European Commission Public Consultation on the Review of the Alternative Investment Fund Managers Directive (AIFMD) – Investor Protection

Submission of the Association of Global Custodians – European Focus Committee (AGC-EFC), 29th January 2021 – Summary and Extract

Executive summary of the AGC-EFC response

1. The European Commission is encouraged to address three broad priorities:

- clarifying the distinction between "financial instruments that can be held in custody" and "other assets"
- clarifying the application of "look-through" requirements to fund-of-funds, master-feeders and other structures in which an AIF invests
- clarifying certain depositary "delegation" requirements to better align with how financial instruments are "held in custody", and by whom

2. For the purpose of clarifying depositary delegation requirements involving ("Third-party Collateral Managers" or "TCMs"), the AGC-EFC recommends focusing on key attributes of TCM-provided services that materially affect how depositaries carry out their responsibilities under the AIFMD. TCM-provided services are characterized by the absolute need for the TCM to retain exclusive control over the disposition of the relevant assets (subject to relevant contractually-imposed constraints with the AIFMs and/or depositaries appointing them): this is for a combination of operational, risk and legal reasons, which are more fully explained in the attached annex. Consequently, TCMs necessarily maintain the definitive record (the "golden source") of custody of the relevant financial instruments of the AIF.

3. The AGC-EFC's recommends focusing on how depositaries can register AIF financial instruments in a financial instruments account so that they can be clearly identified as belonging to the AIF in compliance with the delegation requirements. Further clarification could be set out in Level 3 guidance without the need to amend Level 1 or Level 2. Alternatively, TCM arrangements could be treated as outside of the scope of "delegation" altogether if the Commission were to provide for an approach akin to Art. 36.1(a) for non-EEA AIFs.

5. Recognition is needed that it is not possible for the Depositary to implement true "independent reconciliations" of its books and records against the TCM's books and records. The TCM "owns" the instruction flow of individual deliveries of substitutions of collateral assets to and from a Collateral Receiver account.

6. Depositaries should be able to leverage existing reconciliation processes - and related reporting - at the level of the delegate itself provided that the depositary undertakes appropriate oversight and due diligence of the TCM. Frequency should be linked to settlement activity at the position level but no more frequently than on an end-of-day basis.

Executive summary of the response - continued

7. PB arrangements – like TCM arrangements – can be established in compliance with existing depositary delegation requirements under AIFMD. Alternatively, these arrangements could be treated as outside of the scope of "delegation" altogether if the Commission were to provide for an approach akin to Art. 36.1(a) for non-EEA AIFs.

8. Potential benefits and risks associated with the introduction of the depositary passport include: home and host application of supervisory authority; questions surrounding applicable law for holding of assets by Depositaries domiciled in different states from the AIFs; effect of cross border changes of AIF depositaries; cross border application of organisational/operational process rules; cross border risk awareness by investors/depositaries; additional complexities that might arise across up to three jurisdictions; one for each of the AIF, Depositary and AIFM (who might also be relying on a passport).

9. Investor CSDs should be treated as delegates of the depositary. On any basis despite revisions to the legislation intended to clarify treatment of investor CSDs, uncertainty persists in the industry regarding whether delegation requirements should apply. This uncertainty is untenable. We prefer having clarity and certainty one way or the other.

Index

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Introduction

AGC-EFC members constitute depositaries, global custodians and sub-custodians: we support the needs of our clients whilst complying with our legal and regulatory obligations, which include prudential risk standards designed to ensure that our member firms - who in the main are credit institutions - do not create systemic risk. In addition, as securities custodians and bank groups, we are conscious of the EU's investor protection objectives: these have always been core objectives of our members as well.

As service providers, we do not believe we are well placed to speak to the effectiveness of the AIFMD writ large and we defer to other survey participants who are better placed to do so: however, we remain committed to ensuring the effectiveness of AIFMD by participating in efforts such as these by the Commission.

We are conscious that our roles are crucially important to achieve the EU's investor protection and other objectives with AIFMD. We are responding to this Consultation with this in mind, but we hasten to remind the Commission that our members are subject to other objectives designed to ensure our members do not take undue risks as credit institutions (or their subsidiaries).

Note on annex

This response includes additional explanatory background to support answers to questions contained as an annex – post.

Response

AIFMD Consultation – Depositary issues

b) Depositary regime

Question 24. What difficulties, if any, the depositaries face in exercising their functions in accordance with the AIFMD? Please provide your answer by giving concrete examples identifying any barriers and associated costs.

The AGC-EFC encourages the Commission to address three broad priorities which in our view have not been addressed satisfactorily:

1. The distinction between "financial instruments that can be held in custody" and "other assets"

   Whilst the Commission in the past has attempted to provide clarity regarding the dividing line between "financial instruments" that "can be held in custody" pursuant to AIFMD Level 1 Art. 21.8(a) and "other assets" of an AIF as described in Art. 21.8(b) significant concerns remain around the ambiguity of applying this distinction in practice. For many types of assets this test is not problematic, but for some it is, and it is likely to be increasingly problematic as investment strategies and types of holdings evolve with technology and changing investor demand

   A particularly difficult example is an investment by an AIFM on behalf of the AIF in underlying collective investment schemes ("funds") and other vehicles. Requirements and consequences that arise differ considerably depending on whether such an investment is considered a "financial instrument that may be held in custody" or an "other asset". AGC-EFC members are grateful for previous Commission and ESMA efforts (discussed in the attached uploaded annex to our submission) to arrive at a workable dividing line for these types of holdings that is in accordance with text of the legislation. However, we do not believe these efforts have been satisfactorily concluded. We recommend solutions in the attached annex to this submission.

2. Application of "look-through" requirements to fund-of-funds, master-feeders and other structures in which an AIF invests

   The so-called "look-through" requirements themselves – applicable to "fund-of-fund and master-feeder" investments by an AIF - also require further clarification. The relevant concept that better addresses the depositary's ability to and means of protecting investors in this context is "control". The AGC-EFC's members have long taken the view that the only sensible approach in keeping with public authorities' goals is to require "look-through" requirements where an AIF "controls" the underlying fund by referring to objective criteria such as accounting standards. Our rationale is set out in the attached uploaded annex to our submission, where we also propose a clear articulation of "control" in the Level 2 Regulation at Art. 88.2 or in Level 3 guidance.

3. Clarifying "delegation" requirements to better align with how financial instruments are "held in custody", and by whom

   More broadly, even where it is clear that "financial instruments are "held in custody" questions remain regarding the impact of "delegation" of custody. These questions emerged especially during discussions surrounding the adoption and implementation of the AIFMD Delegated Regulation of 12 July 2018 (the "2018 Amendments") (which took effect April 2020) regarding the applicability of "books and records" requirements referenced at Level 1 Art. 21.8(a)(ii) where the depositary has "delegated" custody. Article 89 paragraph 2 of Delegated Regulation 231/2013 (the "Level 2 Regulation") at the time was amended to clarify that on "delegation" of custody of financial instruments in accordance with Level 1 Art. 21(11), the depositary is still required to comply with Level 1 Art 21.8(a)(ii), but not with Level 1 Art. 21.8(a)(i). In other words, "books and records" or recordkeeping would still need to be maintained by the depositary, but not necessarily "custody" as described in Level 1 Art. 21.8(a)(i): this raised questions about: (i) who holds the custody of those financial instruments under applicable national law and, (ii) how the depositary would satisfy is various responsibilities under Level 2 Art. 89 where – as this the case for TCM and PB arrangements described below - the "delegate" necessarily becomes the "golden source" of the custody record.

   It is important that requirements around delegation conform to the operational and legal realities of where "custody" (as the dispositive – or "golden" - record) actually resides. Our recommendation for achieving this needed clarity is set out in the attached annex to this submission.

Question 25. Is it necessary and appropriate to explicitly define in the AIFMD tri-party collateral management services?

No opinion.

Question 25.1 Please explain your answer to question 25:

The AGC-EFC recommends focusing on the attributes of tri-party collateral management provided by third parties ("Third-party Collateral Managers" or "TCMs") that materially affect how depositaries carry out their responsibilities under the legislation. The defining attribute of a TCM-provided service is characterized by the absolute need for the TCM to retain exclusive control over the disposition of the relevant assets (subject to relevant contractually-imposed constraints with AIFMs and/or depositaries): this is for a combination of operational, risk and legal reasons, which are more fully explained in the attached annex to this submission.

