THE ASSOCIATION OF GLOBAL CUSTODIANS

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RESPONSE TO THE EUROPEAN COMMISSION CONSULTATION

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LEGISLATION ON LEGAL CERTAINTY OF SECURITIES HOLDING AND DISPOSITIONS

Introduction

The Association of Global Custodians is a group of 10 global custodian banks that are major providers of securities custody and trade settlement services to institutional investors worldwide. Established in 1997, the Association primarily seeks to address regulatory and market structure issues that are of common interest to the custody industry. The Association of Global Custodians' members have significant operations involving the provision of securities accounts to clients across Europe, collectively holding more than EUR 55 trillion of assets on behalf of their clients, including a substantial stake in EU domiciled funds assets. Members provide custody-related services to most types of investment funds based in Europe and also service European and non-European institutional clients and other investors. The members, who act directly or through branches and subsidiaries in Europe, play substantial roles in European markets, and currently comprise: The Bank of New York Mellon, Brown Brothers Harriman & Co., Citibank, N.A., Deutsche Bank, HSBC Securities Services, J.P. Morgan, Northern Trust, RBC Dexia Investor Services, Standard Chartered Bank, and State Street Bank and Trust Company. The Association takes an active role in tracking key legislative and market developments within the securities industry, including the Alternative Investment Fund Managers Directive, the UCITS Depositary Function, TARGET2-Securities and various other issues of importance.

The Association welcomes the public consultation on the possible Securities Law Directive[1] and is grateful for the opportunity to express its views on this important legislative development.

[1] Where we refer to "the Directive", we are expecting that the principles in the consultation paper will be translated into articles of the expected Securities Law Directive.

The Association supports the move towards the creation of a harmonised European legal framework for intermediated securities, as this will enhance investor confidence, improve the efficiency of markets, and reduce legal and other fixed cost in the provision of custody and post-trade services. More generally, we support the aims which underpin the proposed Directive, particularly in the context of reducing the inefficiencies in EU financial markets which were identified by Giovannini group and proposing practical solutions to improve market integration. However, the Association considers it vital to ensure that what is ultimately agreed at EU level provides a legal framework which is internationally compatible, given the global nature of financial markets, as well as proportionate and workable provisions which facilitate the appropriate management of risk.

The following submission identifies the key substantive points arising from the Commission's suggested Principles, rather than addressing specific drafting points which might arise if the Principles were adopted as formal legal text. The comments below focus on the potential outcomes, which may have an impact on the business models of custodians and investors, and more generally on the efficient and orderly working of securities holding systems across the EU. We would, however, welcome the opportunity to make drafting comments at an appropriate stage.

We remain at your disposal to provide any further clarification on these issues and would welcome the opportunity to discuss the above points in further detail if it would be helpful to do so.

Information requested about the respondent

- Name and address: Please see above. Please contact Jean-Michel Loehr at 14, Porte de France, L-4360, Esch-sur-Alzette, Luxembourg or by email to Jean-Michel.Loehr@rbcdexia.com, chair of the Association's European Committee in relation to this submission.

- Field of activity: Please see above; also the Website of the Association is http://www.theagc.com/index.htm. The members of the Association conduct domestic and cross-border securities operations in the EEA. The members of the Association are predominantly constituted as credit institutions.

- Securities account provision: The holding of securities by members of the Association is typically carried out in the EEA in the context of regulated activity under the Banking

Directive (2006/48/EC), though members will typically also be authorised additionally under MiFID (2004/39/EC) and comply with its more detailed provisions relating to custody. Disposition of securities is not an activity carried out by members of the Association in executing their role as custodians; however, clients of members will instruct members (as their custodian) to effect settlement of transactions in which the clients have sold or otherwise disposed of interests in their securities, and members will effect dispositions on clients' behalf, typically by transfer of securities across the books of a designated settlement system ("**CSD**"). In cases where subsidiaries of members, acting as trustees or custodians, are not credit institutions or MiFID investment firms, the subsidiaries are required to comply with local law on outsourcing and/or oversight of custodial functions to be performed by the firm providing such functions directly.

- Association of stakeholders: Please see above. The membership structure of the Association is that there is a single class of members, though a European Committee has been established to focus specifically on the issues of the European market, considering the leading market shares our members hold in Europe, acting as custodian and service providers to asset management, investment and pension fund industries.

Preliminary Comments

The consultation paper covers a wide range of issues and invites comment on over 40 questions. The Association appreciates the effort which the Commission has put into its explanation of the points at stake and the amount of detail which has been put forward for public consideration. In that context, the Association considers that it would be appropriate to mention five specific "headline" issues to which particular attention should, in its opinion, be paid. These are as follows:

1. The business of global custody is inherently international and cross-border. It is not confined to the boundaries of the EEA. European investors invest in non-EEA instruments, and third country investors invest in European securities. It is absolutely vital to the economy of Europe and the provision of efficient structures for investment that any legislation relating to holding of securities works as well for inward and outward investment patterns as it does for intra-EEA holdings. The Association is concerned that the proposals suggested in the paper will not achieve this objective without further careful analysis.

2. The members of the Association believe that whilst existing arrangements for holding of securities through chains of account providers generally work well, a future Securities Law Directive could bring benefits by improving the security of ownership along the ownership chain, and by ensuring that domestic legal arrangements in certain countries do not place barriers to the exercise of rights by foreign investors. However, the Association believes that any such improvements would be negated if a future Securities Law Directive resulted in an inappropriate liability regime for account providers and correspondingly increased costs for investors. The Association recommends that the parts of the proposals which would impose greater burdens on account providers should not proceed without a thorough cost-benefit analysis.

3. We note that the consultation seeks feedback about the compatibility between so-called "transparent" and "non-transparent" systems of holding of securities. We believe this distinction – and thus the fundamental premise underlying the subsequent questions – is flawed. There are at least three systems which have been described in the work leading to the Geneva Securities Convention. These include: (i) "Transparent Systems" in which there is a direct relationship between the issuer and the investor and the only "account" maintained in the chain of intermediation is maintained by the Central Securities Depository for "resident" investors; (ii) "Direct" Holding Systems in which there is a direct relationship between the issuer and the investor but upper-tier intermediaries are incapable of recognising lower-tier account holders; and (iii) "Indirect Holding Systems" in which each intermediary maintains a separate securities account (recognising that each intermediary has no property interest in positions reflected in the securities accounts it maintains) and investors' rights flow through the chain of intermediation. It is crucial to recognise the existence of and the continued integrity of global indirect holding systems in order to preserve the fundamental operating premise that each intermediary can and must only be accountable to the next proximate link in the chain of intermediation. To require otherwise would create legal uncertainty about who is accountable to whom on a global basis, thus increasing global systemic instability, which could prove disastrous in times of market stress.

4. Fears of "inflation" or improper "creation" of securities should be put in context. First, the imperative should more properly be stated as ensuring the integrity and accuracy of securities accounts – that is, ideally, there would be neither an excess nor a shortfall in a securities position at any time. The reality of market infrastructure, however, renders this goal unobtainable in practice if it is applied to mean that each intermediary's records must be exactly equivalent to positions reflected on an issuer's share register at any and

all times. Such a result is not possible because there is no privity between issuers and account providers other than those who are appointed to act as their agents. Indeed, it is the CSD's records, and not those of other lower-tier intermediaries, that are expected to mirror the books of the transfer agent / registrar appointed / used by the issuer. Instead, the goal should be to ensure that each intermediary undertakes to act in the best interests of its account holder(s) when unexpected or unpredictable events occur which require reversals or corrections to its records. Requiring more than this will render intermediaries insurers of risks which are unpredictable and beyond their control. Sufficient flexibility is necessary in order to ensure that the Direct and Indirect Holding systems continue to operate effectively and efficiently.

5. It is very important for European investors that the Directive does not impose any form of insurance or guarantee obligations on global custodians in respect of the number of securities which they hold for their clients. If the Directive imposed this form of obligation it is our strongly held fear that few if any banks would have the necessary capital to support the obligation at all or at a reasonable cost. At best this might see the reduction in competition in the industry leading to greater concentration and therefore systemic risk ("too big to fail") and at worst it might contribute to significantly reducing the flow of capital into and out of the EU.

