus accounts. Therefore, no ratio would add up to 100% of all accounts used. Other estimates are: (1) 90% held in omnibus accounts, (2) 70 % held in omnibus accounts and 30 % in segregated, (3) 100 % in compliance with Option 1 at delegate level and 90 % in compliance with Option 1 at sub-delegate level due to difficulties encountered with investor CSDs and tri-party collateral managers, (4) 99 % of clients’ assets held in markets where an omnibus account structure is the prevailing model, (5) 95 % of non-domestic assets belonging to UCITS or AIF kept in omnibus accounts.
46. Other stakeholders stated that 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.
47. Some other respondents acknowledged that each prime broker would report a different number based on its business model and more importantly, based on the markets in which it operates. This participant estimates that approximately 90% of a prime broker’s client

assets would be held in “omnibus accounts”. The prime broker would only operate “separate accounts” in the small number of jurisdictions in which it is required to do so. However, at the level of the prime broker books and records segregation per client is operated. The same applies to global custodians.

48. Finally, three respondents described the various models of account holding namely (1) the Securities Holding Models (ECON 2011), (2) the trust model, (3) the securities entitlement model, and (4) the pooled property model.

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)?

49. Out of the ten respondents who answered this question, four respondents stated that it was not applicable to them.

50. According to most of the respondents, it is common practice to use omnibus accounts throughout the custody chain unless required otherwise in a given jurisdiction or required for practical purposes such as tax reporting.

51. Furthermore, one respondent referred to the CSD links as described and regulated under Article 48 of Regulation 909/2014 (CSDR). According to this provision, CSD links – either direct, indirect or relayed – are established on the basis of omnibus accounts in order to ensure maximum efficiency whilst delivering the norms of asset protection afforded under the same legislation and their founding legal acts or basis in their domestic market. According to another respondent, what is mostly important to protect funds’ assets is that records of entitlements are maintained accurately and timely.

52. From a practical and operational point of view one respondent indicated that a securities provider can refuse, or not be technically able, to provide the large number of accounts that the use of ‘separate’ accounts entails. This may well be the case for an issuer CSD (especially an issuer CSD located outside the European Union). It may also be the case for a sub-custodian, especially a sub-custodian in the country of an issuer CSD located outside the EU. This respondent stated that any general obligation to use ‘separate’ accounts at a high level in the custody chain would imply the provision of potentially millions of securities accounts.

53. Some respondents stated that the use of omnibus accounts is necessary in case a collateral agent/manager is appointed or a triparty collateral management agreement is entered into. According to one respondent, in case of appointment of a third-party collateral agent/manager, there would be segregation (identifying the AIF/UCITS) in the books of the collateral agent/manager, but higher up the chain it would be necessary to use omnibus accounts.

54. According to three respondents also in case of securities lending activities omnibus accounts are needed, because assets of different clients are pooled in order to meet lending requests. Segregation up the chain creates difficulty and complexity both in lending securities and receiving collateral.

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.

55. The majority of respondents who answered this question stated that their model most closely resembles Option 4. Two respondents restricted this to the first paragraph of the option and positioned themselves between Option 3 and 4. Other respondents stated that Option 4 is used broadly and Option 5 is also applied, e.g. to follow clients' requests or market specificities.

56. One respondent positioned itself between Options 1 and 2.

57. According to another respondent, Option 2 is used at the sub-delegate level as a basic model, but – depending on market practices – Option 5 is also applied.

58. Three respondents indicated that Option 1 would probably best match with their model, knowing that there are a few difficulties with some Investor CSDs, tripartite collateral agents and prime brokers who refuse to go further than a segregation between own accounts and client accounts.

59. Regarding options 3 and 5, two respondents mentioned that the Spanish approach might come close to a combination of these two options.

60. Four stakeholders, who did not express a preference for any of the options, mentioned that the account structure model is in particular driven by a combination of factors: local settlement and safekeeping practices in the specific market concerned, systemic and reporting capabilities of the local agent and CSDs and the local regulatory requirement and established market practices and, finally, clients' needs.

61. One respondent stated that models other than the options provided by ESMA are used throughout the custody chain. According to this respondent, the approach and language adopted by ESMA in the context of AIFMD and UCITS V does not lend itself well to all scenarios in the chain of custody: none of ESMA's Options – if applied literally – are entirely consistent with legal concepts underlying account holder-account provider relationships that exist separately at each link in the custody chain. Other respondents stated that there is no need to introduce specific account holding options and that reference to Article 16(8) of MiFID II and the MiFID Level 2 measures should be sufficient.

62. According to two respondents it is important to specify what is meant with reference to 'segregation' when considering accounts maintained by depositaries/global

custodians/brokers with sub-custodians (or by sub-custodians with sub-sub custodians) and thereby what actually matters in order to protect investors' interests.

63. One respondent was of the view that it is important to clarify the nature of omnibus accounts and how they are employed by custodians and brokers. The existence of omnibus accounts does not preclude “segregation” in a way that provides protection to ultimate account holders. Since a custodian intermediary can be both an account provider (where it is facing end-investors) and at the same time an account holder (where it becomes the end-investor) with respect to the same securities entitlements, both concepts apply at the same time.

64. Two respondents indicated that none of the options described by ESMA would provide more protection than any of the others in the event of insolvency of an upper-tier intermediary. This is because an AIF or UCITS could not independently instruct an upper-tier intermediary (such as a sub-custodian) or a competent official in the insolvency of that intermediary with respect to the book-entry securities.

65. One respondent made a distinction on the models used depending on the various levels in the custody chain. This respondent mentioned that, for instance, at the level of delegation between a depositary and the global custodian, its model matches Option 5, as full segregation is applied, while for the delegation between the collateral manager and the global custodian, Option 4 is applied.

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).

66. Some respondents indicated that there is no difference between AIFs and UCITS from an operational perspective because both types of funds are largely managed according to the same, or very similar, custody structure and the relevant requirements are very similar. Additionally, according to two respondents, the Spanish model makes no distinction between AIF and UCITS assets.

67. One respondent indicated that there would be no need for such a distinction as long as appropriate segregation is maintained at the right levels of the chain.

f) According to a Briefing Note²⁴ published by ECON in 2011, there are five basic models for holding securities with an intermediary: the trust model²⁵, the security entitlement model²⁶, the undivided property model²⁷, the pooled property model²⁸ and the transparent model²⁹. ESMA is interested in gathering evidence on whether there may be any link between certain securities holding

²⁴ <http://www.europarl.europa.eu/document/activities/cont/201106/20110606ATT20781/20110606ATT20781EN.pdf>

²⁵ See pages 14-15 of the Briefing Note.

²⁶ See page 16 of the Briefing Note.

²⁷ See page 17 of the Briefing Note.

²⁸ See page 18 of the Briefing Note.

²⁹ See page 19 of the Briefing Note.

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.**

68. This sub question was answered by 9 respondents. Some stated that the model varies depending on the applicable jurisdiction. Others mentioned the Trust model for UK and the Securities Entitlement Model for the US. For Germany, the Pooled Property Model was mentioned. One respondent positioned itself somewhere between the Security Entitlement Model and the Undivided Property Model and another mentioned the transparent model for Denmark.

69. According to one respondent the undivided property model is the reference in France. This respondent considered this to be a very protective model that (a) avoids any conflict on ownership (b) as a consequence, enables strict and continuous certainty that there are no more securities circulating than those effectively issued and (c) suggests a certain level of segregation to facilitate the exact identification of the owner.

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

70. Various responses evidenced that there is no uniform account naming convention that is considered standard across the industry as this depends on the relevant market and clients' preferences.

71. One respondent stated that, according to national law, the securities accounts must be opened and maintained in the name of the client, who will benefit from the legal presumption of ownership and the right to withdraw and transfer securities.

72. Another respondent stated that accounts are opened in the name of the relevant direct client.

73. According to three respondents, accounts with delegates/sub-delegates are opened in the name of the account holder (depositary or custodian X as nominee) on behalf of third parties/customer account. The account name can contain references to whether it includes

proprietary assets of the account holder or assets of the account holder's clients. In the latter case, the accounts may be styled as held for specific types of end investors (e.g., for UCITS funds) or more broadly for "underlying clients" (i.e., depositary or custodian X "on behalf of UCITS funds" or "on behalf of underlying clients"). In this way, accounts can be named in such a way to put the delegate/sub-delegate and creditors of the depositary on notice that the assets do not belong to the depositary but rather to its end investors (or specific types of end investors). According to one respondent, since the assets are held in custody by the delegate/sub-delegate, it is expected that creditors of the delegate/sub-delegate recognize that the assets do not belong to the delegate/sub-delegate.