An advantage of a more clearly defined role of TCMs is that this recognize that TCMs necessarily maintain the definitive record (the "golden source") of custody of the ***relevant*** financial instruments of the AIF (i.e., those financial instruments that are delivered or maintained by it subject to the contractually-agreed collateral arrangements over which it

retains exclusive authority). This in turn helps clarify the role and responsibilities of depositaries, which as we have long pointed out, fully comply with the legislation, including with the recent 2018 Amendments, as they relate to depositary "books and records" and "reconciliation" requirements. The advantage is clarity for all parties – including investors – regarding where key responsibilities reside while preserving the efficacy, efficiency and safety of these arrangements, which in part depend on speed, resiliency and straight-through or automated processing. We explain the necessity and the interrelationship of these factors by describing the relevant structural arrangements, focusing on operational and process flows and legal considerations, in the attached annex to this submission.

We believe that by defining and setting out parameters that are relevant to TCM-provided arrangements – perhaps in Level-3 guidance – may help to clarify compliance with existing "delegation" requirements under AIFMD. Alternatively, if this approach is not preferred, these arrangements could be treated as outside of the scope of "delegation" altogether if the Commission were to provide for an approach akin to Art. 36.1(a) for non-EEA AIFs: this approach permits "one or more entities" to carry out the duties set out in Art. 21(8). This approach would ensure that both EEA and non-EEA AIFs operate consistently with each other and would better align with how TCMs operate in practice.

Please refer to the attached uploaded paper we have prepared explaining in detail the relevant attributes and process flows as well as the legal assumptions underlying them.

Question 26. Should there be more specific rules for the delegation process, where the assets are in the custody of tri-party collateral managers?

Yes.

Question 26.1 Please explain your answer to question 26, presenting benefits and disadvantages of your suggested approach as well as potential costs of the change, where possible:

As noted previously, we believe any further clarification could be provided in Level 3 guidance without further amendments at Level 1 or Level 2 in order to ensure that AIFMD delegation requirements are attuned – where warranted – to the operational, risk and legal realities surrounding TCM arrangements. Ensuring there is no "gap" requires a clear understanding of the roles and responsibilities of TCMs versus depositaries, which we seek to explain in the attached annex to this submission.

TCM arrangements are different other "traditional" custodial arrangements over which depositaries have responsibility: in these arrangements, there are no instructions transmitted throughout the day (intra-day) to or from a depositary/global custodian that might affect disposition of assets at the TCM unless, as permitted in some cases, the global depositary/custodian has unilateral authority to terminate the arrangement and withdraw the AIFs assets from the arrangement entirely. As explained in the annex attached to this submission, the TCM necessarily retains ***exclusive control*** under "standing" authority, subject to any contractual constraints.

Detailed relevant guidance regarding a depositary's responsibility to regarding "delegation" actually is already set out in AIFMD Level 1: Art. 21(8)(a)(ii) – which applies pursuant to Level 2 Art. 89.2 when a depositary delegates the custody of financial instruments - requires a depositary to "ensure that all those financial instruments ... are registered in the depositary's books within segregated accounts ***in accordance with the principles set out in Article 16 of [MiFID]"*** (emph. added).

The applicable text (which replaced MiFID Article 16) is MiFID II Article 2.1, which specifies certain obligations falling on MiFID firms holding or controlling client financial instruments. Among these are *inter alia.* obligations to *"maintain their records and accounts in a way that ensures their accuracy, and in particular their correspondence to the financial instruments and funds held for clients and that they may be used as an audit trail"* as well as to *"conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held".*

Similar to the AIFMD, a MiFID firm is required to maintain its own "internal accounts and records" even if the relevant financial instruments are actually held ("deposited") with a third-party.

Therefore, whilst a Depositary is required to "properly register" financial instruments held with TCMs in the Depositary's books in accordance with Article 21(8)(a)(ii) and maintain separate records of them pursuant to Art. 89.1, a proper understanding of TCM-provided services and roles makes it clear that the Depositary would utilise information ***provided by TCMs*** in establishing and maintaining these books and records (similar to the MiFID approach).

A Depositary would be expected to identify accurately in its records settled positions of financial instruments held in custody: settled positions are determined on an end-of-day basis. Consequently, since the TCM (or its third-party custodian) maintains the "golden source", there is no purpose in trying to construct a separate Depositary record of financial instruments based on individual movements and settlements: the only place that this occurs with dispositive effect is at the TCM (or its custodian).

Depending on the type of TCM arrangement, depositaries may not themselves be within the custody chain (per national law): a depositary therefore should be expected to create and maintain a record of financial instruments based on end-of-day settled position information from the TCM(s) themselves or other sources deemed appropriate, provided that it the depositary undertakes appropriate oversight and due diligence of the TCM.

Authority is given to a TCM to hold the assets under security arrangements in favour of the relevant (secured) counterparty. Depending on the particularities of such arrangements, TCMs may have "standing" authorization to transfer financial instruments "from" or "to" the AIF depending on collateral delivery (e.g., "mark-to-market") requirements. Accordingly, ***no separate individualised instructions*** are provided to the TCM by any other party, including by the AIFM. The Depositary relies on end of day custody reports from the TCM.

Alternatively, these arrangements could be treated as outside of the scope of "delegation" altogether if the Commission were to provide for an approach akin to Art. 36.1(a) for non-EEA AIFs: this approach permits "one or more entities" to carry out the duties set out in Art. 21(8), ensuring that both EEA and non-EEA AIFs operate consistently with each other and aligning with how TCMs operate in practice.

Please refer to the annex attached to this submission for a more complete explanation of TCM operational and legal attributes of and process flows.

Question 27. Where AIFMs use tri-party collateral managers' services, which of the aspects should be explicitly regulated by the AIFMD?

Third-party collateral managers ("TCMs") – who hold fund assets as collateral in connection with Repo, OTC derivatives, securities lending or margin – ultimately are appointed pursuant to the direction or consent of the AIFM. AIFMs (or portfolio managers appointed by AIFMs) enter into these arrangements – or direct depositaries to enter into them - in order to gain access to instruments, strategies or financing provided by the counterparties. As far as the TCM is concerned, full authority to instruct is vested in the counterparties who appoint it (or, in some cases, the depositaries where the AIFM permits it).

As a result, and as explained above, it is appropriate to consider assets of the fund held with TCMs that are subject to "collateral" arrangements as outside the immediate control of the depositary. This view currently is entirely consistent with the way in which the AIFMD Level 2 Regulation addresses "delegation" since Level 2 Art. 89.2 expressly does not require a depositary to consider financial instruments that are subject to the delegation arrangement as "held in [its] custody" per Level 1 Art. 21.8(a)(i). Therefore, the sole focus should be on compliance ultimately with Art. 21.8(a)(ii), which, as noted above, prescribes how the depositary is supposed to register the financial instruments "in the depositary's books within segregated accounts in accordance with the principles set out in" the relevant provisions of MiFID "so that they can be clearly identified as belonging to the AIF in accordance with the applicable law at all times". Our response to Q.25.1 recommends definition around TCM-provided arrangements, and our response to Q.26.1 recommends possible additional guidance around delegation to TCMs, in order to ensure an appropriate framework for depositaries to comply with their own responsibilities under the AIFMD.

If TCMs are considered "delegates", the mutatis mutandis provisions of the legislation will apply to them. If our "alternative approach" were adopted (suggested in our previous responses) by which TCMs could be excluded as delegates altogether, the onus then should be placed on the AIFM to "ensure" such entities are duly appointed, with information about them provided to depositaries and supervisory authorities as required.

Please explain why you think the obligation for the asset manager to provide the depositary with the contract it has concluded with the tri-party collateral should be explicitly regulated manager by the AIFMD. Please present benefits and disadvantages of this approach as well as potential costs of the change, where possible:

The AGC-EFC would be supportive of requiring AIFMs to provide contracts that are concluded with TCMs in order to ensure all parties understand that relevant information contained in such contracts must be provided to the Depositary. This would especially be the case of TCM-provided arrangements might document parameters around collateral movements that would help depositaries anticipate "normal" – as opposed to "abnormal" – activities.