More broadly, as outlined more specifically below, we are concerned that not all of the critically important objectives identified in the work of the Geneva Securities Convention[2] appear to be considered in the Consultation. We believe there should be clear recognition of the need to provide for the continued integrity of the Direct and Indirect Holding Systems as well as cross-border compatibility of the respective legal systems. In particular, Systemic Integrity should be emphasised as a crucial goal of a Securities Law Directive.

As a result, we urge the European Commission to consider incorporating key elements of the exhaustive work undertaken leading to the Geneva Securities Convention. Whilst the Association contributed comments during the course of this work, and whilst we acknowledge there may be elements that are not perfect, we believe the Convention is far more compatible with other legal and market infrastructure systems than the Directive as proposed. We encourage the Commission to take the opportunity to facilitate legal certainty – and thus reduce systemic and market infrastructure risk - globally.

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[2] See, Position Paper, The UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities, August 2003 (the "UNIDROIT Study Group Position Paper").

Question 1 - Do you agree that the envisaged legislation should cover the objectives described above? If not, please explain why. Are any aspects missing (please consider also the following pages for a detailed description of the content of the proposal)?

Legal certainty of securities holdings and dispositions is important for protecting investor interests, creating investor confidence, ensuring fair and efficient markets. Whilst the Commission's present consultation provides a helpful opportunity to review current proposals and to engage with the Commission before it formalises its approach, we have concerns about the approaches to conflicts of laws in both the Settlement Finality Directive[3] ("**SFD**") and the proposed Securities Law Directive. The matter of greatest concern in this regard is that the two legislative measures have very different scope. For example, the Principles would cover a much wider range of "securities" than the SFD; in particular, including non-EEA securities, in relation to which the SFD cannot apply.

More broadly, as mentioned above, we believe the objectives of the legislation should ensure compatibility with those outlined in the work of the Geneva Securities Convention. As was emphasised in the Forward of the 2003 UNIDROIT Study Group Position Paper[4]:

- "The global financial system is only as good as the infrastructure that supports it. The smooth functioning of the system – and the confidence on which it depends – will be threatened if its infrastructure is considered unreliable. This is a particular concern in cross-border trading of securities because there are very often no common or even consistent structures, standards or operational rules.

- "It was this concern that motivated the Group of Thirty to commission the report, *Global Clearing and Settlement: A Plan of Action*, published earlier this year. And it was the challenge of strengthening the infrastructure for global securities trading to which that report's recommendations are addressed. The report put forward a strategy with three pillars, aiming to: (1) create a strengthened, interoperable global network by implementing technical and business practice standards intended to improve the connections across borders and systems; (2) mitigate operational and legal risks by introducing a stronger risk

[3] Directive 98/26/EC on Settlement finality in payment and securities settlement systems

[4] UNIDROIT Study Group Position Paper, p.3.

management including a solid legal basis for clearing and settlement; and (3) improve governance of market participants by private boards supported by official supervision."

We believe the work of the UNIDROIT Study Group, its predecessors (e.g., under the 2002 *Hague Convention on indirectly held securities*) and collaborative bodies across Europe (such as in the work of the UK Law Commission's 2006 *Project on Intermediated Securities* and that of the European Commission's own Legal Certainty Group in 2005-2008) clearly established the existence of inconsistencies inherent in phenomenon of holding securities through intermediaries. It was also recognised that regional solutions such as EU Directives, however well constructed, could not themselves "cover the full spectrum of concerns identified"[5]. For this reason that work of the Geneva Convention recognised the importance of identifying the "key aspects of substantive law relevant to the cross-border holding and transfer of securities held through intermediaries," dividing the issues at stake into two categories:

- The first category is internal soundness, which comprises issues relating to the key features which any structure for the holding and transfer of securities through intermediaries must possess if it is to be regarded as sound, bearing in mind in particular the objectives of investor protection and efficiency.

- The second category is compatibility, which comprises issues affecting the ability of different legal systems to connect successfully where securities are held or transferred across national borders.

We appreciate and fully agree with the European Commission acknowledgement of the need for a harmonised approach which does not "seek to harmonise the national laws of legal ownership of shares between Member States." At the same time, however, we believe acknowledgment of the possibility of an Indirect Holding System, and its implications, must be taken into account according to the approach envisioned in the Geneva Convention[6].

Question 2 - Would a Principle along the lines set out above adequately accommodate the functioning of so-called transparent holding systems?

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[5] Id., p. 5.

[6] Article 8(2) of the Convention provides: "This Convention does not determine whom the issuer is required to recognise as the shareholder, bondholder or other person entitled to receive and exercise the rights attached to the securities or to recognise for any other purpose."

Please see our response to Question 3.

Question 3: If not: can you explain which aspect is not correctly addressed and what could be improved? Which are, if applicable, the repercussions on your business model?

As a preliminary remark, it is useful to point out that from an operational and business perspective transparent holding systems pose fundamental challenges to cross-border holding of securities.

If a transparent holding system requires that securities positions at the Central Securities Depositary ("**CSD**") be segregated by ultimate account holder, then this requirement is passed down the custody chain to the ultimate account holder, so that all account providers are forced to use segregated accounts. This represents additional cost and complexity. In practice, only institutional investors can bear the cost and complexity, and retail investors are in effect barred from investing directly in securities deposited in that CSD.

From a legal perspective, we recognise nonetheless the benefits of codifying current market patterns in transparent holding systems within the proposed legislation. In particular, we support the idea that the duties of "account *providers*" and "account *operators*" should be differentiated. However, there is a lack of clarity in the proposed principles, which are based on a distinction between transparent and non-transparent holding systems. Confusingly, this distinction assumes that account operators operate exclusively in transparent holding systems. However, this fails to reflect ordinary market practice, which frequently allows account operators to participate in non-transparent holding systems such as Indirect Holding Systems. Accordingly, we would suggest that the proposed principles be widened to cover both cases in a uniform and consistent manner.

Further, we would not describe the role of an account operator as a "shared function", and by using this phrase we believe that the proposals introduce unnecessary confusion. In particular, the provisions delineating the scope of functions which can be shared appears to extend beyond the activities of an account operator, to other outsourced or delegated activities. Accordingly, greater precision is needed in the proposed rules if the effect is to be limited to account operators. Further, any specific provisions on shared functions may appear obscure without the accompanying background information included in the Commission's present consultation paper. We would therefore consider it helpful to incorporate an additional explanatory section as a recital to the envisaged legislation, which could elaborate on (i) the distinction between permitted shared functions and excluded activities, including pure

outsourcing or delegated arrangements; and (ii) its interaction with other provisions in the Directive, for example, how the relationship between account providers and account operators would operate in relation to Principle 11, which imposes an obligation on intermediaries to take instructions exclusively from the account holder.

Similarly, there is also uncertainty regarding the limits of legal responsibility owed by account operators to account holders. As currently drafted, the obligations which attach to the performance of a shared function have not been restricted or tailored to the nature of an account operator's role: the draft provisions imply that account operators are subject to *all* of the duties imposed on account providers under the Directive. Such an extension does not reflect existing market practice in transparent holding systems and is likely to result in wider practical and operational difficulties. Typically an account operator will not have possession of the securities and will therefore be physically incapable of carrying out the duties imposed elsewhere in the Directive or in MiFID. Furthermore, we do not see how the arrangements suggested can apply where an account operator is situated outside the EU or where the law of the relevant jurisdiction permits a securities account to be operated by the client directly through an electronic settlement system.

Question 4 - Do you know any specific difficulties of connecting transparent holding systems to non-transparent holding systems?

We see the principal difficulties of connecting transparent systems to non-transparent holding systems as being:

- any obligation to segregate by ultimate account holding being passed from the CSD down the custody chain;
- differences in operational process when obligations to segregate by ultimate account holder apply to some categories of ultimate account holder but not to all; and
- non-recognition by tax authorities, issuers, etc that securities in any specific account at the CSD may have multiple ultimate account holders.

Question 5 - Would a principle along the lines described above provide Member States with a framework allowing them to adequately define the legal position of account holders?