74. Another respondent mentioned that the naming convention chosen has little to do with ensuring segregation from the balance sheet (estate) of the delegate/sub-delegate. The naming convention is more relevant to ensuring that assets are protected from creditors of the account holder (e.g., the depositary).
75. According to some respondents, there are (exceptional) cases where an account will be opened in the name of the fund in a pure segregated manner at the request of the manager or of the end client(s) (particularly for dedicated funds). In other cases accounts with immediate delegates of the depositary are opened in the name of the funds for which the depositary acts, which varies by depositary and may depend on scale of the relationship, pricing and other factors.

Q1. General remarks

76. Some respondents referred to the holding model used under Dutch law, which resembles the pooled property model.
77. According to these respondents, under Dutch law, the Securities Giro Transfer Act (*Wet giraal effectenverkeer*, "SGTA") contains the legal framework that governs the holding of securities by investors. The SGTA is applicable to securities that are credited to a securities account that is held in The Netherlands. The SGTA is based on co-ownership and creates pools of securities at different levels. At the level of a CSD, the so called '*girodepot*' and at the level of the intermediary (usually financial institutions), the so called '*verzameldepot*', a specific pool is created per type of security. Such pool is administered by a CSD and intermediaries, but the investors holding securities accounts at the intermediaries are co-owners. A client that holds an account with an intermediary is a co-owner of the pool of securities administered by the intermediary for the proportion as administered in custody account. In turn, an intermediary holds a part of a '*girodepot*' with a CSD. The total amount of a '*girodepot*' is based on the total amount of all the '*verzameldepots*' that are being held by the participating intermediaries. The co-owners of the '*verzameldepot*' are together the owners of a '*girodepot*'. This construction included in the SGTA means that securities do not become part of the estate of the intermediaries or the CSD at any time and will therefore not become part of any bankruptcy estate of such parties.
78. In line with the features that are used in the Briefing Note published by ECON in 2011, it can be said that investors can access their securities only through their account provider.

Other account providers up in the chain would be unable to identify the underlying investors as a consequence of the security pools. The intermediaries and the CSD have no interest in or legal ownership of the securities, they are only allowed to perform acts of management in favour of the investors.

79. Any further segregation by maintaining separate accounts for one or more client, or type of client, at any level in the custody chain will, according to these Dutch respondents, not strengthen or add anything to the protection offered by the SGTA. Also, as stated by these stakeholders, it seems likely to be complex and onerous for the custodian to offer such further segregation because it would need to maintain systems capable of setting up both omnibus and individual segregated accounts with all of its sub-custodians, and to transmit settlement instructions per segregated account (instead of one (net) settlement instruction for the (omnibus) client account), thereby reducing efficiencies and increasing the risk of error (and thus the risk of settlement fails). Furthermore, according to these stakeholders, the operational consequences and costs of account segregation at any level of the custody chain of a custodian, together with the type of protection offered by the SGTA against the insolvency of the custodian should be taken into account.

I. 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 (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?

80. Most participants agreed that investor protection in an insolvency situation is rather determined by the applicable local laws where the insolvent party operates and is not dependent on the level of segregation throughout the investor holding chain.
81. Several participants reported some respective national laws which recognize the segregation arrangements (Dutch, English, US, German, Brazilian, Spanish, Irish, Danish).
82. Most participants pointed out that the key factors for investor protection in omnibus accounts are a proper segregation of assets at each layer of the custody chain, the accuracy and traceability of securities records and ongoing monitoring of the sub-custodian network.
83. Most of the respondents agreed that in the event of insolvency of a client whose assets are commingled with assets of a different client all being held in the omnibus account, this would not have any impact on other asset owners.

84. However, some participants stated that there was a risk of shortfalls between the delegate's internal books and records accounts and the external omnibus client account at the sub-delegate that in some cases will be born pro-rata by all account owners, irrespective of how the shortfall arose.
85. Some respondents mentioned that they followed option 1 to avoid assets being commingled with the assets of clients of another custodian, facilitate checks on the accuracy of the rights all along the custody chain and avoid the effect of any discrepancies affecting the record of ownership rights of other third-party's clients.
86. Several respondents were of the view that this assessment would require a thorough investigation of the insolvency laws of all the different countries where delegates, sub-delegates or CSD operate and would welcome a working group to address these issues.
- 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.**
87. Most respondents agreed that return of assets in the event of insolvency is subject to the insolvency law of the market in which the delegate/CSD operate and – before the assets may be returned – the full reconciliation of the books and charges over the assets by the appointed liquidator is needed.
88. Several respondents reported some respective national laws relating to the return of assets (UK, German, Brazilian, Spanish, Irish, Greece, Belgian, US).
89. Some of the respondents believed that there are no material differences between 'omnibus accounts' (i.e. books and records segregation) and separate accounts in terms of return of the assets from the account in a scenario of potential insolvency or insolvency. Others pointed out that separate accounts do not facilitate a quicker return of assets on insolvency because they complicate the reconciliation process and increase the number of instructions to arrange the transfer.
90. Some respondents stated that other factors dictate the timing of the release of assets, such as insolvency law in each jurisdiction, problems involved in the reconciliation process, the existence of security interest or other contracts to which the assets may be subject.
91. Some respondents were of the view that there are other mechanisms in place in certain jurisdictions designed specifically to expedite the resolution of an investment firm and the

return of assets, e.g. the special administration procedures pursuant to the UK Investment Bank Special Administration Regulation (SAR) which allows administrators to set a “bar date”.

92. One respondent believed that there is an urgent need for a working group with professionals and regulators from different countries to examine the impact of insolvency in different jurisdictions.

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.

Key findings

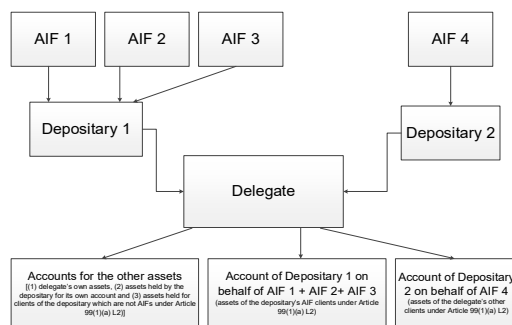
- Daily effective reconciliations is a key measure for client asset protection, including in the case of insolvency, by ensuring accurate records and traceability of the client’s assets throughout the custody chain.
- Individual accounts for clients on their books and records enable delegates at any time to immediately identify client entitlements and distinguish these from a third party entitlement or the delegate’s own entitlements, including in the event of insolvency.
- MiFID permits general omnibus client accounts, provided that (i) the books and records of the investment firm identify the client for whom it is holding the relevant custody assets and (ii) the sub-custodian accounts in which client assets are held are segregated from any proprietary assets of the investment firm.
- Legal mechanisms ensuring segregation of a depositary’s or custodian’s own assets from client assets are widely used to ensure client asset protection.
- Other measures can include carrying out due diligence on custodians and sub-custodians, identifying a fall-back sub-custodian and prompt registration of client securities.

- A number of factors are responsible for determining the return of assets including: the operation of insolvency law within a jurisdiction, the scale and complexity of the sub-custodian business and the factors leading to the appointment of an insolvency practitioner. There may be no single factor, common to all jurisdictions in which they have appointed sub-custodians, that guarantees protection of client assets in the event of insolvency.

Number of respondents	31
Number of respondents supporting Options 1 or 2	2
Number of respondents not supporting Options 1 and 2	29

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?

Key findings

93. The vast majority of respondents held the view that more, i.e. “client” or “fund type“, separation of accounts at the level of the Delegate would not make it easier for the Depositories to enforce rights in respect of the assets held by the Delegate in the event of a default of a Depository or the Delegate. At the level of the Delegate a separation of own assets of the Delegate and separate accounts for each Depository as a client of the Delegate shall be sufficient.
94. Some respondents mentioned a sooner identification of clients’ assets at the level of the Delegate as a possible advantage of more separate accounts at the level of the Delegate, which may result in shorter freezing or a shorter timeframe. However, this was also contradicted by some of them with more efforts and time expected to be spent in an insolvency administration process to retrace and review reconciliation for a higher number of accounts or advantages of omnibus accounts or accurate record keeping as preferable alternative.

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 work³⁰.

