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14 January 2011

By Electronic Delivery

Mr Richard Stobo
Senior Officer
The European Securities and Markets Authority
11-13 Avenue de Friedland
75008 Paris
France

Re: CESR Call for Evidence Concerning Implementing Measures on the Alternative Investment Fund Managers Directive ("AIFMD")

Dear Mr Stobo:

The Association of Global Custodians ("**AGC**") is an informal association of ten global banks. Member banks conduct depositary and custodian services for institutional investors around the globe, including throughout Europe, and they hold more than EUR 55 trillion of assets on behalf of their clients, including a substantial stake in EU domiciled fund assets.

The AGC seeks to play a constructive role in ensuring the effectiveness of regulation, while avoiding unintended consequences. In that spirit the AGC welcomes CESR's call for evidence seeking input on its/the European Securities and Markets Authority's ("**ESMA**") advice on the content and form of the implementing measures to be adopted with respect to the AIFMD ("**implementing measures**"). AGC members have identified a number of areas in the text of the AIFMD that would benefit from clarification, so that the principles elaborated at Level 1 can be practically implemented. Because there has not been a formal process of public consultation on the AIFMD to date, nor an impact statement, there has been limited opportunity to raise and address these considerations, many of which are quite technical in nature. The AGC does not seek to change the principles elaborated in the final text of the AIFMD, but members note that there will be significant benefit for investors, industry participants and regulators to make the process of developing the advice to the Commission on the implementing measures both consultative and iterative.

By way of general comment, the AGC would like to express its concern regarding the potential imbalance between depositaries' duties and the duties of the Alternative Investment Fund Manager ("**AIFM**") under the AIFMD and implementing measures. The AIFMD and the Commission's "Provisional Request to CESR for Technical Advice on Possible Level 2

Measures Concerning the Future Directive on Alternative Investment Fund Managers" ("**ESMA's Mandate**") are presumably intended to achieve the alignment of depositary functions throughout the EU, which AGC members welcome from an operational perspective. However, the expansion of depositary oversight duties set out in Article 21 of the AIFMD attributes responsibility to depositaries for functions that have until now been fulfilled by the AIFM or other third parties. The AGC is concerned that this shift in responsibility may impose a burden on depositaries that is inconsistent with the legal regimes in other jurisdictions where the AIFM, or equivalent entity, continues to retain a higher level of responsibility than is the case under the proposed EU regime.

The submission below identifies and comments on those questions contained in CESR's "Call for Evidence" and ESMA's Mandate which members consider to raise key issues for depositaries. This set of comments is relatively high-level as members understand that ESMA is not seeking detailed comments at this preliminary stage, assuming that detailed consultations will follow in the coming months. While the AGC's submission is primarily focused on depositary issues related to Article 21, it considers that further, more detailed discussion in relation to valuation issues under Article 19 and Issue 9 is required and would be willing to provide detailed comments on this issue. Of course, members also stand ready to provide additional detail on any of the other issues considered below on request. If you have questions regarding this letter or would like additional information, please contact Edwina Dunn, at Clifford Chance, at edwina.dunn@cliffordchance.com or +44 (0)20 7006 1230 as an initial matter.

Sincerely yours on behalf of the Association,

Dan W. Schneider
Baker & McKenzie LLP
Secretariat to the Association

Dan W. Schneider
by Edwina Dunn

RESPONSES TO QUESTIONS FOR CESR'S CALL FOR EVIDENCE

1. **Categories of investment manager and investment fund**

The AGC considers that this subject should be covered by its members either individually or in collaboration with local fund industry associations as there is a huge number of different investment fund categories across Europe.

2. **Form of implementing measures: directive or regulation**

The AGC considers that the implementing measures, at least insofar as they concern depositary issues, should take the form of a directive. Given that the majority of implementing measures relating to depositaries are closely linked to the law of contract, liability and property, all of which are issues for the national law of each Member State, implementing measures must take account of such national laws and must therefore be carried out at the national level.