As noted above, we support many of the basic objectives underpinning the proposed Directive, as well as the Geneva Securities Convention. The Association believes that it is desirable to ensure that there is no risk that an investor could be regarded as having an interest in securities simply because it has chosen (or has been obliged) to hold the securities through a custodian or other account provider. It is right and proper that all Member States in the EEA accept an internationally agreed set of principles, as set forth in the Geneva Securities Convention. Failure to follow the international standard will create uncertainty and lead to expense as investments into and out of the EEA require legal due diligence as to the fundamental issues addressed by Principles 4-12.

Unfortunately some elements of the proposals do not sit well with existing differences in member state rules on investor rights. For example, the specific rights given to ultimate account holders appear to allow them to leapfrog over the proximate account-provider, as they appear to be exercisable against other persons in the holding chain with whom the ultimate account holder has no contractual, property or regulatory relationship. However, we note that while such leapfrog rights are prohibited in some Member States, they are mandatory in other regimes. Such differences cannot easily be reconciled into a uniform approach, and any attempts to do so would be impractical and inconsistent with the Commission's functional approach. More generally, the resulting lack of clarity would be detrimental to the objectives of certainty, efficiency, and reduced cost for investors. We are also concerned that a lack of certainty as to whom an account provider (including CSDs) is accountable could create increased systemic risk, particularly in times of market stress.

We consider it important for the Directive to allow account providers to distinguish between securities accounts (which would have the legal effects specified in the principles) and other records relating to securities (which do not). For example, a custodian acting prudently will keep a record of all securities formerly held in custody but lent out by its clients; such records would not constitute "securities accounts" as they merely represent contractual, rather than proprietary, entitlements of clients, to have such securities returned at the end of the loan. Such records therefore do not confer the rights set forth in Principle 3. See further our response to Question 43.

Finally, the above uncertainties may become exacerbated depending on how the term "securities" is defined (i.e., to which kinds of financial instruments would it apply?). If "securities" includes financial instruments not held through any chain of intermediation such that there is no contractual privity with another account provider (as would be the case in the context

of OTC derivatives, many fund units and private equity shares), account providers would take on unacceptably high and completely uncontrollable risks.
Accordingly, we encourage adoption of the "functional approach" envisioned under the Geneva Convention. "Securities" are defined thereunder to mean "securities credited to a securities account *or rights or interest in securities resulting from the credit of securities to a securities account*."[7]

Question 6 - If not, which legal aspects that belong, in your opinion, to an adequate legal position of each account holder could not be realised by the national law under an EU framework as described above? What are the practical problems that might occur in your opinion, if Member States were bound by a framework as described above? Which are, if applicable, the repercussions on your business model?

We would like to re-emphasise that in the context of a long intermediation chain, additional difficulties will arise where some links are outside the EEA. Indeed, where securities are issued outside the EEA, we do not consider that some or all of the proposed investor entitlements could in practice be enforced. We would therefore suggest that the envisaged legislation be limited to securities of an EU issue. Please also see our response to Question 5.

Question 7 - The Geneva Securities Convention provides for a global harmonised instrument regarding the substantive law (content of the law) of holding and disposition of securities, covering the same scope as those parts of the present outline dealing this subject. Most EU Member States and the EU itself have participated in the negotiations of this Convention. Both the present approach and the Convention are compatible with each other.

See our response to Question 27 on the determination of the applicable law.

The business of members of the Association ordinarily comprises securities holdings and settlement of transactions involving both non-EU account holders and non-EU account providers (including CSDs) and issuers. We believe global compatibility to be essential – an EU-only solution is not viable in the context of integrated financial markets infrastructure. Please see our response to Questions 1 and 5.

[7] Article 1(d) of the Geneva Securities Convention.

Question 8 - Would a principle along the lines described above allow for a framework which effectively avoids that more securities are credited to account holders than had been originally issued by the issuer?

As an introductory remark, we note that the danger of "securities creation" by account providers is unwarranted. Account providers do not wish to incur the liabilities which exist under current law and which would arise if they purport to credit securities to a client's account when the account provider does not in fact hold the securities. We believe that the fears may have arisen out of the following possible scenarios:

- Contractual settlement. In some cases, in particular where securities are held in a CSD outside the EEA, it may be necessary as a result of market practice or appropriate to offer a client "contractual settlement". Contractual settlement means a contractual commitment by the custodian to credit and debit the customer's cash and securities accounts on the expected settlement date, regardless of whether settlement has actually occurred on that date with finality. It is important to remember that this is a hallmark of settlement date processing as this reflects the date upon which legal rights and obligations accrue: if there is a fail, a claim is typically asserted against the counterparty responsible for the fail in order to make the innocent party whole. Contractual settlement has become an important tool allowing portfolio managers to efficiently manage liquidity by relying on the predictability of projected cash positions for investment purposes and maintaining a record of positions to which their clients (typically collective investment schemes and other institutional clients, such as pension schemes) are legally entitled. On this basis, contractual settlement is seen as an important reflection of an economic position, which is supported by “provisional” entries pending “final settlement of any outstanding claims". We believe that contractual settlement is desirable in order to maintain the efficiency of investment services. We do not consider that contractual settlement gives rise to securities creation or other risks, because any credit entries made before securities are received with finality are, as a matter of practice, provisional entries. Securities in practice have to be credited before there has been absolute finality at the highest level of record keeping. If finality is not achieved, the entries will be reversed, as they would in the event of error, discussed below. In the meantime the account provider is fully aware that the credit is provisional. We consider that Principle 4, allowing for conditional credits, adequately caters for contractual settlement.

- Securities Lending. Where a client lends securities, they will be debited from the client's securities account as part of the process of transfer to the borrower. The lender's

custodian will keep a record of the securities lent, but this record does not and should not constitute a "securities account" (see the response to Question 5).

- Use of other intermediaries as account providers who re-use securities in the context of their own business. In such cases the prior express consent of such use by the account holder would be required. However, during the financial crisis the implications of this became clear when certain prime brokers and broker-dealers were unable to promptly identify securities belonging to particular clients. We note, in this respect, that there have been no losses of securities where “traditional” global custody services have been provided via custodians and sub-custodians who do not re-use securities as part of their own business.

The commentary to Principle 4 suggests that any credits which exceed the number of securities in existence would result in the creation of additional securities. This is not legally correct, as a securities account is not a copy of the issuer's register of shareholders (which is the final determination of a shareholder's entitlement), or of the issuance account at the issuer CSD. It creates instead a liability of the account provider to its client, and no more. Moreover, securities "creation" in a manner which would be detrimental to investors is not practically feasible under the terms of the envisioned Directive, for the following reasons. An investor whose account has been credited with securities will expect to be able to dispose of the securities and to enjoy the benefits of dividends and other corporate actions attributable to the securities. If the investor attempts to dispose of the securities, it will expect to receive the purchase price. Under the envisaged legislation, the account provider would be deemed to have "created" the securities by virtue of recording a credit to the investor's account, even though no equivalent upper-tier credit exists in favour of the account provider itself. Accordingly, it would be liable for the price of the securities disposed. The account provider would be penalised not just through liability for this action, but also because the obligation (which is effectively a short position akin to a derivative) would attract regulatory capital and other similar obligations. Likewise, if an investor becomes entitled to a dividend or proceeds of a corporate action which the account provider cannot supply, the account provider will be both liable and subject to consequences under the existing legal and regulatory system. Subject to limited circumstances, securities "creation" is therefore generally not a concern.

Clearly, there is a risk to investors in cases of error or fraud:

- Error by upper tier account provider or CSD. Where the CSD or other upper tier account provider erroneously credits the account of a custodian, the custodian has no means of

knowing that the credit is in error until a query arises. In this situation, the custodian in good faith believes the credit to be genuine and its client to own the credited securities. When the error comes to light the credit will be reversed. We also refer to our response to Question 15 in this regard.

- Fraud. Where an account provider has mis-appropriated the securities held for a client, there may be a mismatch between the holdings recorded for clients in the fraudulent account provider's books and its holdings at the CSD or upper tier account provider. We agree that account providers are under a duty to hold a corresponding number of securities to those credited to the accounts provided to clients, and in the event of insolvency (where the duty cannot be honoured) for shortfall provisions of applicable law to apply.

We agree that the Principles tackle these situations effectively, subject to the comments made in response to Question 10.