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

Key findings

- Segregation in books and records achieve the policy objective by determining asset entitlements and property rights for each client.
- Delegates are required under AIFMD, UCITS and MiFID to undertake regular reconciliations between the omnibus accounts at the sub-custodian and its own books and records to ensure completeness and accuracy of books and records for clients against those of third parties.
- In a number of jurisdictions, legal and contractual protections afforded by the delegate’s jurisdiction determine client entitlements and books and records are used to evidence those entitlements.
- In many jurisdictions, an insolvency practitioner would look to the books and records of the insolvent firm as evidence of each client’s individual asset entitlement.
- A full and final reconciliation of the entire estate of the failed entity would be essential before any assets were delivered.
- With respect to misuse of fraud risk highlighted in the IOSCO report, the following safeguards are undertaken: daily reconciliations; segregation of the assets of the custodian and sub-custodian at all times from client assets; accurate records keeping; and regular monitoring and oversight, including due diligence to ensure asset segregation procedures are being followed.
- Custodians maintain segregated accounts for clients on a “books and records” basis so that it can be said at any time and without delay what the client is holding.
- Misuse of assets held in omnibus accounts is addressed by MiFID requirements, which require systems and mechanisms for omnibus accounts to prevent the use of client assets for own or other clients’ account.
- Risk of misuse of assets exists whether the assets of a CIS are held with a sub-custodian in an omnibus or segregated account (Madoff, for example, had authority to move assets from client accounts whether they were styled omnibus or segregated accounts).
- The IOSCO report did not make a recommendation in respect of segregating CIS assets other than with regard to the industry standard of segregating proprietary assets from clients’ assets, which is normal commercial practice.

Number of respondents	31
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Number of respondents supporting individual accounts	4
Number of respondents not supporting individual accounts	27

II. Complexity/operational costs

a) Complexity

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

- **Cross-border investments**
 - **Through CSD Links**
 - **In relation to cross-border investments through CSD links, what are the functions of an investor CSD³¹?**
 - **Through T2S**
- **Prime broker services**
- **Tri-party collateral management / securities lending.**

Summary/key findings

95. The current cross-border settlement through CSD links and T2S platforms are based on omnibus account structure.

96. Most of the respondents stated that segregation requirements will lead to multiplication of accounts in the custodial chain, prevent investor CSD to use omnibus accounts for settlement, and that if segregated accounts were used, a specific securities settlement instruction would have to be sent to each account. As a consequence, investment funds' ability to use CSD links and T2S platforms would be restricted. Beyond that, the following negative impacts of segregation requirements on cross-border settlement via CSD links are identified:

³¹ According to Article 1(g) of the ESMA draft technical standards under CSDR (ESMA/2015/1457/Annex II), 'investor CSD' means a CSD that is a participant in the securities settlement system operated by another CSD or that uses an intermediary that is a participant in the securities settlement system operated by another CSD in relation to a securities issue (available at www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457_-_annex_ii_-_csdr_ts_on_csd_requirements_and_internalised_settlement.pdf).

- Complicated reconciliation of securities transfer
- Increased transactional costs
- Increased number of mismatched instructions
- Increased booking errors and hence increases operational risks
- Lower settlement efficiency

97. Mostly all respondents were in the view that segregation requirements would exclude tri-party collateral managements for AIFs and UCITS or at least have a negative impact on them. In the latter context they refer to:

- Reduced attractiveness of AIF/UCITS as lenders, therefore reducing fund performance, and further induce clients to withdraw from lending due to decreasing income
- Increased risk and complexity
- Increased costs
- Increased response time
- Split of the collateral/lending pool, reduce potential optimization benefit as additional re-alignments may be required by market participants
- Reduced market liquidity

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.

Summary/key findings

98. Fifteen out of twenty-five respondents agreed with the proposed statement 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.

99. These respondents were in the view that compliance with option 1 and option 2 would lead to the creation of a new account for each underlying client at each of the sub-custodians in the markets in which the client is invested. Assuming that a prime-broker or a CSD operates a global custodian chain model in 50 markets, they estimated that the implementation of option 1 would lead to an increase of accounts opened with sub-

custodians from 50 to at least 550. While it is estimated that the application of option 2 would increase the number from 50 to at least 100.

100. Seven respondents were in the view that the proposed statement is only true for option 5 where full segregation is required. They considered that option 1 would generate a limited increase of accounts at delegate/sub-delegate. When applying option 1, assuming AIFS and UCITS funds of a given depositary have invested in 25 different countries, they estimated that the number of accounts to be opened with delegate would be 35.

101. Three respondents did not answer the question directly.

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)?

Summary/key findings

102. Nineteen out of twenty-eight respondents were in the view that option 1 and 2 will increase settlement instructions and account reconciliation, impede netting transactions, therefore reducing the efficiency of settlement operations, increasing operational risk and settlement fails/delays.

103. Two respondents further stressed the negative impacts of option 1 and option 2 on the efficiency of cross-border settlements via CSD links.

104. Five respondents underlined that they did not witness any changes in the efficiency of their settlement process since after having implemented option 1 since 2014. Neither their market Straight Through Processing rate, nor their Failed/Late settlement rate has increased. They further pointed out that efficiency will not be affected by an increase of accounts prompted by segregation requirements.

105. Two respondents did not answer the question directly.

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.

106. The majority of respondents agreed that both block trades and internalised settlement would become increasingly more difficult or impossible to sustain if option 1 was to be implemented. This was due to the increased transaction costs and operational risks as managers, executing brokers and settlement agents would be required to restructure their

operations to accommodate a significantly larger number of trades. With regard to internalised settlements, several stakeholders argued that advantages from internalised settlement, such as efficiency, would be largely diminished.

107. One of these stakeholders estimated that settlement costs would increase by 20% if mandatory segregation was enforced.

b) Costs

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?

108. Based on the responses received, it can be concluded that option 1 would require significant costs for market participants who currently operate omnibus accounts. Most respondents were unable to give an estimate in figures, but provided examples of new arrangements which would be required to be put in place to implement option 1.

109. The costs for market participants who are already largely operating a segregated account model would not be significant.

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

Summary/key findings

110. Most respondents agreed that omnibus accounts led to reduced maintenance fees and operational costs, which meant lower costs for investors for both firms and clients. These were due to more efficient processes and economies of scale, as well as to the possibility to perform transfers where netting of credit and debit entries can be applied. One respondent argued that these reduced processing costs made markets more open to a wider range of investors.

111. Most respondents also mentioned more efficient operational procedures, pointing towards the efficient reconciliation and settlement processes which were facilitated through omnibus accounts. Two responses also pointed out that settlement failures occurred less often.

112. Several respondents pointed towards the increased liquidity omnibus accounts enable, as well as to the optimisation of collateral. Two respondents remarked that omnibus accounts have enabled securities lending.

113. Some respondents pointed out that omnibus accounts facilitated cross border flow of securities and collateral, and that they provided a quick route to markets for new investors

in the European eco-system. Two respondents highlighted that this was in line with the Commission's strategy under Capital Markets Union to open the borders to Europe and enable borderless, real-time settlement through omnibus accounts, which reduce congestion and operational complexity. Another respondent pointed out that omnibus accounts enabled asset managers to utilise already existing account structures in other markets.

114. Two respondents pointed towards the reduced burden for issuers, as they have to deal only with account providers rather than a large number of investors. This would shift the burden of dealing directly with investors to the account providers.
115. One respondent said that segregation could not be generalised so as to cover all investors and all securities. The limitation of segregated accounts was an advantage of using omnibus accounts.
116. One respondent highlighted that both the Target-System-2 and Shanghai-Hong Kong Stock Connect in Asia endorsed the use of omnibus accounts.
117. One respondent mentioned that omnibus accounts allowed pooling, which was a cost effective means of reducing the number of transactions books to a fund and an efficient means of managing the same asset class as a single portfolio across a range of products.
118. One respondent argued that the abolishment of omnibus account might lead to reduced availability of depositaries due to increased operational fees
119. Two respondents argued that omnibus accounts structures provided clients with more efficient processes to exercise voting rights and other corporate actions in respect of their holdings, as an account provider could gather the voting instructions for the collectively held securities, which would reduce the large numbers of voting instructions required to be processed by the issuer.
120. Finally, one respondent argued that with regards to consumer protection, there was no advantage in segregated over omnibus accounts, as in both cases, the client would be able to withdraw the assets in case of the depositary's insolvency, as long as there was no dispute over the ownership to the assets.

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 EMIR³² (including if this may raise any operational difficulties)? Should you consider that there is any impact, please explain why.

Summary/key findings

121. While several respondents mentioned that they did not see an impact in terms of the interaction between AIFMD and EMIR, others did say that the impact of the interaction between AIFMD and EMIR would depend upon:

- a) the way in which the clearing member receives the collateral - the majority of clearing arrangements operate on a TTCA basis (collateral posted from the client to the clearing member is transferred on a full title transfer basis); and
- b) where the same entity acts as a sub-custodian and clearing agent, it is important to understand in what capacity they are acting when holding the assets.

122. Based on these factors, the respondents distinguish the following scenarios:

- 1) Where assets are passed to a clearing member on a TTCA basis they would no longer constitute “assets held in custody” from an AIFMD perspective, and so the AIFMD segregation rules would not apply;
- 2) Where the same legal entity acts in both the capacity of a sub-custodian and in the capacity of a clearing member, the AIFMD rules (but not the EMIR rules) would apply where the entity is acting in its capacity as custodian. At the point of change of capacity of the entity, in relation to which there would be an expectation to see a movement of the assets within the accounts of the entity, the EMIR segregation rules would apply.
- 3) Where a clearing member (acting in its capacity as such) receives collateral from AIF clients on a security interest basis, then both the EMIR and the AIFMD segregation rules would apply.