AGC-EFC members understand however that some elements of these contracts may be highly sensitive or proprietary, including with respect to information that may be linked to investment strategies, so confidentiality obligations around disclosure of sensitive information may be sensible.

Please explain why you think the flow of information between the tri-party collateral manager and the depositary should be explicitly regulated by the AIFMD Please present benefits and disadvantages of this approach as well as potential costs of the change, where possible:

The TCM performs all necessary asset servicing functions for the AIF that are normally associated with the "custody" function, including debiting and crediting relevant securities accounts (associated with settlement), processing income payments, facilitating payment and reclaims of withholding tax and facilitating the exercise of rights associated with the ownership of securities (e.g. corporate actions), and acting on the AIFM's instructions (e.g., trade instructions) in connection therewith. Most of these debits and credits on the books of the collateral manager mirror activity at the level of the CSD (T2S).

Because the AIF's financial instruments are held with TCMs (or any third-party custodians appointed by a TCM), either directly or via the depositary (depending on the particular arrangement), it is not possible in most cases to "first-register" them in custody accounts maintained by depositaries. As noted above, the records of any true custodial intermediary are continuously updated based on the result of settlement or asset servicing activity performed at the level of the relevant financial market infrastructure (CSD/T2S). Regulations such as CSDR and the SFD provide for a strict regulation of the timing of settlement finality and integrity of the issue, with the specific purpose of avoiding uncertainty or disputes. The governing principle is that the books and records of the CSD prevail in case of discrepancies. As a result, the "first register" is literally (and in all cases) the CSD: a key function of custody delegates is to ensure that their own books and records are updated in line with the changes effected at the level of the CSD.

Any separate set of books and records maintained at depositary level by definition would be based on the same output (i.e. settlement and asset servicing messages generated by the CSD) deriving from the TCM's custody record. Any discrepancy would be resolved by looking at the same source (CSD-generated confirmations).

Given the specific settlement instruction flow of TCM-provided arrangements, and the control the TCM retains over disposition of the collateral, it needs to be recognised therefore that it is not be possible for the Depositary to implement true "independent reconciliations" of the its books and records against the TCM's books and records. The TCM "owns" entirely the instruction flow of individual deliveries of substitutions of collateral assets to and from a

Collateral Receiver account: this is are described in more detail in the uploaded paper that we have attached to submission.

In view of the market infrastructure reality described above, the suggestion that a depositary should be "copied" or "intermediate" with regard to "information flow" between the AIFM and the collateral manager would introduce extensive new risks and confusion.

Please explain why you think the frequency at which the tri-party collateral manager should transmit the positions on a fund-by-fund basis to the depositary in order to enable it to record the movements in the financial instruments accounts opened in its books should be explicitly regulated by the AIFMD. Please present benefits and disadvantages of this approach as well as potential costs of the change, where possible:

In addition to setting out other requirements designed to ensure the accuracy of a depositary's books and records, AIFMD Level 2 Art. 89.1(c) provides that "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." The entry into force of the 2018 Amendments in 2020 introduced the obligation for the depositary to carry out this reconciliation "as often as necessary". Reconciliation is a key tool for validating positions that are maintained by two parties on the basis that each party has control over disposition of the assets and are empowered to communicate changes to this disposition to the other party: this is the essence of a "two-sided" reconciliation.

By way of example, a global custodian might accept a settlement instruction from its client, which is transmitted to a sub-custodian, and onward to a CSD. Conversely, a sub-custodian may be notified of a stock-split or some other activity, which is then transmitted to the global custodian, and onward to the client. There could be many instructions and notifications flowing in both directions every day with respect to such accounts. Both the sub-custodian's and the global custodian's records constitute "custody" accounts over which each has "control". Safety is assured through strict control of who has authority to instruct over these accounts. Instruction authority can only be vested in one other party, which is the client (the "account holder") unless standing authority is given to someone else, such as a collateral manager.

Instruction authority can never be vested in more than one other party. As a result, reconciliation is only meaningful if it is conducted against the records of a third-party whose own records are themselves dispositive, on the basis set out above.

TCM-provided arrangements are fundamentally different: in these arrangements, there are no instructions transmitted throughout the day (intra-day) to or from a "global custodian" (or depositary) that might affect disposition of assets at the TCM unless, as permitted in some cases, the global custodian/depositary has unilateral authority to terminate the arrangement and withdraw the AIFs assets from the arrangement entirely. It is also in the nature of TCM arrangements to effect movements of collateral without any individualized prior instruction from an AIFM. As we have explained above, and as explained in more detail in the annex attached to this submission, the TCM necessarily retains exclusive control under "standing" authority, subject to any contractual constraints.

Detailed relevant guidance regarding a depositary's responsibility to reconcile positions actually is already set out in AIFMD Level 1: Art. 21(8)(a)(ii) – which pursuant to Level 2 Art. 89.2 applies when a depositary delegates the custody of financial instruments - requires a depositary to "ensure that all those financial instruments ... are registered in the depositary's books within segregated accounts ***in accordance with the principles set out in Article 16 of [MiFID]"*** (emph. added). We have set out these requirements in our response to Q.26.1, but here we focus on the relevant reconciliation requirements set out in MiFID II Article 2.1 (which replaced MiFID Article 16). Sub-paragraph (c) of Art. 2.1 requires a MiFID firm holding or controlling client financial instruments to "conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held". Sub-paragraph (d) expressly contemplates this in the context of client financial instruments being wholly "deposited" with third-parties, which (again) clarifies that the MiFID firm may not hold these instruments in custody itself. Similar to AIFMD, a MiFID firm must still maintain its own books and records - even if it no longer holds the assets in custody itself, with reconciliations of these books and records being conducted with the "third-party" custodian. We are unaware of any interpretation requiring reconciliation in these circumstances more frequently than on an end-of-day basis. Because it is cross-referenced in AIFMD Level 1, MiFID II would seem to provide binding guidance that the same approach should be taken in the context of AIFMD.

A depositary therefore should be able to leverage existing reconciliation processes - and related reporting - ***at the level of the delegate*** itself provided that the depositary undertakes appropriate oversight and due diligence of the TCM.

It is appropriate to correlate the reconciliation process with an appropriate frequency linked to settlement activity at the position level but no more frequently than on an end-of-day basis. This is for reasons set out in our previous responses and as explained in more detail in the attached uploaded paper on TCM process and operational flows.

Please specify what are the other aspect(s) that should be explicitly regulated by the AIFMD. Please present benefits and disadvantages of this/these approach(es) as well as potential costs of the change, where possible:

AGC-EFC members are of the view that certain aspects of AIFMD Level 1 Art. 21.7 – regarding the Depositary's cash monitoring duty – should be addressed.

AIFs may maintain cash positions with credit institutions in countries that do not have an equivalent standard of banking authorisation and supervision as those required under the AIFMD framework. A consequence of this is that an AIF may not be permitted to hold cash for settlement and trading purposes in certain markets, i.e. if the market does not have the equivalent banking supervision requirements and a fund has credit exposure to the sub-custodian in the market. This issue does not arise where a Depositary and/or Global-Custodian takes the exposure in these markets onto its balance sheet, but managers may wish to hold exposures to other banks.

Article 86(a) of the Level 2 Regulation sets out the circumstances in which an AIF's cash can be maintained at third countries' credit institutions.[1] We are uncertain if relevant national competent authorities have provided a prescribed list of countries deemed to be regulated to an 'equivalent' standard for purposes relevant to this requirement.

Question 28. Are the AIFMD rules on the prime brokers clear?

- No

Question 28.1 Please explain your answer to question 28, providing concrete examples of ambiguities and where available suggesting improvements:

Like TCM arrangements discussed in our previous responses above, there are attributes of prime brokerage (PB) arrangements that are unique and which materially affect how depositaries carry out their responsibilities under the legislation. Like TCMs, the defining attribute of a PB-provided service is characterized by the absolute need for the PB to retain exclusive control over the disposition of the relevant assets (subject to relevant contractually-imposed constraints with AIFMs and/or depositaries): this is for a combination of operational, risk and legal reasons, which are more fully explained in the attached annex to this submission. A major point of departure from TCM arrangements are the purposes to which the AIF financial instruments can be put for the benefit of the PB's own business, most notably the right of rehypothecation, but this difference doesn't alter significantly depositaries' overarching responsibilities and how they may be carried out in compliance with the AIFMD.