3. **Sources of data and statistical evidence**

The AGC refers to its report "2009-2010 Depository Information-Gathering Project: A Report for Clients and Participating Depositories" of 29 January 2010. A link to the full report and the related press release are included below:

http://www.theagc.com/Comment.Letters/SEC/DIGP/2009-2010%20DIGP%20CD%20Rom%20(Final).pdf

http://www.theagc.com/Press.Releases/DIGP%20-%202009-2010%20Press%20Release.pdf

RESPONSES TO QUESTIONS CONTAINED IN ESMA'S MANDATE

III. PART II: DEPOSITARY (ARTICLE 21)

III.1 **Issue 11 – Contract evidencing appointment of Depositary**

Questions 1 and 2: With regard to the particulars to be found in the standard agreement evidencing the appointment of the depositary, the AGC is of the view that the implementing measures should only come into line with Commission Directive 2006/73/EC implementing Directive 2004/39/EC, which sets out the minimum requirements with which investment firms should comply in relation to the safeguarding of client financial instruments and funds, and the depositing of client financial instruments with third parties. See in particular Articles 16 and 17 thereof. It is not necessary to go further, and to impose a single standard agreement which would have common legal effect in each Member State and would not in any event be practicable to achieve in the cross-border context given the differences in legal forms AIFs may have

and applicable laws and regulations. The merit of a directive as the implementing instrument is that the common principles required by the Level 1 instrument can be given effect with regard to the legal environments in each Member State, so that greater uniformity of result will actually be achieved by allowing for greater sensitivity to the means of implementation in each Member State.

By way of example, and even if it does not completely fit to the appointment of a depositary, we have included in **Appendix 1** hereto, an extract from section 6.3.3 of CASS, the client asset section of the UK Financial Services Authority handbook, which sets out a list of example contractual terms which investment firms should incorporate into agreements with third parties with which it will deposit safe custody assets belonging to a client. This rule only specifies potential content for an agreement rather than specifying particular terms.

Moreover, especially in the context of AIFMD, it is not possible to impose a "one-size-fits-all" document covering all asset classes. Relevant contractual provisions relating to real estate-related funds are likely to be quite different from those relating to funds investing solely in more liquid assets such as exchange-traded equity securities, money-market instruments and cash. This is because considerations impacting different asset classes are enormously varied.

Although the AGC does not consider that a standard agreement is possible or appropriate, we recognise that certain harmonised requirements are possible which might be based on:

- the abovementioned section of CASS that are applicable to funds rather than investment firms;
- certain requirements for cooperation between depositaries and AIFMs as contained in Directive 2009/65/EC ("**UCITS**"); and
- the principles regarding delegation of safe-keeping duties, and transfer of liability to third parties contained in the AIFMD.

III.2 **Issue 12 – General criteria for assessing equivalence of the effective prudential regulation and supervision of third countries**

Questions 1 and 2:

With regard to the criteria for assessing whether the prudential regulation and supervision applicable to a depositary established in a third country with respect to its depositary duties are to the same effect as the provisions laid down in European law, in ESMA's Mandate the Commission asks ESMA, among other issues, to consider whether the depositary "is subject to **specific** capital requirements **for the safe-keeping of assets**" (emphasis added). The AGC considers that this question introduces super equivalent standards which are neither contemplated in the AIFMD, nor in UCITS, as there are currently no specific regulatory capital rules in the EEA relating to safekeeping

activity (apart from an operational risk charge). Since the financial instruments of an AIF held in custody are held off-balance-sheet, the need to treat them in a similar manner as financial instruments held on the balance sheet of the custodian is unclear.

Article 21(10)(d)(ii) of AIFMD provides that the depositary must ensure that a third party "is subject to effective prudential regulation (including minimum capital requirements)" as far as the delegation of custody tasks is concerned. Article 23 of UCITS requires a depositary to be "an institution which is subject to prudential regulation". Neither of these provisions requires prudential regulation to be specific to the safekeeping of assets. Such requirement would therefore be inconsistent with the AIFMD framework directive and with UCITS, and would not reflect current regulatory capital requirements under the Capital Requirements Directive.