III. 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;**

³² Article 39(2) and (3) of EMIR states the following: “2. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients (‘omnibus client segregation’). 3. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients (‘individual client segregation’). Upon request, the CCP shall offer clearing members the possibility to open more accounts in their own name or for the account of their clients”.

b) prime brokerage arrangements.

Summary/key findings

a) Tri-Party Collateral Management

123. The large number of comments on this element highlighted the different views between:
- those who operate under option 1 and believe that there is no practical impediment to tri-party arrangements, other than additional cost and willingness to work under that model; and
 - those, including the tri-party collateral managers, who consider that a significant amount of impediments and challenges would result if option 1 were to apply. They indicate that segregation would also bring about 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).
124. While respondents did not say that option 1 was not possible under tri-party collateral management, those opposed to option 1 considered that EU funds may be disadvantaged if they could not participate in the current model. Moving to a segregation model would not – in their view – provide any better protection.

b) Prime Brokerage arrangements

125. Respondents who operate under option 1 were concerned to ensure that when addressing safe-keeping in the context of prime brokerage, the unencumbered securities held by the prime broker should be distinguished from the assets subject to re-hypothecation. That distinction arises in any case because re-hypothecated securities are no longer held in custody, while unencumbered securities are held in custody and subject to the same requirements as assets of all AIFs and UCITS.
126. Numerous respondents stated that an account segregation requirement would result in significantly increased complexity in an insolvency scenario leading to a likelihood of greater delay in identification, reconciliation and release of client assets following an insolvency event including greater operational risk.

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?

Summary/key findings

127. While many respondents were generally of the view that cost impacts under option 1 would not be significant, there was strong consensus from this group of stakeholders on the potential negative implications that the imposition of option 1 would have on market liquidity and the attractiveness of AIFs / UCITS as securities lending options in the global

market basis. The indications are that sovereign wealth funds and other omnibus formatted accounts would be more attractive due to the ability to execute in a single transaction.

128. With regard to market liquidity, they noted the liquidity and connected funding requirements in the capital markets. Multiple deliveries and receipts of stock and collateral with attendant instructions, account movements and reconciliations would make borrowing securities commercially unattractive.
129. These respondents mentioned that it is acknowledged that AIFs and UCITS could lend their assets on a bilateral basis but that is inefficient and typically not what borrowers want as it involves multiple transactions in order to get the desired position.

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?

Summary/key findings

130. A large number of respondents to this question highlighted the risks and inefficiencies that may materialise through the imposition of segregation requirements as per option 1. The indications are that the impact would be most severe in the tri-party collateral management and prime brokerage models. Numerous respondents highlighted that there will be an increase in operational risk, settlement risk and market disruption in the early phases of implementation if option 1 was mandated. In this regard, respondents attributed the emergence of these risks to the change in settlement arrangements and new accounts to open / settle with / reconcile to which would lead to an inevitable increase in risk of errors.
131. Other respondents expressed a different view and saw the conflicts between securities law and insolvency law across multiple jurisdictions as the main driver of legal uncertainty. Respondents applying option 1 mentioned that no issues arose when they implemented option 1.

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.

Summary/key findings

132. The overwhelming majority of respondents advised that technological upgrades would not solve the challenges faced under option 1.
133. Respondents stated that the fundamental difficulty faced is the inability to execute internalised settlements. The proposed segregation requirements would require physical

movement between accounts and negate the effectiveness of the optimization process currently used.

134. A minority of respondents expressed a different view and mentioned that they were working to formulate a custodial model which facilitates segregation and tri-party collateral management in the same package.
135. A respondent alluded to the other initiatives currently in train for European CSDs – namely T2S and the CSDR – and the extreme difficulties which stakeholders would face in trying to execute major restructuring and systematic changes simultaneously.

IV. 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.

Summary/key findings

136. Some respondents mentioned that they were not aware of any challenges under option 1 for the functioning and efficiency of T2S, as T2S is designed to accommodate high volumes of transactions, number of participants and settlement information. Other respondents referred to potential increased operational complexity associated with the proliferation of accounts which could result in settlement failures and delays and increased costs for the settlement of transactions.
137. Several respondents highlighted that the impact would depend on whether securities accounts provided by several intermediaries in a custody chain are located on T2S, and on whether they are under the obligation to segregate (i.e. are considered delegates of the depositary).
138. Some respondents mentioned that, in their view, AIFMD and UCITS V segregation obligation does not apply with respect to accounts provided by issuer CSDs, which should not be delegates.
139. Some respondents mentioned that T2S was currently in a migration phase across the different markets, which should be followed by a “stabilisation” period, and that the first window that would be opened to accommodate option 1 for the fund industry in T2S would not be prior to 2022.
140. Some respondents referred to a cost impact of the proliferation of accounts in T2S: even though T2S does not currently charge an account fee to CSDs, this was based on

the assumption “that actual usage will be within an expected consumption pattern” as defined when the price list was agreed in 2010³³.

V. 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.

Summary/key findings

- a) Mismatch that will arise between local jurisdiction securities ownership rules and the mandated level of segregation required under option 1 in the CP

141. While a number of respondents already implemented option 1 and did not find that a problem, many others stressed that local custody requirements in third country jurisdictions do not obligate entities to segregate in the manner prescribed under option 1. These respondents indicated that delegates based in certain jurisdictions may be unwilling to facilitate segregation to comply with option 1. This can be attributed to factors such as: (i) local market practice, rules and infrastructure and (ii) the systematic changes required (and the associated costs) that would be required in order to facilitate custody and prime brokerage through a segregated model. Respondents advised that the imposition of option 1 segregation would bring about concentration risk and the consolidation of prime brokerage options.

142. Those entities that have not experienced/do not envision serious difficulties in implementing option 1 suggested that ESMA could provide guidance on a case-by-case

³³ The T2S User Requirements Document (URD) version 5.05 (August 2016):

(1) “For various reasons, an Investor CSD may decide to use several omnibus accounts within the technical issuer CSD for segregating the holdings of its participants within the technical issuer CSD. T2S shall support the use of multiple omnibus accounts, but its use by the CSDs should be very limited in order not to add unnecessary complexity”

basis. This could serve to acknowledge and address potential impediments in third country jurisdictions where omnibus account models are the norm.

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

143. Responses indicate that investments in a number of key jurisdictions, particularly the US and Hong Kong / China (by virtue of the market infrastructure there) would have difficulty complying with option 1.

144. In the case of the US, the differences in custody requirement may see entities unwilling to facilitate this model.

145. Hong-Kong Stock Connect ('HKSC') is a key infrastructural CSD that operates through an omnibus structure. A large number of respondents have set out that HKSC is not prepared to identify in its books and records accounts of underlying account holders other than those of direct participants.

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.

Summary/key findings

146. As set out in detail under Question 19, there are a number of jurisdictions that have custodial models and account structures which, respondents advise, would make the implementation of option 1 difficult.

147. Nevertheless, one respondent advised they have not faced issues and noted that a significant amount of jurisdictions outside the EU enforce end-beneficiary segregation. Another respondent supported option 1 for segregation requirements as it provides transparency and enables the depositary to monitor its delegates appropriately requiring a limited increase in accounts.

148. Conversely, several other respondents stressed that the implementation of physical segregation under option 1 is not operationally feasible in a number of non-EU jurisdictions where the prevailing market practice/infrastructure employs omnibus models. One respondent set out the circumstances when individual accounts are used and also noted that while omnibus accounts are used for around 1/3 of the markets serviced, these tend to be in the high volume markets.

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

Summary/key findings

149. Three respondents who currently apply option 1 indicated that higher fees do not apply. In some cases they pointed to their existing delegates in the custody network who have not charged higher fees including in circumstances where they were instructed to open additional accounts at CSDs. This may be attributed to the commercial relationship between the entities or the negotiations entered into.

150. Other respondents argued strongly that additional costs must apply due to increased operational related costs. These have set out in some detail the fees and other impacts which would arise from the opening of additional accounts at the sub-custodian including:

- capacity constraints;
- impact on system development;
- KYC / AML burdens to comply with; and
- additional paperwork and administration.

151. They further indicate that the costs incurred would be passed on to end clients.

VI. The optimal asset segregation regime for achieving a strong level of investor protection without imposing unnecessary requirements

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.
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	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	<p>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.</p> <p>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.</p>
Option 4	<p>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.</p> <p>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).</p>
Option 5	AIF assets should be segregated on an AIF-by-AIF basis at the level of the delegate or sub- delegate.