Like TCMs, PBs necessarily maintain the definitive record (the "golden source") of custody of the ***relevant*** financial instruments of the AIF (i.e., those financial instruments that are delivered or maintained by it subject to the contractually-agreed collateral and rehypothecation arrangements over which it retains exclusive authority). This in turn helps clarify the role and responsibilities of depositaries, which as we have long pointed out, fully comply with the legislation, including with the recent 2018 Amendments, as they relate to depositary "books and records" and "reconciliation" requirements. Understood this way, there is clarity for all parties – including investors – regarding where key responsibilities reside while preserving the efficacy, efficiency and safety of these arrangements, which in part depend on speed, resiliency and straight-through or automated processing. We explain the necessity and the interrelationship of these factors by describing the relevant structural arrangements, focusing on operational and process flows and legal considerations, in the attached annex to this submission.

Existing PB arrangements – like TCM arrangements – can therefore be seen as consistent with existing depositary "delegation" requirements under AIFMD. Alternatively, these arrangements could be treated as outside of the scope of "delegation" altogether if the Commission were to provide for an approach akin to Art. 36.1(a) for non-EEA AIFs: this

[1] *… all cash of the AIF is booked in accounts opened with entities referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC in the relevant markets where cash accounts are required for the purposes of the AIF's operations and which are subject to prudential regulation and supervision that has the same effect as Union law, is effectively enforced and is in accordance with the principles laid down in Article 16 of Directive 2006/73/EC*

approach permits "one or more entities" to carry out the duties set out in Art. 21(8). This approach would ensure that both EEA and non-EEA AIFs operate consistently with each other and would better align with how PBs operate in practice.

Please refer to the attached uploaded paper we have prepared explaining in detail the relevant attributes and process flows and why depositaries should not be considered to hold relevant financial instruments subject to such arrangements "in custody" under national law where this is not consistent with the relevant PB arrangement.

Question 29. Where applicable, are there any difficulties faced by depositaries in obtaining the required reporting from prime brokers?

- Yes

Question 29.1 Please explain your answer to question 29, providing concrete examples and suggesting improvements to the current rules and presenting benefits and disadvantages of the potential changes as well as costs:

Similar to TCM arrangements (discussed in our previous responses) there are limits to the extent to which depositaries may "reconcile" their books and records with custody accounts maintained at PBs. Like TCM arrangements, PB-provided arrangements are fundamentally different from the way in which financial instruments are ordinarily held in custody by depositaries/global custodians: in these arrangements, there are no instructions transmitted throughout the day (intra-day) to or from a "global custodian" (or depositary) that might affect disposition of assets at the PB. As we have explained above, and as explained in more detail in the annex attached to this submission, the PB necessarily retains exclusive control under "standing" authority, subject to any contractual constraints. If PB arrangements are to be considered "delegations" of custody of AIF financial instruments by the depositary, depositaries can only expect reporting and reconciliations on positions on an end-of-day basis. There is no prospect of reliance on information or instructions from AIFMs.

Question 30. What additional measures are necessary at EU level to address the difficulties identified in the response to the preceding question? Please explain your answer providing concrete examples:

As we note in our previous responses, in addition to setting out other requirements designed to ensure the accuracy of a depositary's books and records, AIFMD Level 2 Art. 89.1(c) provides that "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." The entry into force of the 2018 Amendments in 2020 introduced the obligation for the depositary to carry out this reconciliation "as often as necessary".

As noted in our previous response, the depositary is able to receive and to record end-of-day positions sent by the PB, which is a regulated and supervised entity (subject to regulations significantly enhanced since the 2008 crisis).

As we have also noted above, detailed relevant guidance regarding a depositary's responsibility to reconcile positions actually is already set out in AIFMD Level 1: Art. 21(8)(a)(ii) – which pursuant to Level 2 Art. 89.2 applies when a depositary delegates the custody of financial instruments - requires a depositary to "ensure that all those financial instruments ... are registered in the depositary's books within segregated accounts ***in accordance with the principles set out in Article 16 of [MiFID]"*** (emph. added).

The applicable text (which replaced MiFID Article 16) is MiFID II Article 2.1, which provides at sub-paragraph (c) that in addition to other things a MiFID firm holding or controlling client financial instruments must "conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held". Sub-paragraph (d) expressly contemplates this in the context of client financial instruments being wholly "deposited" with third-parties, which (again) clarifies that the MiFID firm may not hold these instruments in custody itself. Similar to AIFMD, a MiFID firm must still maintain its own books and records even if it no longer holds the assets in custody itself, with reconciliations of these books and records being conducted with the "third-party" custodian. We are unaware of any interpretation requiring reconciliation in these circumstances more frequently than on an end-of-day basis. MiFID II, then, would seem to provide clear guidance that the same approach should be taken in the context of AIFMD.

If PBs are to be considered "delegates" of the depositary, it is appropriate to correlate the reconciliation process with an appropriate frequency linked to settlement activity at the position level but no more frequently than on an end-of-day basis: this is for reasons set out in our previous responses and as explained in more detail in the attached uploaded paper on PB process and operational flows.

Whilst a depositary in turn would be required to "properly register" financial instruments held with PBs in the Depositary's books in accordance with Article 21(8)(a)(ii) and maintain separate records of them pursuant to Art. 89.1, a proper understanding of PB-provided services and roles makes clear that the Depositary would utilise information ***provided by PBs*** in establishing and maintaining these books and records. Like TCMs (or their custodial agents), PBs maintain the "golden source": there is no value whatsoever in trying to construct a separate Depositary record of financial instruments based on individual movements and settlements since the only place that this occurs with dispositive effect is at the PB.

Depositaries are not themselves within the custody chain as it is recognized under national law: a depositary therefore should be expected to create and maintain a record of financial instruments based on end-of-day settled position information from PBs themselves or other sources deemed appropriate, provided that it undertakes appropriate oversight and due diligence of the TCM.

We emphasise that in all cases, authority typically is given by the AIFM to the PB to hold the assets under appropriate security arrangements in favour of the PB, which may be under either pledge or title transfer arrangements. In addition, depending on the particularities of such arrangements, a PB will have "standing" authorization to rehypothecate the AIFs financial instruments subject to contractually agreed limitations. Accordingly, ***no separate individualised instructions*** are provided to the PB by any other party, including the AIFM, in

these cases. The Depositary therefore must be entirely reliant on an end of day custody report from the PB.

Alternatively, as noted above, these arrangements could be treated as outside of the scope of "delegation" altogether if the Commission were to provide for an approach akin to Art. 36.1(a) for non-EEA AIFs: this approach permits "one or more entities" to carry out the duties set out in Art. 21(8). This approach would ensure that both EEA and non-EEA AIFs operate consistently with each other and would better align with how PBs operate in practice.

Question 31. Does the lack of the depositary passport inhibit efficient functioning of the EU AIF market?

- No

Question 31.1 Please explain your answer to question 31:

The current regime operates on the basis of domestic and non-domestic (through branches and subsidiaries) depositaries offering the provision of depositary services to AIFs established throughout EEA member states. The main question is whether a depositary passport would create increased risks for the investors and the conditions under which such a passport should operate, which we address in our subsequent responses.

Question 32. What would be the potential benefits and risks associated with the introduction of the depositary passport? Please explain your position, presenting benefits and disadvantages of your suggested approach as well as potential costs of the change, where possible:

Potential risks and considerations that should be taken into account:

1. Different national laws are implemented by supervisory authorities: agreement would need to be made regarding which national laws apply as between home and host states.

2. If an AIF and a depositary are domiciled in different states, different laws may apply with regard to the assets held in custody, causing. potential legal uncertainty (e.g., different member state treatment of rights *in rem*), which may be exacerbated if member states have different approaches to conflicts of laws. A depositary that itself acts as "global custodian" for the AIF would typically apply the national property law (establishing rights *in rem*) of the state in which it is located and supervised. A question arises regarding whether it would take the same approach for AIFs domiciled in other states.

3. If the law of the state where a depositary is located is to be applied, a future change of an AIF's depositary domiciled in a different jurisdiction might lead to a change of material law applying to the AIF's assets. The process and consequences around this would need to be considered. AIFMs' information obligations to the investors may also be affected.