Question 9 - If not, how could a harmonised EU-framework better guarantee that account providers do not create excess securities by over-crediting client accounts (keeping in mind that all account providers are either banks or MiFID regulated entities)? Please distinguish between regulating the account providers' behaviour and issues relating to the effectiveness of excess credits made.

Please see our response to Question 8.

Question 10 - Is the principle relating to the passing on of costs of a buy-in appropriate? If not, in which way should it be changed and why? What would be the repercussions on your business model?

We agree in principle that it should be open to account providers and account holders to reach agreement on the consequence of losses or reversals. The Commission's proposal is, however, restrictive. An agreement would "only" be allowed in certain cases. As an example, it does not apply if the upper-tier account provider is outside the EEA or has lost its licence (owing to the requirement for the account provider to be MiFID-regulated – see our response to Question 41); and it also does not apply if the loss arises in relation to a segregated account. The outcome therefore appears to be that contractual arrangements would be disallowed in other circumstances; and consequently the account provider would not be permitted to share costs or losses with its client.

The effect of such an obligation is potentially to make each account provider who is the victim of an upper-tier error obliged to buy-in, as no securities would be available. This obligation would apparently be imposed regardless of fault on the part of the account provider. As explained above, there are circumstances where the account provider may have no credit in its favour but where the account provider is wholly without fault.

We are concerned that the imposition of a strict duty on account providers to immediately make up shortfalls of securities that occur in their accounts, but without enabling them to pass the costs of doing so on to their account holders, would have broad unintended consequences for the EU's markets. Indeed, the effect of the current text is to make lower tier intermediaries insurers of the solvency, integrity and operational efficiency of higher tier intermediaries, including CSDs, both within and without the EEA. Alternatively, it would require CSDs to assume a standard of liability which may exceed their financial and business capabilities. The above risks and consequent cost burden may compel some custodians to withdraw from the market, which would reduce effective market competition and investor choice. In view of the Commission's proposals to align the latest UCITS regulations with the depository liability regime under the AIFMD Directive, we would encourage similar principles to be adopted under the SLD, in order to create a clear and harmonised legal framework across the EU.

Question 11 - Would a principle along the lines described above provide Member States with a framework allowing them to determine legal effectiveness and ineffectiveness to an extent sufficient to safeguard basic domestic legal concepts, like e.g. the transfer of property?

We are concerned that the proposed provisions appear to conflict with the governing law provisions of the SFD, which state that the applicable law in relation to transfer of settlement finality is the law governing the settlement system in which the securities are held. This creates a potential conflict with governing law provisions of the SLD, which refers to the "national law" of the country where the relevant securities account is maintained by the account provider, subject to certain contingencies identified in Principle 14. The result would appear to be as follows:

If a transfer is not final under the law of the designated securities settlement system, under the SFD or under a legal system outside the EEA, each lower-tier account provider might have to reverse credits to the accounts of its clients. Those credits may, however, be subject to different "national law" requirements, and may therefore be legally effective under SLD as proposed notwithstanding the lack of finality at the CSD level. This would expose the account provider to

liability under Principle 4. Under the current system all that would happen is that the failure of finality would be treated as an error leading to a reversal at all levels and without loss to any person.

Multiple rules on the applicable law, settlement finality and account recording could thus allow for more errors and complaints to arise in intermediated securities holdings, which in turn could lead to increased systemic risk, particularly in times of market stress. As to applicable law, we also refer to our response to Question 15.

Question 12 - If not, please specify how and to what extent national legal concepts would be incompatible. Please specify the practical problems linked to these Background, and, if applicable, the repercussions on your business model.

Please see our response to Question 11.

Question 13 - Would a principle along the lines described above provide for a framework allowing effective protection of client securities in case of insolvency of an account provider?

We consider that it would be more appropriate for the Directive to focus on the necessary steps to ensure proper record-keeping among prime brokers who, unlike global custodians, will wish to exercise rehypothecation rights in relation to customer securities. In our view, the central problem revealed by the financial crisis was not that acquisitions and dispositions were ineffective against insolvency officers, but that the books and records of institutions did not clearly reveal whether securities holdings were off of the balance sheet of the account provider (ie, held in custody) or on the balance sheet (ie, rehypothecated). Steps to facilitate identification of customer securities would, in our view, be more valuable.

Question 14 (Principle 6) - If not, which measures needed for effective protection could not be taken by Member States under the proposed framework?

As stated above, taking steps to facilitate the identification of customer securities are appropriate. This has been a key area of focus since the financial crisis. It is nonetheless important not to over-extend this principle unnecessarily.

Question 14 bis (Principle 7) - Is the list of cases allowing for reversal complete? Are cases listed which appear to be inappropriate? Are cases missing? What are, if applicable, the repercussions on your business model?

We have no substantive comments to the proposals, as such. We do wish, however, to stress that as set out in the answer to Question 15, an account provider needs the ability to reverse credits that are not final at its account provider, and as set out in the fifth preliminary comment there must be no imposition of any form of insurance or guarantee obligations on custodians.

Question 15 - Should national law define the extent to which general consent to reversal can be given in standard account documentation? What are, if applicable, the repercussions on your business model in case your jurisdiction would take a restrictive approach to this question and limit the possibility of general consent to reversal?

Whilst we support the idea of allowing national law to prescribe a general right to reverse book entries, the current text is ambiguous on the applicable jurisdiction to implement this policy. In particular, it is unclear whether this would be the law of the Member state in which the account is deemed to be situated, the law of the head office of the account provider or the governing law contractually agreed upon between the relevant parties to the account agreement (which typically defers to the governing law of the relevant settlement system, etc.). In this regard, we note that under MiFID[8] the regulation of custody business is reserved to the home state regulator. We strongly believe that greater clarity in Principle 14 on the meaning of "national law" as used in the Directive will be needed, and that the choice between the three possible meanings should be carefully considered in order to avoid restricting freedom of contract and imposing needless regulatory burdens and, more importantly, legal uncertainty leading to the potential for increased systemic risk. Furthermore, we consider that there is a risk of introducing legal uncertainty where the general law, regulatory rules, and agreed upon contractual provisions, are in conflict. We consider that the Directive should strive for harmony between all relevant legal systems.

We consider that account providers should have a clear statutory power to reverse credits whenever there is no final credit in favour of the account provider. In any case, we also feel that

[8] Article 32 paras 1 and 7 remove the ability of branch state regulators to regulate custody business.

such a provision would be more effective if the Directive were to state expressly that it is open to account holders and account providers to agree the circumstances for reversal.

Question 16 - Do you agree with the 'test of innocence' as proposed ('knew or ought to have known')? Do you know of any practical obstacle that could flow from its application in your jurisdiction? What would be the negative consequences in that case?

Whilst we have no significant concerns with the 'test of innocence' proposed under the Directive, it is unclear how the duty to ensure investor protection against reversals would be implemented in practice. In particular, it is not clear how Principles 7 and 8 work together, specifically whether the restrictions limiting reversals in Principle 8 would take priority over Principle 7. Clarity on the right to make reversals and the rules which limit this process is of vital concern. We consider that it would be more helpful if the Directive set out further guidelines outlining when reversals could be prohibited.

Although we support the overriding objective of investor protection under this Principle, we are concerned that limiting the ability to reverse an erroneous credit may lead to certain effects and obligations not originally contemplated or intended by the legislation. For example, the reversal of a credit which resulted from a miscalculation by the CSD would introduce a no-fault liability standard for custodians and other account providers. The risk arises in the following way. If a CSD or other upper-tier account provider were to make an erroneous credit to a securities account held by a lower-tier account provider, under Principles 4 and 5 it appears that the lower-tier account provider must reverse the credit entry. But Principle 8 protects the lower-tier account provider's client, unless the client "knew or ought to have known that the crediting should not have been made". In ordinary operational situations there is no reason why the client knew or ought to have known that the CSD had made an error. Principle 8 does not explicitly provide that the lower-tier account provider is liable to the client in this case – it leaves it to the "national law" of member states to say who is liable. Whilst we recognise the difficulty in predicting potential commercial repercussions without regard to specific national restrictions, our concern is that there is no other person who could in practice be made liable to the client. The effect of the text is to ultimately require custodians to insure the investor against such potential errors, which would adversely impact credit lines and risk profiles and could lead to increased systemic risk in periods of market stress.