In light of the above, the AGC wishes to emphasise that depositaries established in a third country should be subject to prudential regulation which is equivalent to the standards set down by the Basel Committee, but should not be required to be subject to specific regulations relating to the activity of safekeeping assets.

The AGC is of the view that the implementing measures should only come into line with Commission Directive 2006/73/EC implementing Directive 2004/39/EC which sets out in Article 17(3) the requirements for investment firms. In order to maintain a level playing field with respect to other players on the financial markets such as insurance companies, investment firms or normal credit institutions, depositaries should not be subject to more burdensome due diligence requirements than the aforementioned entities.

III.3 Issue 13 – Depositary functions

Issue 13.1 – Depositary functions pursuant to paragraph 6

Question 1: With regard to the requirement for depositaries to ensure that the AIF's cash flows are properly monitored and that all payments made by or on behalf of investors upon the subscription of shares or units of an AIF have been received and booked in one or more cash accounts, the AGC considers that in order to set down implementing measures in this regard it may be useful for the AGC to provide additional information in the form of a more interactive discussion in order to explain the cash flow life cycle, from subscription to redemption, as well as in the course of clearing, settlement and distributions. These issues can be very complex when taking into account chains of distribution through which shareholders subscribe for or redeem shares (or receive income and/or dividend payments) and the AGC would therefore like to offer its assistance by providing additional information on how the cash life cycle functions in practice.

With regard to the requirement for depositaries to ensure that where cash accounts are opened with certain other entities[1] "in the name of the AIF or in the name of the AIFM

[1] i.e., ". . . at an entity referred to in Article 18(1)(a) to (c) of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational

acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF," none of the other entity's or the depositary's own cash is kept in the same accounts (AIFMD Article 21(6), final paragraph), the AGC considers that it is essential to clarify this requirement with respect to the manner in which credit institutions (as opposed to non-bank investment firms) hold cash, i.e., cash belonging to a bank is recorded on a bank's books as an asset, whereas cash belonging to clients is recorded on a bank's books as a liability.

While the AGC understands and supports the policy objective, namely to ensure the effective segregation of depositaries' own funds from the funds of their AIF clients, the implementing measures should clarify that Article 21(6) is not intended to prevent banks from treating cash received from AIFs as ordinary deposits (liabilities), nor to require them to handle such cash in some novel way inconsistent with the accepted approach to deposit-taking and accounting. Moreover, the global system of securities settlement requires recognition that banks provide and receive liquidity to and from each other in the form of correspondent accounts. As a result, Article 21(6) must be read to continue to permit continued operation of correspondent ("nostro") accounts by and among banks in the context of funding of securities settlement requirements of AIFs. For example, whilst AIFs (or AIFMs on behalf of AIFs) might hold cash deposits with a depositary (assuming the depositary is a credit institution), usually the depositary will effectively fund the AIF's securities purchase in another market. This is because a deposit liability to the AIF is offset by a bank depositary on its balance sheet by an asset representing a claim on the subcustodian via an omnibus correspondent banking account. In other words, the subcustodian's liability will be to the depositary, and not to the AIF, and therefore will not be "cash of the AIF" (within the meaning of Art 21(6)): this is a core concept underpinning the functioning of the global financial system. If it would be of assistance, the AGC would be happy to provide additional information on this issue by way of interactive discussion.

In the case of deposits held with third party credit institutions as investment, it is possible that deposit obligations may be opened in the name of the depositary acting on behalf of the AIF (i.e., "registered in the nominee name" of the depositary), but this approach is often seen to inhibit critical liquidity requirements of the AIFMs. Recording the deposits in the name of the AIFM or the AIF may serve to facilitate liquidity, but in this case the depositary would not be able to ensure all cash held with and income payments coming from the third party bank are properly monitored.