4. The supervision of the AIF and of the depositary by relevant national competent authorities would be carried out in different states, creating challenges and risks unless

a division of supervisory authority is clarified. In particular, subscription and redemption processes typically are handled differently across member states.

5. In order to establish the organisational and operational processes enabling it to carry out its duties, the depositary must know, interpret and consider correctly in its internal operational processes under national rules applicable to the fund. This requires a continuous dialogue with:

    - the national competent local authorities of the AIF, and
    - professional associations located in the home country of the fund of depositaries, asset managers, accountants of funds and external auditors of the AIFs.

6. If an AIF appoints a depositary that has no presence in its home country, investors and the depositary itself bear the risk that:
    - the depositary does not sufficiently understand/apply local regulation, and
    - oversight is less robust.

7. The supervision of the fund and enforcements of investor rights may be more complex or uncertain.

    - Having an AIF, its AIFM and its depositary potentially located in three different countries may make their supervision more complex and would require a high level of cooperation between the different competent authorities involved.
    - The combined effects of potentially three different legislative regimes could also create legal uncertainty. Therefore, as regards enforcement rights, before considering the appropriateness of introducing a depositary passport the Commission must ensure that the fund and its investors have the same rights they would have if the depositary were established in the domicile of the fund.

8. These considerations may lead to higher risks and costs unless suitably addressed.

Question 33. What barriers are precluding introducing the depositary passport? Please explain your position providing concrete examples and evidence, where available, of the existing impediments:

The depositary must ensure national rules applicable to the fund are complied with when the latter carries out the following activities:

- the sale, issue, re-purchase, redemption and cancellation of units or shares of the investment fund,
- the calculation of the value of the units or shares of the investment fund,
- the distribution or reinvestment of an AIF's income,
- the instruction of the AIF to the depositary. Those instruction can relate to the following events of the life of the fund ruled by national rules or practices:
- the setting up and authorisation of the fund;
- the investment policy the fund;

- errors in the calculation of the net asset value and related investor compensation;
- the merging and restructuring of the fund;
- the winding-up and liquidation of the fund.

As set out in Recital 10 of the AIFMD, this directive does not regulate AIFs themselves. AIFs are regulated and supervised at national level. Under the UCITS Directive, the same approach is taken and the rules of the home country of the UCITS apply (see Art. 19 of the consolidated UCITs Directive).

In order to be able to establish the organisational and operational processes enabling it to carry out its duties, the depositary must therefore know, interpret and consider correctly in its internal operational processes those rules applicable to the fund. Reaching this level of expertise also presupposes the existence a continuous dialogue:

- with the competent local authorities of the fund,
- with the professional associations located in the home country of the fund of depositaries, asset managers, accountants of funds, and external auditors of funds.

If a fund appoints a depositary that has no presence in the home country of the fund, investors and the depositary it-self bear the risk that:

- the depositary does not correctly understand/apply local regulation,
- the oversight is less robust.

Question 34. Are there other options that could address the lack of supply of depositary services in smaller markets? Please explain your position presenting benefits and disadvantages of your suggested approach as well as potential costs of the change:

Question 35. Should the investor CSDs be treated as delegates of the depositary?

- Yes

Question 35.1 Please explain your answer to question 35, providing concrete examples and suggesting improvements to the current rules and presenting benefits and disadvantages as well as costs:

Whether or not a given central securities depository should be considered a 'custody delegate' of a depositary has serious implications for investors, investment managers, custodians and other intermediaries and market infrastructure providers as a whole. As the AGC-EFC has written in prior submissions, clarification is needed in this respect.

Despite revisions to the legislation intended to clarify treatment of investor CSDs, uncertainty persists in the industry regarding whether delegation requirements should apply. This uncertainty is untenable. We prefer having clarity and certainty one way or the other.

If additional clarity is to be provided by which investor CSDs are to be considered "delegates", a coherent and sensible approach this would be to clarify that all investor CSDs be considered as "delegates".

ANNEX

This Annex is prepared as additional explanatory background in support of the Association of Global Custodians European Focus Committee's (AGC-EFC's)[2] on-line submission in response to certain questions contained in the European Commission's Consultation on the Review of the Alternative Investment Management Funds Directive (AIFMD).

Question 24: Difficulties depositaries face in exercising their functions in accordance with the AIFMD

The AGC-EFC recommends that the Commission address three broad areas of concern to depositaries:

1. The need for a clearer distinction between "financial instruments that can be held in custody" and "other assets"

AIFMD Level 1 Art. 21(8)(a) requires a depositary to (i) "hold in custody all financial instruments that can be registered in a financial instruments account" which is "opened in the depositary's books" and (ii) "ensure that all those financial instruments ... are registered in the depositary's books within segregated accounts in accordance with the principles set out in Article 16 of [MiFID][3], opened in the name of the AIF or the AIFM acting on behalf of

[2] Established in 1996, the Association of Global Custodians (the "AGC") is a group of 12 global financial institutions that each provides securities custody and asset-servicing functions primarily to institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory matters and market structure. The member banks are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses. The members of the Association of Global Custodians are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.

[3] Art. 2.1 of the MiFID II Delegated Directive specified the following relevant obligations (edited for relevance) falling on MiFID firms holding or controlling client financial instruments:

> (a) they must keep records and accounts enabling them at any time and without delay to distinguish assets held for one client from assets held for any other client and from their own assets;
> (b) they must maintain their records and accounts in a way that ensures their accuracy, and in particular their correspondence to the financial instruments and funds held for clients and that they may be used as an audit trail;
> (c) they must conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held;
> (d) they must take the necessary steps to ensure that any client financial instruments deposited with a third party . . . are identifiable separately from the financial instruments belonging to the investment firm and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection;
> …
> (f) they must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of client assets, or of rights in connection with those assets, as a result of misuse of the assets, fraud, poor administration, inadequate record keeping or negligence.

the AIF, so that they can be clearly identified as belonging to the AIF in accordance with the applicable law at all times".

For "other assets" of an AIF (*i.e.*, other than those that would be covered by Art. 21.8(a)), the depositary is required pursuant to Art. 21.8(b) to "verify the ownership" and "maintain a record" of them. Art. 21.8(b) appears to be premised on recognition that such assets cannot be "held in custody" as "property" of the fund as contemplated in Art. 21.8(a): accordingly, it requires instead that the depositary assess ownership "based on information or documents provided by the AIF or the AIFM and, where available, on external evidence".

Whether or not a depositary – or any other putative "custodian" - can actually be "hold" an asset "in custody" depends on two factors:

I. If the asset is considered under applicable national law "property" - whereby the investor has rights *in rem* in the asset – the question turns on whether the depositary actually, literally is capable of "holding" it itself: real estate or various kinds of tangible assets and certain intangible assets are unlikely to satisfy this test; and

II. If the asset is not "property" in the first place - as is the case *inter alia.* with respect to financial instruments in which investors have contractual rights (*i.e*., rights *in personam*) such as OTC derivatives and loan participations – the depositary cannot "hold it" in any case.

Article 21.8(a) stipulates that it applies only to "financial instruments" that "can be held in custody" for these reasons.

The Commission attempted to provide additional clarity on the dividing line between "financial instruments that can be held in custody" and "other assets" in the Delegated Regulation 231/2013 (the "Level 2 Regulation"), at Art. 88.1, by specifying that financial instruments are to be included in the scope of the depositary's custody duties if *inter alia* they are "they are capable of being registered or held in an account directly or indirectly in the name of the Depositary". Level 2 Art. 88.2 addresses whether such financial instruments should be deemed "capable" of being "held" in the depositary's name by deferring to national law requirements ("in accordance with applicable national law"), which suggests that holdings in financial instruments may be registered "in the name of the AIF with the issuer itself or its agent, such as a registrar or transfer agent" so long as

It is emphasised that whilst sub paragraph (c) above contemplates reconciliations being conducted between the MiFID firm's "internal accounts and records" and those of "any third parties by whom those assets are held", sub paragraph (d) specifically addresses where the investment firm "deposits" the clients' financial instruments with a third party. This makes it clear that a MiFID firm is expected to maintain its own "internal accounts and records" even if the relevant financial instruments are actually held ("deposited") with a third-party.

national law permits it.[4] In such cases, the holding would be considered an "other asset" of the AIF rather than a "financial instrument held in custody".

We fear this well-intentioned attempt to provide clarity has created more confusion and uncertainty rather than less.