Summary/key findings

152. Feedback from respondents may be summarised as follows:

- All of the options achieve the policy objective of providing strong client asset protection, especially in insolvency, for the safekeeping of AIF and UCITS assets. However, whilst neither option offered greater protection than the other, option 4 offers a better solution for achieving the policy objective without damaging the industry.
- Additional use of segregated accounts would not increase client assets protection.

- Option 4 represents MiFID requirements and offers the best mix of investor protection and efficiency, providing there is accurate record-keeping of client entitlements along the custody chain, local law recognises the effects of segregation between client assets and own assets, tracing is guaranteed and reconciliations are conducted.
- Flexibility should be given to the depositary or delegate to choose any of the five options after undertaking insolvency, legal and market analysis.

Number of respondents	34
Number of respondents supporting Option 1	5
Number of respondents supporting Options 1 and 2	1
Number of respondents supporting Options 2 and 5	1
Number of respondents supporting Option 3	2
Number of respondents supporting Options 3 and 4	2
Number of respondents supporting Option 4	20
Number of respondents supporting an alternative approach (excluding options above)	3

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 option³⁴.

- 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.
- b) Applying a regime similar to the one under Article 38 of the CSDR to the AIF/UCITS framework would mean that the fund investors would have the choice to invest in a given fund or not, after having been made aware – through appropriate disclosures – of the level of asset segregation that the managers of AIFs/UCITS had chosen and the related costs. However, investors would not have the opportunity to participate in the choice of the level of asset segregation as such a choice would have to be made by the manager for each individual fund as a whole (i.e. it would not be possible to have different levels of segregation for the investors in the same fund). Do you consider that this could raise any concern in terms of investor protection or could any concern be alleviated through appropriate disclosures? Please explain the reasons for your answer.
- c) Please comment on any implications of such a regime for the account related provisions under Article 39 of EMIR.

Summary/key findings

153. A large number of respondents would welcome a regime similar to the one under Article 38 of the CSDR. A number of respondents stated that this approach would provide for investor protection and maximum transparency by giving market participants information as to the consequences and implications of their choices, while having the advantage of accommodating different national legal approaches as regards segregation.
154. Notwithstanding the above, a large number of respondents was of the opinion that a regime similar to the one under Article 38 of CSDR would not help to achieve the policy objectives described in the CfE. Specifically, these respondents were of the opinion that client protection is not achieved per se by segregating accounts at the delegate or sub-

³⁴ However, under Article 38(5) of the CSDR a CSD and its participant shall provide individual clients segregation for citizens and residents of, and legal persons established in, a Member State where required under the national law under which the securities are constituted as it stands at 17 September 2014.

delegate level. According to these respondents, book-entry registration of the assets is per se sufficient to achieve the dual policy objectives outlined in the CfE.

155. Other respondents stated that a similar regime as the one under Art. 38 of CSDR is too complex and onerous for a depositary to administer. This is because a depositary would need to maintain systems capable of setting up both omnibus and individual accounts with all of its sub-custodians, and to maintain records and systems reflecting the different approach chosen for each fund. The same would apply to sub-custodians and all other intermediaries through which the assets are held even if these entities have no direct relationship with the fund manager. According to these stakeholders, this regime will thus lead to an increase of the costs, which finally will be borne by end-investors.

156. A large number of respondents pointed out that an implementation of a similar regime as the one under Article 38 of CSDR should take into account the case of non-European securities. Specifically, depositary banks may not be able to offer their clients a full choice regarding the account structure up the custody chain with respect to those parts of the custody chain that are located in third countries and thus fall under their own national regulatory obligations.

157. The large majority of respondents was of the opinion that the fund manager should make the choice for each individual fund as a whole and not the end investor. According to two respondents, the vast majority of investors are not in a position to understand all technical issues at play and therefore cannot formulate a reasoned judgement, even after having received sufficient disclosure. One respondent stated that it is the depositary that performs due diligence and ongoing monitoring and is therefore in the best position to assess any potential risks and decide the level of segregation that is needed in every situation.

158. Two respondents were of the opinion that Article 39 of EMIR has been rejected by the market as there has been very limited take up of the opportunity for segregated clearing and margin accounts throughout the industry despite having the legal right to segregate.

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

Summary/key findings

159. The responses of a vast majority of the respondents were guided by the need for flexibility and the consideration of different factors such as local market regulations, prevailing custodial practices and available insolvency protections of the local markets.

160. Respondents highlighted that the account segregation structure is not necessarily the critical element in ensuring the policy objectives. Elements to be considered should be (a) the enforcement of the ownership rights of a client through accurate recordings of those rights, (b) an effective reconciliation process, and (c) recognition under the laws of the

relevant jurisdiction that rights of the holder or owner of the assets are insulated from the claims of any creditor of the relevant intermediary.

161. A large group of respondents would favour option 4 as the most effective and practical to achieve these requirements if forced to choose between options 1 to 5.
162. However, a vast majority of respondents did not support a prescriptive regime altogether, and recommended a principles-based approach leaving room for market and technical adaptations.
163. Two of the respondents were of the opinion that such a principles-based approach could be built on the existing MIFID requirements.
164. One respondent favoured this flexible approach only for professional investors, while recommending the more prescriptive option 1 in cases where retail investors are involved.

VII. 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?

Summary/key findings

165. The majority of respondents considered that the definitions are sufficiently clear, both in the AIFMD and UCITS Directive.
166. According to several respondents, safekeeping is understood as the broader concept/term covering the function of providing custody of financial instruments and the function of verifying the ownership of the assets which cannot be held in custody.
167. Some respondents, mostly CSD respondents, did ask for a clarification of the notion of custody, but they linked the question to another issue, which is whether custody functions are delegated to a CSD and whether the AIFMD rules apply to these entities. They also mentioned that an alignment between UCITS and AIFMD rules would be desirable.
168. One respondent did not see a need to clarify the concept of custody, but would welcome a clarification of the terminology of safekeeping.
169. One respondent considered that both terms are used interchangeably and that there should be a clarification.
170. One respondent considered that a common definition of custody across all relevant legislation would be helpful.

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’)³⁵;**
- 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?**

Summary/key findings

171. The majority of respondents considered the functions described under Q26 a) and b) as core functions of “issuer CSDs”. While representatives of CSDs were of the view that both “issuer CSD” and “investor CSD” are out of the scope of the delegation rules of UCITS V and AIFMD, other respondents considered the “investor CSD” function within the scope of those rules.
172. Some respondents felt that points a) and b) of Q26 do not relate to the custody function under UCITS V or AIFMD, but are core CSD functions regulated under CSDR. Some respondents deemed these functions as the core functions to define “issuer CSDs”.
173. Some respondents asked for clearer definitions of the terms “issuer CSD” and “investor CSD”, while others mentioned CSDs were sufficiently regulated under CSDR.
174. There was a split of views on whether the services described under Q26) d) and e) should be seen within the scope of custody.
175. Some respondents saw no need to expand the concept of custody to the services mentioned in Q26. In their view, this would be inconsistent with the definition of custody under the MiFID.
176. Some respondents considered the service described under point c) of Q26 as a function of the custodian.

³⁵ These services are part of the core services of central securities depositories under Section A, point 2 of the Annex to Regulation (EU) No 909/2014 (“CSDR”).

177. Some respondents argued that it is possible, under certain contractual arrangements, that some parties have access to the securities or the accounts (as requested under Q26 d) and e)) without necessarily providing custody services.

178. Some respondents were of the view that all the listed services are included in the concept of “custody” of financial instruments.

179. One respondent found that the core concept of custody includes 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. The custody chain extends from the issuer CSD to the end investor and each part of this chain provides custody services.

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

Summary/key findings

180. The majority of respondents did not see any additional service that should be included in the concept of “custody” of financial instruments for the purpose of the AIFMD or the UCITS Directive. Three respondents saw merit in differentiating between the scope of the term “custody” for financial instruments and other assets. In their view custody is broader than pure safekeeping and should include the maintenance of securities accounts, “holding” securities in a securities account, record rights of clients to securities, collecting and providing information related to securities recorded in the securities accounts and processing of corporate actions and withholding tax reclaims with regards to those securities held in the accounts.

181. Only a couple of respondents suggested that additional services should be included in the concept of custody. The term custody should, in their view, include the maintenance of securities accounts, “holding” securities in a securities account, record rights of clients to securities, collecting and providing information related to securities recorded in the securities accounts and processing of corporate actions and withholding tax reclaims with regards to those securities held in the accounts.

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 2³⁶) and Article 22(5) of the UCITS Directive (as well as Article 13 of the UCITS V Level 2³⁷).

³⁶ Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012.

³⁷ Commission Delegated Regulation (EU) 2016/438 of 17 December 2015.