We would add two further comments:

- Please refer to our response to Question 15 in relation to the concept of "national law".

- Please refer to our response to Question 5 in relation to the difficulties which arise as a result of the Directive's proposals to govern investor rights, due to wide-ranging divergences in the approach amongst member states towards the creation of "leapfrog liabilities", i.e. where a client has apparent rights against any person other than its immediate account provider.

Question 17 - Will a principle along the lines set out above, under which the applicable law would need to afford an inferior priority to interests created under a control agreement, be appropriate and justified against the background that control agreements are not 'visible' in the relevant securities account? If not, please explain why.

We recognise the existence of priority conflicts among market participants with respect to the same securities and support the harmonisation of priority rules as a way of alleviating any uncertainty. However, where assets are held in a chain of intermediaries, we are concerned that the proposed provisions would allow upper-tier intermediaries to earmark the securities to the detriment of lower-tier intermediaries and their investor clients. This is because, as currently proposed, earmarking rules do not require prior notification to the account holder (in contrast to the proposals regarding control agreements). This could prevent any subsequent disposition of the securities which would be the subject of an invisible security interest in favour of a third party. In any case, lower-tier account-providers remain potentially exposed to broker-lien rights or similar entitlements which may arise by operation of law or contract in the event of a shortfall. Certain securities settlement systems would, for example, allow an upper-tier account-provider to assert broker-lien rights against other participants in the chain. In addition, the above scenarios may lead to difficulties in enforcing liability at the sub-custodian level, and the lower-tier account provider would apparently be liable to compensate the investor for any resulting shortfall. We consider that this would be an unfair and inappropriate outcome, and we would propose that the obligations of an account provider who is an intermediary in a chain of holdings be made subject to earmarking and any other rights which may be exercised by the upper tier account-provider.

Furthermore, in the interests of facilitating the protection of existing collateral structures, it would be helpful if such collateral arrangements could be grandfathered into the new regime, where they are incompatible with the prescribed collateral taking mechanics under the Directive.

Question 18 - Have you encountered difficulties regarding the priority/rank of an interest created under a mechanism comparable to a control agreement in the context of a priority contest, or, more generally, in an insolvency proceeding? If yes, please specify.

We have not encountered difficulties with control agreements. These arrangements are well understood and have been in legal effect in other countries for many years, where there has been no practical difficulty with their operation under the provision of services by custodians.

Question 19 - Would there be negative practical consequences for your business model flowing from a Principle along the lines set out above? If yes, please specify.

In view of the practical difficulties and cost implications associated with the current proposals, we re-emphasise our response to Question 17, with respect to grandfathering existing collateral structures under the Directive where appropriate.

Question 20 - Would a Principle along the lines described above pave the way for the national legal frameworks to effectively protect client securities in case of the insolvency of an account provider?

Please see our response to Question 13.

Question 21 - If not: Which mechanisms should be available which could not be implemented under a framework designed along the lines described above. Please specify.

We have no substantive comments to the proposals.

Question 22 - Should the sharing of a loss in securities holdings (occurring, for example, as a consequence of fraud by the account provider) be left to national law ? Would you prefer a harmonised rule, following the *pro rata* principle or any other mechanism?

We have no substantive comments to the proposals.

Question 23 - Would a Principle along the lines described above provide for a framework allowing the national law to effectively apply restrictions on whose instructions to follow for purposes of investor protection, notably in connection with the envisaged Principle contained under section 4 (Paragraph 2)? If not, please explain why.

We support the concept of limiting the ability to provide account instructions as a way of strengthening investor protection. In order, however, to align the current text to existing market practice, we would suggest that the right to instruct the account provider as the account holder's attorney or any other person duly authorised by the account holder to give instructions on its behalf, should be added to the list of exceptions.

Question 24 - Would a Principle along the lines described above provide Member States with a framework allowing them, in combination with the envisaged Principle on shared functions, to effectively reflect operational practice regarding attachments in your jurisdiction? If not, please explain why.

We have no substantive comments to the proposals.

Question 25 - Have you ever encountered, in your business practice, attempts to attach securities at a tier of the holding chain which did not maintain the decisive record? If yes, please specify.

We have not encountered such a problem. In some cases a client will specifically request an account provider to allow the enforcement of the account provider's rights against an upper tier account provider, but we do not believe this to be a case of "upper-tier attachment".

In fact, we believe that the current arrangements in place today provide an effective bar to "upper-tier attachment".

Question 26 - Would the proposed framework for protecting client accounts be sufficient? Should the presumption that accounts opened by an account provider with another intermediary generally contain client securities become a general rule? If not, please explain why.

We agree that it is desirable to protect investors against attachments attributable to the obligations of account providers. However, we have concerns that the proposal as currently formulated would be wider than is necessary to achieve this objective.

Account providers incur obligations in carrying out their clients' instructions and will typically take some form of rights (lien, security interest etc) in relation to the securities credited to the client's account in order to manage the risk stemming from such obligations. In large part this is done to

ensure the smooth functioning of securities settlement and liquidity by providing credit to account holders such as UCITS and other funds, broker-dealers, pension funds, hedge funds and ordinary investors in the course of their simple purchase of securities in the everyday cash markets. In the absence of pre-funding, which can be too costly for clients, the smooth functioning of settlement processes depends on the availability of this credit. Even when cash is to be raised from the proceeds of a sale of securities, account providers may provide credit in the event that such proceeds are not delivered when expected (e.g., on settlement date). Such credit arrangements are usually short-term and technical in nature to bridge, for example, differences in operating hours between markets or market infrastructures and hence are distinct from financing of trading activity.

Custodians thereby provide credit to their ordinary investor clients to ensure sufficient liquidity in the investment management process allowing those making decisions to buy or sell securities to do so efficiently (e.g., by not having to wait until settlement date on a securities sale before committing to a purchase on trade date).

The scope of services provided by members of the Association also includes ensuring timely settlement of foreign currency conversions, contractual settlement and ensuring liquidity to collective investment schemes (funds) in anticipation of cash being available to fund shareholder redemptions, all of which involve substantial extensions of credit to custody clients. Taken together, we believe that the amounts at stake are very significant indeed, and without adequate protection in the form of reliable securities collateral arrangements there is a systemic threat to these vital services which underpin the ordinary, low-risk activities of the financial markets.

Custodians therefore depend on the effectiveness of security financial collateral arrangements in order to make such credit available. It is neither appropriate nor fair that such rights should be denied to account providers. If denial of this basic method of protection against credit risk were to be entrenched in legislation, the consequence would be that custodians might well reduce credit availability, with unpredictable (but undesirable) consequences in terms of the liquidity of cash available to portfolio managers on a day-to-day basis as well as the liquidity of securities markets. Alternatively, systemic risk would increase as account providers would need to set aside more capital against increased unsecured exposures necessary to support the same activity.

The proposal as currently expressed may have other unintended consequences.. For example, securities can be held either in physical form in the vaults of a CSD (single certificates, jumbo certificates) or in dematerialised (book-entry) form. CSD participants currently are generally not

liable for the actions and omissions of the CSD, however, the rules and actions of CSDs effectively dictate legal consequences of participation in the CSD in practice. A CSD participant pool of funds might (or might not) be established to make participants whole for certain losses incurred which are caused by a CSD or other participants. A CSD is likely to have arrangements under its rules by which shortfalls and losses are divided up. Each participant in a CSD is thereby in a sense a potential "creditor" of each other participant, which in turn is an unavoidable consequence of investing in securities markets.

Cash settlement – inherently an "on-balance sheet" activity – is therefore inextricably linked with securities settlement. We are concerned that the proposal might have the effect that existing loss-allocation arrangements are disapplied or rendered legally uncertain.

Question 27 - Would a Principle along the lines described above allow for a consistent conflict-of-laws regime? If not: Which part of the proposal causes practical difficulties that could be addressed better?

We agree with the principle that legal certainty requires the account holder to know exactly which law governs its account. However, we believe there are doubts as to whether the approach set out in Principle 14 is capable of delivering such certainty.