An example of the difficulty of the application of this approach is investments in underlying collective investment schemes ("funds"). ESMA addressed investments specifically in underlying funds in its Q&A of 4th December 2019 (ESMA34-32-352), stating at Question 6 that such investments should be considered "other assets" if, "in accordance with applicable national law, they are only directly registered with the issuer itself or its agent, in the name of the AIF or the AIFM acting on behalf of the AIF". Otherwise, according to ESMA, they should be considered "held in custody".

We believe it is inappropriate to determining the duties of a depositary by looking solely to the name ascribed to a registration of a holding in an underlying fund given that this asset class involves the same attributes and risks regardless of how it is registered. Focusing exclusively on account registrations and naming conventions departs from original rationale for the distinction between Articles 21.8(a) and 21.8(b): as noted above, the first question should be whether the financial instrument constitutes "property" under applicable national law in the first place.

A clearer understanding of the meaning of "custody" as referred to in the AIFMD Level 1 legislation (at Art. 21.8(a)) is therefore warranted. Most fundamentally, ***"custody" of "book-entry" financial instruments should be premised on holdings that are first immobilized and dematerialized at central securities depositaries (CSDs), either in the EEA or without, with respect to which intermediaries acting as "account providers" provide access to property rights for their customers (as "account holders") under applicable national law.*** The national law applicable to each account in a chain of custody (which often extends cross-border, resulting in multiple custody accounts each subject to its own national law) establishes the nature, rights and obligations of the account provider and the account holder regarding such an account. In our view, Article 88 of the Level 2 Regulation should be clarified to specify that financial instruments held in custody are financial instruments satisfying these criteria.

We urge the adoption of this clarification particularly because clarity will be more important as investment strategies and types of holdings evolve with technology and changing investor demand. Digital asset holdings present an obvious example as laws and regulations develop to conform to them: questions arise as to the nature of property rights, if any, in such assets, and who might "hold" these rights on behalf of investors. Inevitably, whether financial instruments can be considered "held in custody" by an intermediary is dependent on still-evolving national law, among other things.

[4] AIFMD Level 2 Art. 88.2 provides: *Financial instruments which, in accordance with applicable national law, are only directly registered in the name of the AIF with the issuer itself or its agent, such as a registrar or a transfer agent, shall not be held in custody.*

2. Look-through

AIFMD Level 2 Art. 89.3 provides in relevant part that a depositary's safe-keeping duties will apply on a "look-through" basis to underlying assets held by "financial and, as the case may be, or legal structures controlled directly or indirectly by the AIF or the AIFM acting on behalf of the AIF".[5]

We are aware that some national competent authorities and industry participants have taken divergent approaches to look-through in cases where the investing AIF may not have "control" of an asset in which it invests (including an underlying fund) but the AIFM acting for the AIF ***does*** have control due to interests held by other vehicles for which it or associated entities act, including via non-EEA vehicles. We believe clarity is warranted that the depositary's duties are unaffected by activities of an AIFM that are beyond the scope of the depositary's responsibilities with respect to the AIF for which it is appointed.

The AGC-EFC's members have long taken the view that a far more sensible approach in keeping with public authorities' goals is to require "look-through" requirements where an AIF "controls" the underlying fund by applying objective criteria such as accounting standards. This approach is in keeping with Article 4(1)(i) of AIFMD Level 1, which defines 'control' with reference to accounting standards, including with respect to whether accounts should be consolidated. A clear articulation of "control" should in our view be expressed in this context in the Level 2 Regulation at Art. 88.2 or in Level 3 guidance.

The current exemption from the look-through rules for fund of funds and master-feeder structures with a depositary should also be extended to all financial or legal vehicles which have appointed a depositary.

Further, ESMA's Q&A[6] (Question 9)[7] indicates that liability with respect to the underlying assets of investment by an AIF, including the underlying assets of an investment fund in which the AIF invests, should apply where look-through tests are met, however, para 3 of Article 89 and para 5 of Article 90 of the regulation provide that that only the duties in para (1) and (2) of those articles, and not the liability provisions in the AIFMD Level 1 Art. 21.12, apply in such cases. If such liability were to apply where an AIF only has "indirect" control of looked-through assets, depositary banks would be subject to uncontrollable risks as only one individual depositary or custodian can be in direct control of assets held in custody. It should be clarified – either at Level 2 or in Level 3 guidance - that Art. 21.12 liability should only apply to assets the assets that are actually, ***directly*** held by the depositary on behalf of the AIF in accordance with Art. 21.8(a)(i).

[5] Art. 89.3 goes on to provide that this "look-through" requirement will not apply in any case where an underlying fund (invested in by the AIF in "funds of funds or master-feeder structures") has appointed a "depositary" under AIFMD or the UCITS Directive.

[6] ESMA34-32-352, 4th December 2019.

[7] "*Does the depositary's liability regime apply to those assets for which a depositary has safe-keeping duties on a look-through basis according to Articles 89(3), first sub-paragraph, and 90(5), first sub-paragraph of the AIFMD Level 2 Regulation?"* Updated 16th December 2015.

3. Clarifying "delegation" requirements to better align with how financial instruments are "held in custody", and by whom

Even where it is clear that "financial instruments" are "held in custody", questions remain regarding the impact of "delegation" of custody in certain settings. These questions emerged especially during discussions surrounding the implementation of the AIFMD Delegated Regulation of 12 July 2018 (the "2018 Amendments") (which took effect April 2020) regarding the applicability of "books and records" requirements referenced at Level 1 Art. 21.8(a)(ii) where the depositary has "delegated" custody.

Article 89 para. 2 of the Level 2 Regulation at the time was amended to clarify that when a depositary "delegates" custody of financial instruments in line with Level 1 Art. 21(11), the depositary is still required to comply with Level 1 Art 21.8(a)(ii)[8]: Level 1 Art. 21.8(a)(i) is not referenced. In other words, whilst the depositary is required to "register" the AIFs financial instruments "in the depositary's books"[9], holding them "in custody" as prescribed in Level 1 Art. 21.8(a)(i) is not required. This raised questions about: (i) who holds the custody of those financial instruments under applicable national law and, (ii) how the depositary would satisfy its various responsibilities under Level 2 Art. 89 where – as this the case for TCM and PB arrangements - the "delegate" necessarily becomes the "golden source" of the custody record.

Requirements around delegation must conform to the operational and legal realities of where the dispositive (or "golden") record actually resides. If this is made clear, prime brokerage and third-party collateral arrangements, for example, would be more sensibly addressed (discussed in more detail further below). "Books" and "accounts" as mentioned in Level 1 Art. 21.8(a)(ii) would not be confused with "securities custody accounts" established under national law: indeed, this approach would be more consistent with the approach taken in MiFID, which is explicitly referenced as the guiding frame of reference in Level 1 Art. 21.8(a)(ii). [10]

Questions 25-30: Treatment of relevant AIF financial instruments held by third-party collateral managers (TCMs) and Prime Brokers (PBs)

The additional background describes the operational and legal attributes and process flows associated with "tri-party collateral" arrangements and "prime brokerage" arrangements, which explains crucial operational and legal attributes of and process flows for TCM- and PB-

[8] "*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 (a) 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 and segregation obligations laid down in Article 99."*

[9] "*… 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;"*

[10] See footnote 1, above.

provided bearing on how AIF and UCITS depositaries may fulfil their responsibilities under the relevant legislation.

Tri-Party Collateral Management Arrangements – Contractual and Operating Model

When a TCM is appointed by an investment fund:

- The investment fund does not instruct collateral movements to the depositary; rather it provides an authorization to the TCM to instruct collateral movements as and when necessary (in connection with Repo, OTC derivatives, securities lending) documented under template agreements and collateral schedules created under the auspices of relevant industry associations (ISDA, RMA, ISLA, etc.);
- The TCM will require full control of the investment fund's financial instruments that are held as collateral, including the ability to move these assets in line with the above authorizations;
- The investment fund's rights in the financial instruments are recorded in the nominee name of the TCM (directly or through a sub-custodian appointed by the TCM) in the books/registers of the issuer CSD/issuer of the financial instruments;
- The TCM may effect numerous collateral movements per day for an investment fund and/or the counterparty in order to update the ownership rights of parties to the arrangement in the relevant financial instruments as well as identify those financial instruments that remain subject to a Collateral Taker's security interest. Settlement instructions are transmitted by the TCM to custodians, and CSDs /issuers of the financial instruments. All instructions occur – and must occur - without prior instruction from the depositary in order to optimize the value and use of collateral and to ensure that the Collateral Taker is sufficiently covered at all times.