Summary/key findings

182. The large majority of respondents indicated that the concept of safekeeping is broader: it covers custody and record-keeping. Custody cannot be done for all types of assets. One respondent considered that safekeeping is largely synonymous with custody. Another respondent criticized that individual EU Member States have adopted different approaches to what safekeeping entails.
183. Respondents to the consultation mainly sought clarification regarding CSDs performing custody activities (in line with the responses to Q25).
184. Three CSD respondents did not agree with the ESMA Q&A on the AIFMD, opposing the application of AIFMD requirements on top of CSDR requirements for services which they consider to be provided as part of the CSDs' standard service offering.

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.

Summary/key findings

185. Several respondents were of the opinion that CSDs should never be considered a delegate and that the provision of core or ancillary services should never result in a CSD being considered as a delegate under AIFMD or UCITS Directive.
186. For these respondents there was no reason why the approach under the AIFMD and UCITS Directive should be different and a CSD should not be regarded as a delegate. In this respect, the following arguments were submitted:
- Custody of securities is included in the services of securities settlement systems and therefore no meaningful distinction can be made here.
 - The settlement of financial instruments in a securities settlement system ("SSS") should not be seen as a delegation of safekeeping functions under the respective directive. Settlement in an SSS is, in fact, the execution of transfer orders within the meaning of Article 2 of Directive 98/26/EC (the SFD).
 - The abovementioned position is specified by the AIFMD and UCITS Directive. In fact, both Article 21(11) of the AIFMD and Article 22a(4) of the UCITS Directive stipulate that the provision of services by SSS as designated should not be considered a delegation of custody functions (Article 21 of the AIFMD has been complemented with

recital 41 confirming the exemption of custody service of CSDs from the requirements on the delegation of custody).

- The new regulatory framework under which CSDs activities are being developed, including organizational requirements and strict conduct of business rules, also pursue the protection of client assets and provide appropriate safeguards with reference to assets held in CSDs without any need to impose the AIFMD/UCITS segregation requirements. Should CSDs be subject to article 21 (11) AIFMD and Article 22a UCITS Directive, it would produce a significant increase of custody cost and, consequently, settlement cost without providing additional benefits in terms of investor protection.

187. According to one respondent, a CSD should never be considered a delegate when providing core services, but the provision of ancillary services may result in a CSD being considered as a delegate: there is a need to differentiate between whether the depositary can select a sub-custodian of its choice (including the CSD) or not: in the first case the delegation of the custody function is deemed possible.

188. One respondent focused its answer on the international CSDs (ICSD) and stated that in its view ICSDs act like delegates and should, therefore, be liable and follow the same process as all other delegates.

189. According to one respondent, all services in the scope of Section A of the Annex to CSDR (i.e. core services under CSDR) should be considered as non-delegated services.

190. Several other respondents were of the opinion that CSDs should be considered delegates only when they act in a capacity of Investor CSD. For these respondents it should be clarified that issuer CSDs are not delegates /sub-delegates of the depositary as opposed to investor CSDs, by introducing such distinction in the relevant articles of the AIFMD and UCITS directives or in associated regulation and they suggest that “appropriate language is provided in ESMA report RTS 2015/1457 page 15” (i.e., ‘investor CSD’ means a CSD that is a participant in the securities settlement system operated by another CSD or that uses an intermediary that is a participant in the securities settlement system operated by another CSD in relation to a securities issue).

191. One respondent pointed out that investor CSDs, being in commercial competition with depositaries and their delegates (i.e. global custodians), ought to be treated as “delegates” under UCITS/AIFMD rules in a number of very clear and prescribed circumstances in the absence of a comparable and harmonised liability regime for CSDs.

192. Several respondents mentioned that CSDs should be considered delegates when they act in a capacity of Investor CSD but only in links that are intermediated by non-SSS entities (i.e. direct links out of the scope of the delegation):

- Those CSDs providing access to other CSDs using links that are intermediated by non-SSS entities could be classified as delegation arrangements; and

- Those CSDs providing access to other CSDs using direct links between SSS entities should be classified as infrastructure access and not as delegation arrangements.

193. One respondent was of the view that CSDs should be regulated under the CSDR, rather than AIFMD and UCITS V, which are specific to AIF and UCITS entities. The CSDR is the best place to impose strict liability and a high standard of investor protection. This should level the playing field for global custodians without creating uncertainty regarding the issuer/investor CSD distinction.

194. In addition to the main issue concerning when CSDs fall in the scope of the delegation, several respondents raised the issue concerning the potential liability gap between CSDs and custodians. Some respondents argued that there is a liability gap and that CSDs should assume an equivalent high standard of liability for loss of securities. For these respondents even if the CSDR RTS already set out detailed measures designed to ensure the integrity of the issue, the frequency and amount of reconciliations and the quality of the links between CSDs, no explicit provision regarding CSDs' liability for loss of assets is included in the draft CSDR Level 2 RTS.

195. Where UCITS/AIF's securities are "lost" at the level of an appointed CSD agent and the latter is not clearly recognised as a "delegate" under the current UCITS/AIFMD framework given that it is also considered as an "issuer" CSDs for other securities than those belonging to the UCITS/AIF fund, the fund depositary may avail itself of the opportunity to prove that such loss has resulted from "an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary". Where such test is convincingly proven and in the absence of any eventual guarantees (in the form of privately negotiated general terms and conditions), a regulatory loophole would exist, implying fund end-investors would potentially not be able to claim any liability against the depositary. Such outcome would contravene the spirit and the EU legislators' original rationale behind the depositary requirements under both UCITS and AIFM frameworks.

196. Other respondents argued that there is no such liability gap and that allowing for a transfer of liability to CSDs under the delegation of custody regime in the AIFMD and/or UCITS would not be appropriate and would not enhance investor protection. Specifically, these respondents were of the view that a loss at an Investor CSD cannot be considered an external event, and hence the depositary is always liable.

Annex II

Summary of the Insolvency Roundtable

1. On 14 September 2016, ESMA gathered at its premises a number of insolvency experts (both academics and practitioners) and representatives of national competent authorities in order to discuss asset segregation and investor protection in the event of insolvency.
2. The discussions are summarised below.

Introductory presentation

An academic gave an introductory presentation on Asset Segregation and Custodian Insolvency. The main messages of the presentation were as follows:

- there is no investor protection without both adequate legal and operational infrastructure;
- there are legal impediments to investor protection, i.e. non-harmonised insolvency law and property law;
- segregation gives no better priority in insolvency yet adequate administration is essential.

Asset segregation – investor protection in the event of insolvency

Participants (both insolvency experts and representatives of national competent authorities) had a number of exchanges on the introductory presentation and, more generally, on the insolvency-related aspects of asset segregation.

Comments made included the following:

- An academic mentioned that the added value of segregation is not sure, the key aspect being following property rights and identifying the relevant assets. Another academic was of the view that a legal regime may not be sufficient if the relevant rules are not applied in practice.
- An insolvency practitioner was of the view that operational segregation only is not sufficient and echoed the view that legal protection is not sufficient without appropriate operational arrangements.
- The same insolvency practitioner mentioned that if the rules on operational segregation are not complied with, clients are treated as unsecured creditors.

- Another insolvency practitioner argued that physical segregation makes sense when dealing with physical assets, not when dealing with dematerialised securities (only IT codes in all cases).
- An academic was of the view that record keeping is very important and different from account segregation.
- An insolvency practitioner mentioned that when considering a prime broker, there is no mean to assess what happens to assets subject to securities lending or collateral arrangements.
- Two experts argued that through sound recordkeeping at all levels in omnibus account one should be in a position to reconcile positions back to individuals.
- An academic considered that operational segregation and recordkeeping are necessary but would not be sufficient: consideration should also be given to the relevant civil law. Precise bookkeeping is more important than segregation, i.e. what matters is that at all levels records are kept.
- An insolvency practitioner mentioned that AIF client assets from multiple depositaries should not be included in the same account. In case of insolvency of a depositary, it would be uncertain which parties could access an omnibus account. Three other experts mentioned that segregation is almost irrelevant from a legal point of view to the extent that assets are properly identified throughout the custody chain.
- While considering the diagram under Q5 a) of the ESMA call for evidence, a couple of experts were of the view that the assets of Depository 1 and Depository 2 would have to be kept separate at the level of the Delegate, but not necessarily at the further levels in the custody chain (sub-delegate, CSD).

Participants also exchanged views on the Lehman case and the document from an auditor on asset segregation which was shared with them in view of the roundtable. Remarks from insolvency experts included the following:

- Although the Lehman administration is still under way, the vast majority of securities and cash were returned to depositors within the first few years.
- In the Lehman case timing represented a problem in identifying the assets; transactions were done on a T+3 basis.
- Different levels of segregation would not have made any difference in the Lehman case. Difficulty also lay in the complexity of the relationships between various Lehman entities.