The test for identifying the relevant governing law initially appears to be 'where the relevant securities account is maintained'. We note, however, that an account is deemed to be maintained where the relationship with the account holder is 'handled'. Application of the handling test raises significant potential difficulties. Although it is intended that the location approach should be based upon a single factual criterion, in practice the actual process of deciding which branch is maintaining or handling the account will depend upon the identification of a number of operational and administrative factors, including the branch through which the account was opened, the branch which handles the commercial relationship with the account holder, and the branch which administers payments or corporate actions. The location of some of these may be different and may change from time to time. These various factors will often point to different locations, thus reducing the level of legal certainty obtainable. Even more problematic, it is not uncommon for relationships to be managed by a branch or subsidiary located within the EEA when the custodial account is considered to be located outside the EEA. This impact of the envisaged legislation will ultimately reduce investor protection and legal certainty, in view of the growing number of organisations which operate account processing systems on a multi-jurisdictional basis.

These difficulties are increased to the extent that any chain of holding goes through several intermediaries, and in particular, in a cross-border context. The ability to undertake an analysis of relevant governing laws (and associated interconnected relationships and legal risks) based on such a combination of operational and administrative factors would be time consuming and expensive, and, we believe, may even be impossible in practice.

The current approach used by global custodians is broadly effective. Global custody contracts typically disclose risks of holding securities via cross-border settlement systems as being subject to other laws, regulations and other factors that are beyond the reasonable control of the global custodian. The kinds of risks that are typically disclosed in such contracts – for which custodians would not be liable - are described briefly in Appendix 1. It is essential that these risks are considered as part of the decision to invest in such markets, a decision that rests ultimately with the party responsible for making the investment rather than the account provider.

Question 28 - Would the mechanism of communicating to the client, whether the head offices or a branch (and if a branch, which one) is handling the relationship with the client, add to *exante* clarity? Is it reasonable to hold the account provider responsible for the correctness of this information? If applicable, would any negative repercussions on your business model occur?

Please see our response to Question 27.

Question 29 - The Hague Securities Convention provides for a global harmonised instrument regarding the conflict-of-law rule of holding and disposition of securities, covering the same scope as the proposal outlined above and the three EU Directives. Most EU Member States and the EU itself have participated in the negotiations of this Convention. The proposed principle 14 differ from the Convention as regards the basic legal mechanism for the identification of the applicable law. However, the scope of principle 14 is the same than the scope of the Convention: property law, collateral, effectiveness, priority. Do you 26 agree that this will facilitate the resolution of conflicts with third country jurisdictions? If not, please explain why.

Please see our response to Question 27. We prefer the approach taken in the Hague Convention, or failing that, that the location of the "relevant account" be a matter which can be agreed between the account holder and account provider, subject of course to a reality check such as that set out in article 4(1) of the Hague Convention.

Question 30 - Would a general non-discrimination rule along the lines set out above be useful? Have you encountered problems regarding the cross-border exercise of rights attached to securities?

We believe that the general non-discrimination rule set out in the first part of 15.1 is not simply useful, but is absolutely essential.

We are concerned by the second part of this rule, which states that national law can prescribe which holding methods account providers (including CSDs) should offer to their account holders. Our specific concern is the possibility that national law may require a national CSD to offer only the possibility of single beneficiary accounts to their account holders (i.e. that each securities account at the CSD holds securities from only one ultimate account holder). Such a prescription would be a major obstacle to cross-border holdings, as it would require all account holders in the chain to segregate securities positions in their books by ultimate account holder; such a prescription would generate an insurmountable barrier for most cross-border retail investors who would wish to invest directly in securities deposited at that CSD.

We believe that the second part of the rule is acceptable to the extent that it does not result in thwarting the effect of the first part of the rule. We also consider that in most countries in Europe the cross-border exercise of rights is hampered to a greater or lesser extent by dispositions in national laws and in company statutes.

Further, we would like to emphasise that this rule will be ineffective against non-EEA issuers and account providers (including CSDs). Therefore, it is important that EEA-located account providers not be required to provide for rights and remedies that cannot be obtained in practice. Please also see our response to Question 38.

Question 31 - If applicable, would a Principle along these lines have (positive or negative) repercussions on your business model? Please specify.

This depends on how such a Principle would be implemented (please see previous response).

Question 32 - Is the duty to pass on information adequately kept to the necessary minimum? Is it sufficient?: If applicable, would there be any (positive or negative) repercussion of such a Principle on your business model? Please specify.

The flow of information available at upstream and downstream levels may be considerable. In view of the potential cost incurred by financial intermediaries in processing such information, we consider that conferring a degree of flexibility on the account provider with respect to sharing information would allow the contracting parties to be more efficient. In any case, certain ultimate account holders may wish to decline this information in certain cases and accordingly, it would be helpful if the Directive recognised that an indirect account holder may not necessarily require the same level of access to information as a direct account holder. This would be of vital importance where the provision of information is routed, at the direction of the economic owner of the securities, to other agents, thus affecting the type of information which can be provided. As a preliminary proposal, we would therefore suggest that a right to exclude or redefine these obligations by express contractual consent would achieve this aim without undermining the objective of information transparency. In view of the potential costs involved, we consider it both unfair and impracticable for account providers to supply information where time restrictions may apply or where it would be disproportionate to the relative benefit provided to the account holder.

We believe that Principle 16 should confirm, but should not go beyond, the requirements set out in the Market Standards for General Meetings, and the Market Standards for Corporate Actions Processing. Among other points, Principle 16 should not impose obligations on account providers to pass on general meeting information in cases where issuers have not provided the information in standardised electronic form, and in cases where the ultimate account holder is unable to receive information in electronic form.

In addition, we consider that it would be the issuer's ultimate responsibility that certain information reaches ultimate account holders and that they are able to exercise their rights effectively, for example, by exercising relevant voting rights. Accordingly, whilst the provision of such information would constitute a service performed by account providers, issuers should, under certain circumstances, be required to bear the cost of such activities. From an operational perspective, significant improvements to this particular process require clarification of, for instance, the party who is responsible for standardising the information (such as the conversion of information into a transmissible electronic format).

We recognise the difficulties which may be encountered in implementing the above requirements prior to adoption of the Directive, as they imply fundamental re-engineering of this process according to the standardisation procedure under Principle 16. Accordingly, we would re-emphasise our recommendation to give account providers a clear right to define the scope and level of information passed onto account holders.

Question 33 - How do you see the role of market-led standardisation regarding the passing on of information? What are your views on a regulatory mechanism for streamlining standardisation procedures?

We see market-led standardisation as absolutely critical to achieve the underlying objective which is to ensure that there is the possibility for efficient and cost-effective communications between issuers and investors through the custodial chain. We see close cooperation with regulatory authorities, both at national and at European levels, as a necessary condition for successful market-led standardisation initiatives.

Question 34 - If you are an investor, do you think that a Principle along the lines described would make easier any cross-border exercise of rights attached to securities, provided that technical standardisation progresses simultaneously? If not, please explain why.

We make no comment in the capacity of investor.

Question 35 - If you are an account provider, would you tend towards the opinion that your clients can exercise the rights attached to their cross-border holdings as efficiently as their domestic holdings? What would be the technical difficulties you would face in 31 implementing mechanisms allowing for the fulfilment of the duties outlined above? What would be the cost involved?

We believe that we and our clients have significantly greater problems in facilitating the exercise of, and exercising, rights attached to securities for cross-border holdings than for domestic holdings. We see the sources of the problem as being both national law (including company law) as well as market practice (including issuer articles of association).

Whilst we understand the principles which underpin the proposals, we consider that they go beyond the difficulties which the envisaged legislation seeks to address. In our view, the effective recognition of the ultimate account holder's rights is largely dependent on the company law regimes in each individual member state and, in particular, the performance by the issuer of its obligations and duties. In the absence of harmonising all national corporate rules into a uniform set of principles, we consider that such national divergences should continue to be followed, rather than implementing a wide-ranging set of rights, which may be incompatible with

member state laws or result in consequences not originally foreseen by the envisaged proposals.