Models vary (in many cases accounts are established and maintained for AIFs and in others they are established and maintained for Depositaries/global custodians on behalf of their clients), but a common denominator across all these arrangements is that the TCM (or its own custodial agent if a separate one is appointed) typically is the "golden source" of disposition of financial instruments held for all customers participating – whether directly or indirectly - in these arrangements.

Consequently, in all cases, a Depositary ultimately must rely on information it receives from a TCM in order to maintain "books and records" required pursuant to the 2018 Amendments. There is no way around this as a TCM may effect thousands of movements per day involving an investment fund's assets that are held with it: the depositary would be unable to separately record all of these movements in order to calculate an ever-changing "balance" as a definitive record of the investment fund's holdings. The depositary would only be able to receive and record an end-of-day position sent by the TCM.

Whilst the Depositary should be able to identify accurately in its record settled positions of financial instruments held in custody, settled positions are – in general – determined on an end-of-day basis: consequently, there is no value whatsoever in trying to construct a separate Depositary record of financial instruments based on individual movements and settlements

since the only place that this occurs with dispositive effect is at the TCM (or its custodian if a separate one is appointed).

As noted above, clarity in this respect is needed first and foremost because depositaries usually are in no position to actually "hold in custody" under relevant national law financial instruments that are actually so held or controlled by tri-party collateral agents. The reasons for this are many.

The Tri-Party Collateral Management Model carefully distinguishes functions and responsibilities of the parties involved in order to ensure proper segregation of assets, validity of security interests in favour of secured parties and the protection of the collateral-givers' rights in the collateral assets.

There are three categories of these arrangements, which are broadly similar to each other in most respects but not in others (discussed below). These categories include:

- Tri-party repo collateral
- Tri-party securities lending collateral
- Tri-party (cleared and uncleared) derivatives collateral

The contractual relationships of the Tri-Party Collateral Manager can be described as follows:

- Custodian to the Collateral Provider to hold assets that shall be used as collateral in custody
- Collateral Manager for the Collateral Provider
    - This function includes the selection of collateral assets and collateral eligibility screening as well as a daily mark-to-market valuation of collateral assets and a substitution of collateral assets where required or instructed by the Collateral Provider; and
    - The Collateral Manager typically has a standing instruction from the Collateral Provider to trigger substitution of collateral assets in line with specified collateral criteria agreed by the collateral provider and the collateral taker
- "Delegate" of the AIF/UCITS depositary as required by the legislation
- Collateral Manager for the Collateral Receiver (which in the case of a triparty set-up is the same entity as the Collateral Manager for the Collateral provider)
    - This function includes the eligibility screening against the Collateral Receiver's defined collateral criteria to ensure an ex-ante validation of any collateral asset that will be delivered into the Collateral Receiver's account;
    - The function includes the daily mark-to-market of collateral assets; and
    - The Collateral Manager typically has a standing instruction from the Collateral Receiver to accept substitution of collateral assets in line with specified substitution conditions and collateral criteria assets in line with specified collateral criteria agreed by the collateral provider and the collateral taker.

The operational flows distinguish between two key workflows:

- initiation of a new collateral exposure or new transaction (as applicable) and
- daily substitution of collateral or exchange of cash for securities (as applicable).

Figure 1 below depicts the relevant processes in the context of tri-party repo transactions:

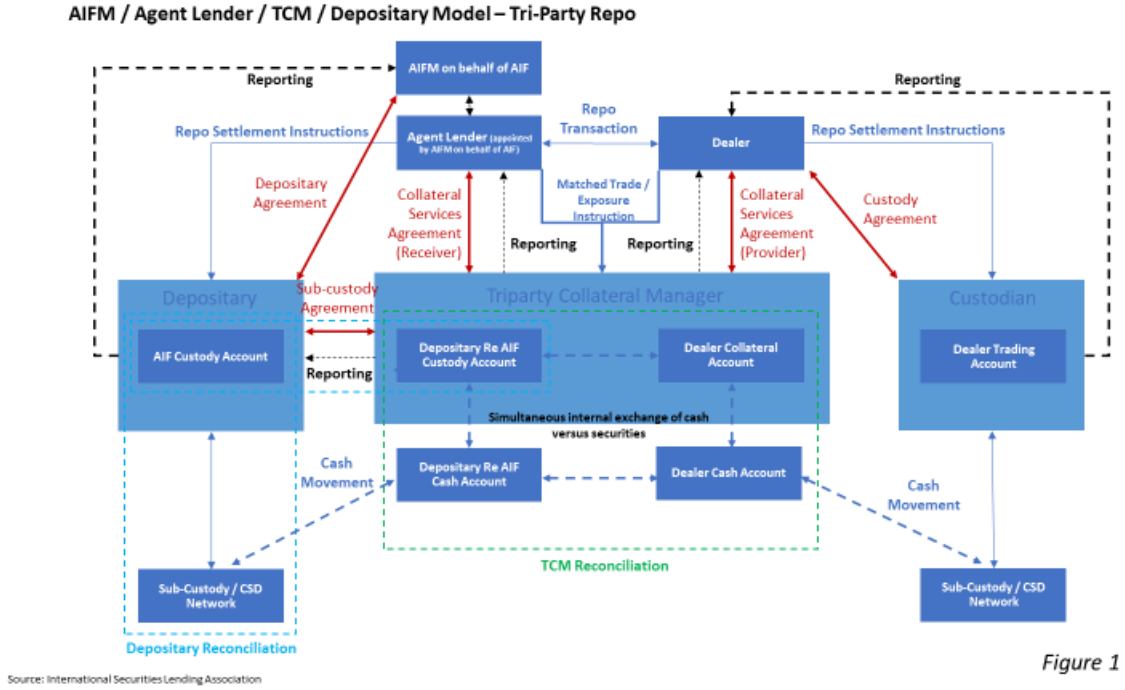

Figure 1

Here the depositary is instructed by the AIFM to establish an account that is to be maintained by the TCM, instead of through the depositary's usual sub-custodian network. As this illustration makes clear, the TCM is responsible for all exchanges of cash versus securities in order to maintain exposures that are properly secured with collateral.

Figure 2 depicts the relevant processes in the context of securities lending transactions:

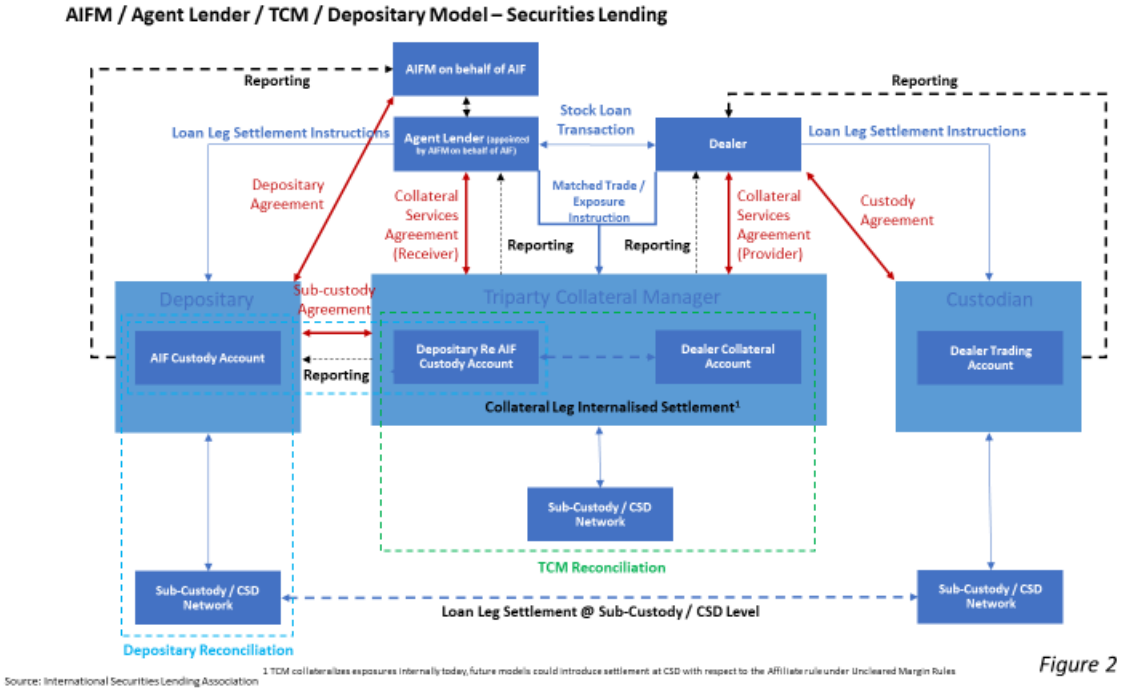

Figure 2

Again, the depositary opens an account at the TCM to facilitate the arrangement. Whilst some of the workflows are different from tri-party repo, the TCM similarly retains full control over movement of collateral to secure any exposures represented by securities out on loan.