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requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, or another entity of the same nature as the entity referred to in Article 18(1)(a) to (c) of that Commission Directive 2006/73/EC in the relevant market where cash accounts are required as long as such entity is subject to effective prudential regulation and supervision of the same effect as the provisions laid down in European Union law and which are effectively being enforced, and in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive."

Finally, insofar as cash is held on deposit with credit institutions, such deposits will be subject to counterparty insolvency risk. The AGC wishes to highlight that ensuring appropriate diversification of counterparty exposures by spreading cash between different credit institutions to mitigate concentration risk remains the role of the AIFM through its risk management processes in accordance with regulatory requirements or, where more stringent, its own internal diversification requirements.

Issue 13.2 – Depositary functions pursuant to paragraph 7

Question 1: With regard to the type of financial instruments to be included in the scope of the depositary's custody duties, the AGC considers that the implementing measures should clarify that the types of financial instruments which can be held in custody in accordance with AIFMD Article 21(7)(a) do not include all financial instruments listed in Annex I, Section C of Directive 2004/39/EC. In particular, the depositary's safekeeping duties should not extend to instruments such as over-the-counter derivative contracts or private equity participations and interests (shares or units) in any funds, including in funds not available for trading on regulated markets, since these are not normally instruments which a depositary would actually safekeep, although a depositary might well record such interests at the request of the AIFM for record-keeping purposes only. This point is clearly made in Box 2 of the Commission's consultation paper on the UCITS depositary function of 14 December 2010 (MARKT/G4 D (2010) 950800) and the preceding explanation on pages 8-9 of the consultation paper.

This issue could be clarified by specifying in the implementing measures that, for the purposes of the safekeeping duties of depositaries under Article 21 of the AIFMD, "financial instruments" do not include instruments in the nature of contracts (such as OTC derivative contracts or contracts for difference) or other financial instruments that are not held via ICSDs or CSDs acting as final issuer CSDs (such as interests in partnerships or funds not traded on regulated markets). Definitionally, the key legal distinction which might determine which financial instruments are capable of being "held in custody" versus those that cannot might depend on whether the depositary: (i) holds the financial instrument itself or via a sub-delegation or (in the case of CSDs or ICSDs) participation arrangement versus (ii) the financial instrument is a contract right or is reflected on books and records of some third party not appointed by the depositary directly or via one of its sub-delegates. Financial instruments falling within category (i) are often referred to on the continent as securities held in "nominative form" by the depositary or its sub-delegate. Financial instruments falling within category (ii) would include OTC derivative instruments, private equity shares (with respect to which the registrar is solely the agent of the issuer) and fund units or shares not available for trading on regulated markets (in which case the transfer agent, who is the agent of the issuer and not of the depositary or any of its sub-delegates, reflects ownership interests).

Questions 2 and 3: With regard to the depositary's duties in relation to other assets (see AIFMD Article 21(7)(b)), the implementing measures should acknowledge that the depositary's ability to validate ownership of assets is dependent on external factors that are effectively beyond its control (and far more within the control of the fund manager). On this basis, while the depositary may obtain title certificates or other evidence of title in

relation to, for example, real property, depositaries are not in a position to be able to "verify" ownership unconditionally, since "ownership" in relation to non-securities investments is dependent on a number of external factors and risks which are not necessarily patent on the face of title certificates or other documentary evidence; this is particularly true in view of widely diverging practices throughout the world for different asset classes such as real estate. As the depositary will often have no means to access evidence of title (for example, legal opinions covering real estate transactions are typically obtained by the property fund manager), the depositary would have to rely upon representations of third parties, which it is not in a position to verify with absolute certainty.

Even more fundamentally, an investment decision undertaken by the AIFM may take into consideration a variety of factors. In the case of real estate funds, the price at which a property is acquired is dependent on factors that may include impaired legal title. The key, therefore, is not whether legal title is considered "clean" or "unimpaired", but whether any defects in title were taken into account by the manager in making the decision to invest on behalf of investors. Depositaries might query whether considerations relating to legal title have been considered, but they are in no position to second-guess the validity of the manager's investment decision.