However, we recognise that the effective exercise of the ultimate account holder's voting rights may be undermined where such rights continue to be governed by national law. Nevertheless, such operational changes as would follow from the proposed Principle relate to the methods and infrastructure under which account holders can exercise their rights. We therefore believe that they lie outside the scope of this Directive and may be more suitably encompassed under other harmonisation initiatives.

Question 36 - If you are account holder, have you encountered differing prices for the domestic and the cross-border exercise of rights attached to securities? If yes, please specify.

The requirement to align fees for both cross-border services and comparable domestic holdings does not reflect standard industry pricing practices. In particular, this requirement fails to recognise that many account providers do not generally base price tariffs on geographical considerations. Rather, such tariffs are based on a number of factors, such as service level requirements, local rates for services provided by overseas market participants (primarily sub-custodians and CDSs) and the costs associated with servicing the relevant assets. For example, it would be more expensive to provide custody services in a market which is not dematerialised. Whilst the various factors which determine service pricing may vary depending on different markets, it is not always based on an assessment of where the securities are held. Accordingly, we do not consider that the current cost mechanisms for providing such services should refer to 'domestic' or 'cross-border services. We understand that the policy of uniform pricing is being analogised to the pricing under Regulation 924/2009 in relation to euro-denominated payments. However, cross-border securities custody and settlement services are materially different from cross-border euro payments.

In particular:

- The costs of custody and securities settlement services are still highly dependent on the national company law applicable to the securities in question. A corporate action relating to a Finnish share is handled in a different way from an English share, in part because Finland uses a direct holding system (see Question 3), in part because the company law is different and that requires a different approach. In either case, it is the service level requirements for each type of security which will determine the relative cost of the

services which relate to it. Added to that, the language in which corporate events are notified will differ in a case where the investor is in a different member state.

- The euro is a single, international currency with a centralised, non-national mechanism for achieving settlement. We note that Regulation 924/2009 does not attempt to establish uniform pricing regardless of currency. It is restricted to the euro because the costs of cross-border settlements in other currencies are subject to national factors which do not arise in relation to settlements in euro.

- The securities law proposals are not restricted in their geographical extent to the EEA. We do not see any policy reason for requiring pricing of inward or outward services the same as domestic services, particularly in the case of less-developed markets.

If uniform pricing were mandated through legislation, we believe that this would introduce an element of artificiality into existing pricing structures, which will no longer reflect the environment in which markets operate. Further, this may ultimately require account providers to raise the price of services in less expensive markets. The impact would be that investors investing in more efficient markets would be subsidising those investing in less efficient ones. This defeats the purpose of market efficiency and investor protection.

Finally, it will not follow from uniform pricing at the custodian level that pressure is put on CSDs to lower their charges or introduce efficiencies in essentially what is a low-margin business, because of the persisting national differences explained above. We believe that the forthcoming legislation relating to CSDs is the right place to implement policy regarding competition and efficiency among market infrastructure.

Question 37 - If you are an account provider: do you price cross-border exercise of rights differently from domestic exercise? If yes: on what grounds are different pricing models necessary?

The Association does not share pricing information among its members.

Question 38 - Have you encountered difficulties in using non-EU linkages as regards the exercise of rights attached to securities? If yes, please specify. If not, please explain why.

We recognise the inherent difficulties in guaranteeing the effective exercise of rights against non-EU account providers and issuers. However, we consider that the introduction of an

extended duty applicable to EU regulated account providers, as proposed under the Directive, is not a viable solution. As currently drafted, the proposals would place an onerous obligation on EU account providers to compensate for any errors committed outside the EU. This would effectively require custodians and other intermediaries to underwrite third country investment risk.

Question 39 - Admitting that non-EU account providers cannot be reached by the planned legislation, which steps could be undertaken on the side of EU account providers involved in the holding in order to improve the exercise of rights attached to securities through a holding chain involving non-EU account providers?

We consider that recourse to best practices which are generally consistent with legal regimes outside of the EEA and which are currently undertaken by global custodians would provide an effective form of protection. Please see Appendix 2 for a summary of the main principles proposed.

Question 40 - Do you think that a general authorisation to exercise and receive rights given by the account holder to the account provider should be made subject to certain formal requirements? Please specify.

As stated in our response to Question 1, we recognise the potential difficulties in harmonising the diverse legal systems of the EU's Member States in relation to securities holdings and dispositions, and support the functional approach employed by the Commission as being a practical way of achieving a harmonised framework across the EU. We consider that this approach would be a particularly effective way of addressing the transfer of rights attaching to securities, where differing national rules on contract and company law may apply. Accordingly, we believe that a general authorisation to exercise and receive rights provided by the account provider should be subject only to those formal requirements imposed by national law and agreed market practices, rather than laid down in EU-wide legislation, which may distort existing market practice and stifle competition.

Question 41 - Should the status of account provider be subject to a specific authorisation? If not, please explain why.

We agree in principle that it is desirable for there to be regulatory supervision of account providers. However, we are concerned that the proposal intended to ensure suitable regulation may have unintended consequences.

To require account-providers to obtain authorisation under article 5 of MiFID is unobjectionable. But to deem the provision of a securities account to be a full MiFID 'investment service' appears unreasonable, given that there are many other provisions of MiFID, designed with broking services in mind. These other provisions (for example, to assess 'appropriateness' of the service, and to obtain irrelevant information from the client about his/her experience) do not strengthen the level of protection enjoyed by the client but will add significantly to the cost of providing account-related services. Whilst most of our UK-based firms are already authorised, this is not the case with regard to overseas subsidiaries in jurisdictions such as Ireland (where trustees and custodians need not be a MiFID firm) and Luxembourg (where custodians tend to be credit institutions). As these firms do not have licenses under MiFID, these proposals represent an additional layer of regulatory compliance on their operations.

This principle is also unclear on the potential consequences of a financial institution which loses its licence to hold securities. In such cases, the firm would no longer amount to an 'account provider' under the Directive as it would no longer be regulated. We are concerned that lower-tier account providers, as well as investors, should not lose the rights conferred by the Directive simply because of a compliance failure at an upper tier. The Directive should therefore contain a saving clause which protects third parties in the event of loss of (or failure to obtain) a licence as mandated by the Directive.

Question 42 - If yes, do you think that MIFID would be an appropriate instrument to cover the authorisation and supervision of account providers?

Please see our response to Question 41 above.

Question 43 - Do the terms used in this glossary facilitate the understanding of the further envisaged Principles? If no, please explain why.

(i) *Definition of 'securities'*

We are concerned at the breadth of the meaning of "securities" under the Directive. The proposed definition covers all financial instruments under MiFID where they are capable of being credited to a securities account. This is an extremely wide provision which extends the application of the Directive from securities in the traditional sense to instruments such as derivatives, money market instruments and fund units.

A general reference to the definition of financial instruments under MiFID may therefore lead to effects and obligations not originally contemplated or intended by the legislation. We do not see,

for example, how some provisions applicable to equities accounts could be applied to accounts to which derivative instruments are credited (for example Principles 3, 4, 10, 15); nor do we find it straightforward to predict how provisions which would work well for equities and bonds credited to accounts would operate for other types of transferable investment such as units in collective investment undertakings, which have different transfer and distribution characteristics (such as Principles 4, 7, 8, 9, 17) and where the custodian is not an agent of the issuer (no chain of intermediation and no privity). We believe that to extend the Principles in a blanket fashion to all MiFID financial instruments would introduce immense legal uncertainty and therefore enormous risk.

Similarly, we believe that greater clarity should be provided to ensure that units in collective investment schemes are excluded from the scope of the Directive. Units in collective investment schemes exist in a wide variety of form. We do not believe that applying the provisions of the proposed Directive, which derive from the work of the Legal Certainty Group on shares and debt securities, would be safe without further legal analysis. We think there is an unacceptable risk of unintended consequences by broadening the scope of application of the Principles in this way.

In our view, all these issues would be avoided if "securities" under the Directive were limited to equities and debt securities.

(ii) Definition of "securities account"

We explained in our response to Question 5 that we were concerned that some administrative records might become, or be deemed to be, "securities accounts", with unintended and unwanted consequences. We therefore consider that it would be preferable for the definition of "securities accounts" to make it clear that only *safekeeping* accounts are within the scope of the definition.