- If client assets of Lehman had not been commingled with Lehman's assets, this would have made a difference.
- In the Lehman case it was a matter of omnibus accounts in which Lehman had securities, not Lehman's omnibus accounts. It may have been uncertain on which part of the account Lehman had ownership rights.
- The relationships between Lehman and its sub-custodians were frozen at both levels.

Annex III

Provisions on asset segregation which may be deemed as equivalent under AIFMD and UCITS V

<u>AIFMD</u>	<u>UCITS Directive</u>
<p>Art. 21(8)(a)</p> <p>8. The assets of the AIF or the AIFM acting on behalf of the AIF shall be entrusted to the depositary for safe-keeping, as follows:</p> <p>(a)for financial instruments that can be held in custody:</p> <p>(i)the depositary shall hold in custody all financial instruments that can be registered in a financial instruments account opened in the depositary’s books and all financial instruments that can be physically delivered to the depositary;</p> <p>(ii)for that purpose, the depositary shall ensure that all those financial instruments that can be registered in a financial instruments account opened in the depositary’s books are registered in the depositary’s books within segregated accounts in accordance with the principles set out in Article 16 of Directive 2006/73/EC, opened in the name of the AIF or the AIFM acting on behalf of the AIF, so that they can be clearly identified as belonging to the AIF in accordance with the applicable law at all times;</p>	<p>Art. 22(5)(a)</p> <p>5. The assets of the UCITS shall be entrusted to the depositary for safekeeping as follows:</p> <p>(a) for financial instruments that may be held in custody, the depositary shall:</p> <p>(i) hold in custody all financial instruments that may be registered in a financial instruments account opened in the depositary’s books and all financial instruments that can be physically delivered to the depositary;</p> <p>(ii) ensure that all financial instruments that can be registered in a financial instruments account opened in the depositary’s books are registered in the depositary’s books within segregated accounts in accordance with the principles set out in Article 16 of Directive 2006/73/EC, opened in the name of the UCITS or the management company acting on behalf of the UCITS, so that they can be clearly identified as belonging to the UCITS in accordance with the applicable law at all times;</p>
<p>Art. 21(11) first paragraph</p>	<p>Art. 22a (1)</p>

<p>The depositary shall not delegate to third parties its functions as described in this Article, save for those referred to in paragraph 8.</p>	<p>The depositary shall not delegate to third parties the functions referred to in Article 22(3) and (4).</p>
<p>Art. 21(11)(d)(iii)</p> <p>The depositary may delegate to third parties the functions referred to in paragraph 8 subject to the following conditions:</p> <p>(d) the depositary ensures that the third party meets the following conditions at all times during the performance of the tasks delegated to it:</p> <p style="padding-left: 40px;">(iii) 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 they can at any time be clearly identified as belonging to clients of a particular depositary;</p>	<p>Art. 22a (3)(c)</p> <p>3. The functions referred to in Article 22(5) may be delegated by the depositary to a third party only where that third party at all times during the performance of the tasks delegated to it:</p> <p>(c) segregates the assets of the clients of the depositary from its own assets and from the assets of the depositary in such a way that they can, at any time, be clearly identified as belonging to clients of a particular depositary;</p>
<p>Art. 21(11)(d)(v)</p> <p>The depositary may delegate to third parties the functions referred to in paragraph 8 subject to the following conditions:</p> <p>(d) the depositary ensures that the third party meets the following conditions at all times during the performance of the tasks delegated to it:</p> <p>(v) the third party complies with the general obligations and prohibitions set out in paragraphs 8 and 10.</p>	<p>Art. 22a (3)(e)</p> <p>3. The functions referred to in Article 22(5) may be delegated by the depositary to a third party only where that third party at all times during the performance of the tasks delegated to it:</p> <p>(e) complies with the general obligations and prohibitions laid down in Article 22(2), (5) and (7) and in Article 25.</p>
<p>Art. 21(11) penultimate paragraph</p>	<p>Art. 22a ultimate paragraph</p>

<p>The third party may, in turn, sub-delegate those functions, subject to the same requirements. In such a case, paragraph 13 shall apply mutatis mutandis to the relevant parties.</p>	<p>The third party may, in turn, sub-delegate those functions, subject to the same requirements. In such a case, Article 24(2) shall apply mutatis mutandis to the relevant parties.</p>
<p><u>AIFMR</u></p>	<p><u>UCITS V Regulation</u></p>
<p>Art. 89(1)</p> <p>1. In order to comply with the obligations laid down in point (a) of Article 21(8) of Directive 2011/61/EU with respect to financial instruments to be held in custody, a depositary shall ensure at least that:</p> <ul style="list-style-type: none"> (a) the financial instruments are properly registered in accordance with Article 21(8)(a)(ii) of Directive 2011/61/EU; (b) records and segregated accounts are maintained in a way that ensures their accuracy, and in particular record the correspondence with the financial instruments and cash held for AIFs; (c) reconciliations are conducted on a regular basis between the depositary's internal accounts and records and those of any third party to whom custody functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU; (d) due care is exercised in relation to the financial instruments held in custody in order to ensure a high standard of investor protection; (e) all relevant custody risks throughout the custody chain are assessed and monitored and the AIFM is informed of any material risk identified; (f) adequate organisational arrangements are introduced to minimise the risk of loss or diminution of the financial instruments, or of rights in connection with those financial instruments as a result of fraud, poor administration, inadequate registering or negligence; (g) the AIF's ownership right or the ownership right of the AIFM acting on behalf of the AIF over the assets is verified. 	<p>Art. 13(1)</p> <p>1. A depositary shall be deemed to comply with the requirements set out in point (a) of Article 22(5) of Directive 2009/65/EC with respect to financial instruments to be held in custody where it ensures that:</p> <ul style="list-style-type: none"> (a) the financial instruments are properly registered in accordance with Article 22(5)(a)(ii) of Directive 2009/65/EC; (b) records and segregated accounts are maintained in a way that ensures their accuracy, and in particular record the correspondence with the financial instruments and cash held for UCITS; (c) reconciliations are conducted on a regular basis between the depositary's internal accounts and records and those of any third party to whom safekeeping has been delegated in accordance with Article 22a of Directive 2009/65/EC; (d) due care is exercised in relation to the financial instruments held in custody in order to ensure a high standard of investor protection; (e) all relevant custody risks throughout the custody chain are assessed and monitored and the management company or the investment company is informed of any material risk identified; (f) adequate organisational arrangements are introduced to minimise the risk of loss or diminution of the financial instruments, or of rights in connection with those financial instruments as a result of fraud, poor administration, inadequate registering or negligence; (g) the UCITS's ownership right or the ownership right of the management company acting on behalf of the UCITS over the assets is verified.

<p>Art. 89(2)</p> <p>Where a depositary has delegated its custody functions to a third party in accordance with Article 21(11) of Directive 2011/61/EU, it shall remain subject to the requirements of points (b) to (e) of paragraph 1 of this Article. It shall also ensure that the third party complies with the requirements of points (b) to (g) of paragraph 1 of this Article and the segregation obligations laid down in Article 99.</p>	<p>Art. 13(2)</p> <p>Where a depositary has delegated its safekeeping functions, with regard to assets held in custody, to a third party in accordance with Article 22a of Directive 2009/65/EC, it shall remain subject to the requirements of points (b) to (e) of paragraph 1 of this Article. The depositary shall also ensure that the third party complies with the requirements of points (b) to (g) of paragraph 1 of this Article.</p>
<p>Art. 99(1) (a) to (d)</p> <p>1. Where safekeeping functions have been delegated wholly or partly to a third party, a depositary shall ensure that the third party, to whom safe-keeping functions are delegated pursuant to Article 21(11) of Directive 2011/61/EU, acts in accordance with the segregation obligation laid down in point (iii) of Article 21(11)(d) of Directive 2011/61/EU by verifying that the third party:</p> <ul style="list-style-type: none"> (a) 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 its own assets, assets of its other clients, assets held by the depositary for its own account and assets held for clients of the depositary which are not AIFs; (b) maintains records and accounts in a way that ensures their accuracy, and in particular their correspondence to the assets safe-kept for the depositary's clients; (c) conducts, on a regular basis, reconciliations between its internal accounts and records and those of the third party to whom it has delegated safe-keeping functions in accordance with the third subparagraph of Article 21(11) of Directive 2011/61/EU; (d) introduces adequate organisational arrangements to minimise the risk of loss or diminution of financial instruments or of rights in connection 	<p>Art. 16(1) (a) to (d)</p> <p>1. Where safekeeping functions have been delegated wholly or partly to a third party, a depositary shall ensure that the third party to whom safekeeping functions are delegated pursuant to Article 22a of Directive 2009/65/EC acts in accordance with the segregation obligation laid down in point (c) of Article 22a(3) of Directive 2009/65/EC by verifying that the third party:</p> <ul style="list-style-type: none"> (a) keeps all necessary records and accounts to enable the depositary at any time and without delay to distinguish assets of the depositary's UCITS clients from its own assets, assets of its other clients, assets held by the depositary for its own account and assets held for clients of the depositary which are not UCITS; (b) maintains records and accounts in a way that ensures their accuracy, and in particular their correspondence to the assets safe-kept for the depositary's clients; (c) conducts, on a regular basis, reconciliations between the depositary's internal accounts and records and those of the third party to whom it has sub-delegated safekeeping functions in accordance with the third subparagraph of Article 22a(3) of Directive 2009/65/EC; (d) introduces adequate organisational arrangements to minimise the risk of loss or diminution of financial instruments or of rights in connection with