In all cases, given the nature of the TCM operating model, a depositary would be expected to utilise the reporting at a minimum once per day, before the end of its business day, to register in its own books the relevant assets of the fund client.

Given the specific settlement instruction flow of Tri-Party Collateral Management Arrangements, and the control the Collateral Manager retains over disposition of the collateral, it needs to be recognised that it will technically not be possible for the Depositary to implement "independent reconciliations" of the Depositary's books and records against the TCM's books and records. The TCM "owns" the instruction flow of individual deliveries of substitutions of collateral assets to and from the Collateral Receiver account.

<u>Prime Brokers</u>:

If an investment manager wishes to utilise leverage for an investment fund, a prime broker ordinarily will be appointed. As part of the bilateral understanding between the prime broker and the manager on behalf of the fund, fund assets are pledged, and rights of reuse/rehypothecation are granted, to the prime broker in return for financing. The amount of financing available typically is linked to collateral levels and amounts of assets available for reuse/rehypothecation: this in turn requires the employment of a mark-to-market margin calculation that is carried out by the prime broker. Under the terms of the agreement

appointing the prime broker, this calculation determines whether assets of the fund are validly reused/rehypothecated.

The AGC-EFC has consistently pointed out that the interposition of the depositary in these arrangements has raised unnecessary complications and cost and has artificially created risk for depositaries in having to effectively underwrite operational risk incurred in the appointment of prime brokers (the margin calculation and consequent availability of assets that the prime broker "should" be maintaining in custody for the fund).

Rehypothecation and re-use

When a PB is appointed by an investment fund, it has the ability to reuse the AIF's assets. In order to do so, the PB will require that it holds in its custody encumbered financial instruments of the investment fund (i.e. subject to a security interest or right of re-hypothecation in favour of the PB):

- Those investment fund's rights in encumbered financial instruments are recorded in the name of the PB, either directly or through a sub-custodian appointed by the PB in the books/registers of the issuer CSD/issuer of those financial instruments;
- Encumbered financial instruments are under the control of the PB: the investment manager gives instructions directly to the PB relating to these financial instruments Furthermore, the PB has the right to use some of those financial instruments and return them to the investment fund at its discretion and time of its choosing..

If numerous movements are effected by the PB per day for a given investment fund the depositary is unable to record all such movements. In this case the depositary is only able to receive and to record an end-of-day position sent by the PB which is a regulated and supervised entity.

- Subject to the terms of the prime brokerage agreement, brokers may rehypothecate and re-use client assets. Where assets have been lent out into the market, equivalent assets would need to be sourced and re-delivered to the client's custody account by the prime broker.

- If the client has consented to rehypothecation of its assets and those assets have been rehypothecated, then the client would lose its proprietary interest in those assets and become an unsecured creditor.

As is the case with Tri-Party Collateral Arrangements, given the specific settlement instruction flow of Prime Brokerage Arrangements, it needs to be recognised that it will technically not be possible for the Depositary to implement "independent reconciliations" of the Depositary's books and records against the Tri-Party Collateral Manager's books and records. The Prime Broker "owns" the instruction flow of individual deliveries of substitutions of collateral assets to and from the account it maintains, and retains exclusive control over re-

use or rehypothecation (subject to any limitations or constraints in the Prime Brokerage Agreement).

Legal principles underlying tri-party collateral and prime brokerage arrangements and challenges created by AIFMD:

Collateral can be provided under different legal arrangements. In some cases, under applicable European laws,[11] legal title to the collateral actually transfers to the counterparty, and in others it does not,[12] while under New York law – which is heavily utilized in the financial markets – different attributes arise.[13]

A key – critical – common denominator for all collateral arrangements is that they must be legally certain: legal certainty is seen by market participants as crucial in order to ensure continued liquidity in the markets and systemic stability, especially in times of market stress, including where an insolvency intrudes: collateral arrangements typically require the support of legal opinions that over time have become standardized but which vary considerably by jurisdiction. These legal opinions – which must take into account the interplay of arrangements covering different jurisdictions – address whether collateral arrangements will be respected in insolvency settings (thus ensuring continuity of transactions and liquidity).

Where security interests are taken, they cover the concept of 'perfection', which is necessary in order for security interests to be considered valid. One element of 'perfection' is ***'control'*** by the party taking the security interest (the counterparty) – or its agent.[14] Indeed, the importance of this particular element (control) is singled out in recitals to the Financial Collateral Directive in order to ensure that the Directive does not interfere with the requisites of perfection under the laws of individual Member States:

> *the only perfection requirement regarding parties which national law may impose in respect of financial collateral should be that the financial collateral is under the control of the collateral taker or of a person acting on the collateral taker's behalf [e.g., an 'agent'].*[15]

The "agent" referenced above – who must "perfect" through "control" of collateral on behalf of Collateral Taker – would include a TCM.

[11] See, e.g., Art. 2(1)(b), defining 'title transfer financial collateral arrangements', Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims, as amended by Directive 2009/44/EC of the European Parliament and the Council of 6 May 2009 (collectively, the 'Financial Collateral Directive').
[12] See e.g., Art. 2(1)(c), defining 'security financial collateral arrangements', Financial Collateral Directive.
[13] See, e.g., New York Uniform Commercial Code, Art. 9, Parts 2 and 3, regarding Effectiveness of Security Agreements, Attachment of Security Interest, Rights of Parties to Security Agreements, Perfection and Priority.
[14] The ISDA has published a guide to collateral for practitioners: this publication describes key legal distinctions that are central to collateral arrangements under ISDA.
[15] Recital 9, Financial Collateral Directive.

It is difficult to envision how a depositary could ***also*** retain control if collateral is required to be held in custody and made subject to the exclusive control of the Collateral Taker or its agent: "control" over disposition of an asset cannot be vested in two parties at the same time in order to be assured of the adequacy of perfection of the security interest in that asset.

We note that ESMA recommended in its 2011 Final Report[16] that - with respect to collateral provided by the AIF or AIFM on behalf of the AIF- consideration should be given to the definitions of financial collateral arrangements laid out in Directive 2002/47/EC ('the Collateral directive') which distinguishes two types of collateral arrangement:

> *(i) title transfer financial collateral arrangements defined as arrangements, including repurchase agreements, under which a collateral provider transfers full ownership of, or full entitlement to, financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations;*
> *(ii) security financial collateral arrangements defined as arrangements under which a collateral provider provides financial collateral by way of security to or in favour of a collateral taker, and where the full or qualified ownership of, or full entitlement to, the financial collateral remains with the collateral provider when the security right is established*

ESMA concluded that in order to promote convergence in national regulatory approaches, only collateral arrangements within the meaning of the Collateral Directive (or equivalent such arrangements in non-EU jurisdictions, where applicable) should be taken into account for the purposes of determining whether financial instruments provided as collateral should be considered "held in custody" by the depositary. In such cases, ESMA recommended excluding from the scope of the depositary's custody duties "financial instruments provided by the AIF under a financial collateral arrangement where there is a title transfer or under a security financial collateral arrangement by which the ***control or possession*** (*emph. added*) of the financial instruments within the meaning of Article 2(2) of Directive 2002/47/EC on financial collateral arrangements has been transferred away from the AIF or the depositary to the collateral taker or a person acting on its behalf.

[16] ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379 (16th November 2011), see p.158, para 19 ("Definition of the financial instruments that should be held in custody).