(iii) Definition of 'account provider'

We note that the geographical status of account providers needs to be clarified. In particular, the definition of "account provider" fails to specify a geographic scope for the application of the Directive, which currently assumes that all securities are held in the EU. This is significant, as the current drafting would suggest that the Directive is capable of applying EU ownership rules to securities issued or held outside the EU.
The absence of a clear geographic scope to the Directive also leads to uncertainty in other parts of the text, which are conceptually unworkable. For example, the purpose behind Principle 17,

which seeks to ensure that the ultimate account holder should enjoy the same rights as those enjoyed by a registered shareholder, would be difficult to achieve where the issuer is situated outside the EU. This is because various practical constraints, particularly in relation to voting and communication procedures, are likely to apply. This kind of practical issue would make it impossible for the investor to receive and exercise precisely the same rights as if the investor were directly registered as a shareholder in a company's own register.

Finally, for the reasons outlined in our above consideration on the proposed definition of "securities", we would propose that the Directive adopt a narrower definition of "account provider" to exclude from the scope of the Directive transfer agents in respect of collective investment undertakings.

Question 44 - Would you add other definitions to this glossary?

Please see our response to Question 43.

We hope this submission is helpful in assisting the European Commission in the preparation of a revised draft of the Directive. Association members stand ready to provide any further clarification on these issues and would welcome the opportunity to discuss the above concerns in further detail if it would be helpful to you.

Appendix 1

Illustrations of the Types of Risk for which Account Providers Cannot be Responsible

1. Settlement System (CSD) Rules	• Rules of and/or Conditions for Participation in Settlement Systems, including compulsory liens and transaction reversals imposed by central securities depositaries; • Settlement failures in non-DVP markets; • Non-exclusive control of accounts under client-specific account structures.
2. Market Infrastructure Deficiencies	• Market infrastructure outages; • Sub-standard market infrastructure and quasi market infrastructure (including sub-custodians); • Fraud by a sub-custodian, beyond the account provider's reasonable control and monitoring/reconciliation/due diligence responsibilities.
3. Local Market Conditions	• Market volatility; • Widespread defaults; • Market closures and currency devaluations; • Sovereign Risk events.
4. Appointment of Counter-parties by account holder or its designated agent	Failure of the trading counterparty in the context of: • Securities lending and repo arrangements; • Prime brokerage arrangements involving rehypothecation of account holder assets; or • Derivatives transactions.
5. Investment Decisions of account holder or its designated agent	The decision to invest in: • Markets where infrastructure does not meet EU standards; • Highly volatile or unstable markets.

More detailed “case studies” illustrating each of these risks have been developed by the Association in connection with the AIFM Directive. We would be pleased to provide this detail, however, the list above, and the more detailed case studies, should not be considered exhaustive. It is suggested that the Directive makes clear that an Account Provider should not be responsible where it has performed according to prescribed standards of care and for those risks that are disclosed and which are beyond its reasonable control.

Appendix 2

Proposed Approach for Selection, Supervision and Oversight of Foreign Sub-Custodians and Settlement Systems

1. General Requirements.

In general, the following requirements may be prescribed:

(a) The records of the EEA account provider custodian should at all times delineate the name of the party for whose accounts the securities are so deposited, including when these securities are held through third parties outside the EEA.

(b) If securities are to be placed onward with third parties, such as with sub-custodians, this possibility should be disclosed in the relevant agreement with the account holder together with sufficient disclosure of the conditions under which they are so held and which might limit their availability to be returned.

(c) It should be disclosed that under various settlement systems records of securities considered “in transit” in connection with their settlement and records of registrars and other agents of issuers may not at any particular time match the EEA account provider’s records, as it is not possible to ensure this.

2. Appointment of “Foreign Sub-Custodians”

In respect of securities held via non-EEA sub-custodians ("**Foreign Sub-Custodians**") appointed by the account provider:

(a) The EEA account provider should be required to determine that securities held via Foreign Sub-Custodians will be subject to reasonable care, taking into account the standards applicable to custodians in the relevant market, after considering all factors relevant to the safekeeping of the securities in such market, including:

- The Foreign Sub-Custodian's practices, procedures, and internal controls, including the physical protections available for certificated securities (if applicable), the method of keeping custodial records, and the security and data protection practices;

- Whether the Foreign Sub-Custodian has the requisite financial strength to provide reasonable care for the securities;

- The Foreign Sub-Custodian's general reputation and standing; and

- Whether the account holder will have jurisdiction over and be able to enforce judgments against the Foreign Sub-Custodian, such as by virtue of the existence of offices in a member state of the EEA or consent to service of process in member state of the EEA.

(b) The EEA account provider should also be required to establish a system to monitor the appropriateness of maintaining the securities via a particular Foreign Sub-Custodian and to monitor performance under the contract appointing the Foreign Sub-Custodian.

(c) Holdings with Foreign Sub-Custodians should be verified at least three times per fiscal year, two of which could be without notice, either directly or by qualified, reputable, independent auditors.

(d) Provision should be made that more sophisticated account holders (without an account provider having to “look through” immediate account holders to ultimate account holders) may consent to take risks identified contractually by the EEA account provider such that use of certain sub-custodians may be at the risk of the account holder (with the presumption that similar consent has been obtained by the ultimate account holder or its appointed representative). In such cases, some or all of the requirements need not apply where the EEA account provider identifies them as not capable of being performed with assured care. Such an approach would seem appropriate where account holders qualify as Professional Clients or Eligible Counterparties under MiFID.

3. Use of Foreign Settlement Systems

In respect of direct or indirect use of non-EEA depositories and/or settlement systems (**"Foreign Settlement Systems"**) which are considered operators of 'designated settlement systems' as designated for the purposes of SFD or the provision of similar services by Foreign Settlement Systems:

(a) It should be recognised that the ultimate account holder, or the party to whom it delegates investment responsibility, is ultimately responsible for the consequences of investing in markets where securities settlement, market infrastructure and other local factors are beyond the control of an EEA account provider. In other words, the decision whether to place assets (including securities) with a Foreign Settlement System should be made by the ultimate account holder or its designated representative, but it is to be acknowledged that

this decision at least in part should take into consideration of information provided by the EEA account provider. It is not realistic to require that all information that is relevant to this decision must come from the EEA account provider because such decisions must be made in the overall context of the decision to invest in a particular country: this is the essence of fiduciary responsibilities undertaken as part of the investment process. However, it is to be expected that EEA account providers should provide information enabling ultimate account holders or their representatives to make these determinations to their satisfaction. If they lack sufficient information to make a particular determination as to whether to invest in a particular country, the ultimate account holder or its designated representative should either decline to invest or request additional information.

(b) Ultimate account holders or their designated representatives should therefore be expected to apply risk analysis based on information provided by the EEA account provider about the relevant Foreign Settlement System(s).

(c) Information that the EEA account provider might provide, and factors that the ultimate account holder or its representative might consider, in applying such risk analysis include whether a Foreign Settlement System:

- operates as a system for the central handling of securities or book-entries in the country where it is organised and domiciled, or operates as a transnational system for the central handling of securities or equivalent book-entries;
- is regulated by a foreign financial regulatory authority;
- holds securities under safekeeping conditions for the relevant EEA account provider or Foreign Sub-Custodian on terms that are no less favourable than those applying to other participants;
- maintains records identifying each participant's assets and segregates assets of the Foreign Settlement System from those of participants;
- provides periodic reports to participants; and
- undergoes periodic examination by regulatory authorities or independent auditor review.

(d) The EEA account provider should be expected to conduct a preliminary risk analysis and ongoing risk monitoring of a Foreign Settlement System, and give notice to its account

holder material change in risk such that this information is passed on to the ultimate account holder or its appointed representative in a timely way. The EEA account provider's analysis should cover the Foreign Settlement System's expertise and market reputation, the quality of its services, its financial strength, any insurance or indemnification arrangements, the extent and quality of regulation and independent examination of the Foreign Settlement System, its standing in published ratings, its internal controls and other procedures for safeguarding securities, and any related legal protections. Finally, the EEA account provider should be required to contractually agree to exercise (at a minimum) reasonable care, prudence and diligence in performing its duties in respect of holding securities directly or indirectly in foreign securities settlement systems.