<p>with those financial instruments as a result of misuse of the financial instruments, fraud, poor administration, inadequate record-keeping or negligence;</p>	<p>those financial instruments as a result of misuse of the financial instruments, fraud, poor administration, inadequate record-keeping or negligence;</p>
<p>Art. 99(3)</p> <p>Paragraphs 1, and 2 shall apply mutatis mutandis when the third party, to whom safe-keeping functions are delegated in accordance with Article 21(11) of Directive 2011/61/EU, has decided to delegate all or part of its safe-keeping functions to another third party pursuant to the third subparagraph of Article 21(11) of Directive 2011/61/EU.</p>	<p>Art. 16(2)</p> <p>Paragraph 1 shall apply mutatis mutandis when the third party, to whom safekeeping functions are delegated in accordance with Article 22a of Directive 2009/65/EC, has decided to sub-delegate all or part of its safekeeping functions to another third party pursuant to the third subparagraph of Article 22a(3) of Directive 2009/65/EC.</p>

Annex IV

Summary of the AIFMD/UCITS Directive provisions on asset segregation and delegation requirements in comparison with the CSDR framework

AIFMD / UCITS	CSDR
Asset Segregation Requirements	
<p>At the delegate level, there should be three different segregated accounts per depositary as follows:</p> <ul style="list-style-type: none"> - Own assets of the delegate; - Own assets of the depositary; and - Assets of the depositary's clients. <p>At the sub-delegate level, there should be three different segregated accounts per delegate as follows:</p> <ul style="list-style-type: none"> - Own assets of the sub-delegate; - Own assets of the delegate; - Assets of the delegate's clients. 	<p>Article 38(3)-(5) of CSDR enables participants of a CSD to choose between holding the securities that belong to different clients in one securities account (omnibus client segregation) or segregate the securities of any of its clients (individual client segregation). Thus the participant chooses the level of asset segregation. In this respect, CSDs and their participants are required to provide for both omnibus client segregation and individual client segregation (as clarified by recital 42 of CSDR).</p> <p>The minimum asset segregation requirements are compatible with CSDR and therefore can be implemented by the investor CSD in its capacity as a delegate of the depositary.</p>
Delegation of Custody	
<i>Due Diligence</i>	
<i>Ex-ante D.D.</i>	
<p><u>Level 1 - Article 21(11)(a) to (c) of AIFMD (as implemented by Article 98(2) of the AIFMR) and Article 22a(2)(a) to (c) of UCITS V Directive (as implemented by Article 15(2) of the UCITS V Regulation)</u></p> <p>The depositary may delegate to third parties the safekeeping functions only where:</p>	CSDR Considerations
<ul style="list-style-type: none"> - the tasks are not delegated with the intention of avoiding the requirements laid down in this Directive; 	To be determined by the depositary.

<ul style="list-style-type: none"> - the depositary can demonstrate that there is an objective reason for the delegation; 	To be determined by the depositary.
<ul style="list-style-type: none"> - the depositary has exercised all due skill, care and diligence in the selection and the appointment of any third party to whom it intends to delegate parts of its tasks [...]. 	In performing due diligence on a potential delegate investor CSD, it might be reasonable for a depositary to confirm and place reliance upon the delegate investor CSD's authorisation under the CSDR or equivalent. This can be confirmed by reference to the CSD register under Article 21 of CSDR.
<i>On-going D.D.</i>	
<p><u>Level 1 - Article 21(11)(c) and (d) of AIFMD (as implemented by Article 98(3) of the AIFMR) and Article 22a(2)(c) and 22a(3) of UCITS V Directive (as implemented by Article 15(3) of the UCITS V Regulation)</u></p>	CSDR Considerations
<p>The depositary may delegate to third parties the safekeeping functions only where:</p>	
<ul style="list-style-type: none"> - the depositary [...] continues to exercise all due skill, care and diligence in the periodic review and ongoing monitoring of any third party to which it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it. 	
<p>The functions may be delegated by the depositary to a third party only where that third party at all times during the performance of the tasks delegated to it:</p>	
<ul style="list-style-type: none"> - has structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the UCITS / AIF or the management company acting on behalf of the UCITS / AIF which have been entrusted to it; 	<p>In assessing structures and expertise, it might be reasonable for a depositary to take into account the CSD's authorisation under CSDR or equivalent.</p> <p>According to Article 26(1) of CSDR, a CSD shall have robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective</p>

processes to identify, manage, monitor and report the risks to which it is or might be exposed, and adequate remuneration policies and internal control mechanisms, including sound administrative and accounting procedures. According to para. (2) of the same Article, a CSD shall adopt policies and procedures which are sufficiently effective so as to ensure compliance with CSDR, including compliance of its managers and employees with all the provisions of CSDR.

According to Article 27(1) of CSDR, the senior management of a CSD shall be of sufficiently good repute and experience so as to ensure the sound and prudent management of the CSD. According to para. (2) of the same Article, A CSD shall have a management body of which at least one third, but no less than two, of its members are independent.

Article 29 of CSDR on record keeping obliges a CSD to maintain, for a period of at least 10 years, all its records on the services and activities, including on the ancillary services, so as to enable the competent authority to monitor the compliance with the requirements under CSDR.

Article 53 of the EC Delegated Regulation on CSD Requirements adds that the record keeping system shall ensure that all of the following conditions are met: (a) each key stage of the processing of records by the CSD may be reconstituted, (b) the original content of a record before any corrections or other amendments may be recorded, traced and retrieved, (c) measures are put in place to prevent unauthorised alteration of records, (d) measures are put in place to ensure the security and confidentiality of the data recorded, (e) a mechanism for identifying and correcting errors is incorporated in the record keeping system, and (f) the timely recovery of the records in the case of a system failure is ensured within the record keeping system.

<ul style="list-style-type: none"> - for custody tasks, is subject to: <ul style="list-style-type: none"> (i) effective prudential regulation, including minimum capital requirements, and supervision in the jurisdiction concerned; (ii) an external periodic audit to ensure that the financial instruments are in its possession; 	<p>In assessing regulation and auditing requirements, it might be reasonable for a depositary to take into account the CSD's authorisation under CSDR or equivalent.</p> <p>See above - Article 47(1) and Article 54 of CSDR address prudential regulation and capital requirements for CSDs.</p> <p>Article 22 of CSDR obligates the competent authority to review the arrangements, strategies, processes and mechanisms implemented by a CSD in order to comply with CSDR. This is carried out at least on an annual basis.</p>
<ul style="list-style-type: none"> - segregates the assets of the clients of the depositary from its own assets and from the assets of the depositary in such a way that they can, at any time, be clearly identified as belonging to clients of a particular depositary; 	<p>In assessing asset segregation, it might be reasonable for a depositary to take into account the CSD's authorisation under CSDR or equivalent.</p> <p>Article 38(2) of CSDR stipulates that a CSD must keep records and accounts that enable any participant to segregate the securities of the participant from those of the participant's clients. This implies that a participant of a CSD is obliged to segregate its own securities from those of its clients.</p>
<ul style="list-style-type: none"> - takes all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS / AIF held by the third party in custody are unavailable for distribution among, or realisation for the benefit of, creditors of the third party; and 	<p>In assessing asset segregation, it might be reasonable for a depositary to take into account the CSD's authorisation under CSDR or equivalent.</p> <p>Article 38(6) of CSDR stipulates that CSDs and their participants shall publicly disclose the levels of protection and the costs associated with the different levels of segregation that they provide and shall offer those services on reasonable commercial terms. Details of the different levels of segregation have to include a description of the main legal implications of the respective levels of segregation offered, including information on the insolvency law applicable in the relevant jurisdiction.</p>

<p>- in the case of UCITS, complies with the general obligations and prohibitions laid down in Article 22(2), (5) and (7) of Directive 2009/65/EC.</p>	<p>According to Article 38(7) of CSDR, a CSD shall not use for any purpose securities that do not belong to it. A CSD may however use securities of a participant where it has obtained that participant's prior express consent. The CSD shall require its participants to obtain any necessary prior consent from their clients.</p>
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