Other considerations may apply across other alternative asset classes:

1. In the case of OTC derivative instruments, any rights of the AIFM or the AIF on behalf of which it invests are in the nature of contract rights. As a result, it cannot be said that "property" interests arise.

2. In the case of loan notes in which an AIF may invest, these may or may not be evidenced by promissory notes, which may or may not evidence the indebtedness incurred by the borrower (depending on the applicable legal regime). Loan transactions may be subject to complex structures in which the loans are divided into participations in respect of which an agent lender act for other lenders, one of which may include the AIF. Such participations may be securitised, or they may not be. They may be traded on secondary markets, or they may not be.

3. In the case of private equity investments, ownership of shares of target companies typically are recorded on registers maintained by registrars of the target companies who act solely as agent for those companies. They have no contractual link with the depositary or any of its sub-delegates. It is possible that depositaries or their sub-delegates might own the private equity shares in nominative form, but this is not standard practice and would likely not be accepted as a recognised form of ownership throughout the world.

4. In the case of investment by the AIF in other fund units or shares (i.e., so-called "fund of funds"), similar to private equity investments, ownership interests are recorded on registers maintained by agents of the issuers (often a transfer agent) who have no contractual privity with a depositary or any of its sub-delegates.

Whilst it is possible some target funds may permit investments by the depositary or its sub-delegate in a nominative form, many or most will not. Limited partnerships, for example, appear never to permit such forms of title to the fund shares because a limited partner in effect accepts certain legal obligations under the target fund's partnership agreement.

5. Assets, including those that might otherwise be considered Financial Instruments, which are delivered to third-party trading counterparties pursuant to valid collateral arrangements, in which case such assets will fall under the depositary's duties in respect of "other assets" pursuant to Article 21.7(b).

It is therefore essential to establish a basis for determining when the depositary has discharged its responsibility, which can apply across all relevant asset classes and having regard to the nature and type of evidence which is available to the depositary.

With regard to depositary functions more generally, the AGC would like to emphasise that such functions should be elaborated in a manner which is consistent with the functions and duties of custodians provided for in the proposed legislation on legal certainty of securities holding and dispositions (the "**Securities Law Directive**").

Question 4: With regard to circumstances where assets belonging to the AIF are subject to temporary lending or repurchase arrangements, the AGC considers that such arrangements constitute different forms of counterparty trading arrangements in which assets of the fund may be lent or delivered as collateral to a counterparty. Subject to the depositary's duty to oversee the adequacy of arrangements put in place by the AIFM for the return of assets of the fund that are either lent or delivered as collateral to such counterparties, it should be clarified that assets which are the subject of securities loans, repos or other collateral arrangements are excluded from the scope of depositary's safekeeping duties. In order to provide further background in relation to our view on this issue, please see the case study illustrations provided by way of separate attachment (the "**Case Studies**"). The Case Studies were prepared and submitted to the Commission by the AGC in May 2010 in order to provide additional information to the Commission in relation to the drafting of the framework directive at Level 1. The AGC would be happy to update the Case Studies as appropriate to reflect the final AIFMD text or to elaborate on additional points of interest to ESMA. In addition, the AGC would also be happy to provide further information on this issue or the Case Studies by way of interactive discussion.

Issue 13.3 – Depositary functions pursuant to paragraph 8

The AGC is of the view that the additional depositary duties should only come into line with Commission Directive 2009/65/EU (UCITS) and remain proportional in relation to the duties of the other involved parties.

As such the duties should not require the depositary to conduct ex ante investment compliance monitoring or re-execute tasks such as re-calculating the net asset value,

but should instead only require depositaries to ensure that adequate procedures and systems are in place.

III.4 **Issue 14 – Due diligence**

Question 1: The AGC considers that the types of procedures for the selection and appointment of third party delegates and the procedures for the periodic review and ongoing monitoring of that third party should reflect international standards for depositaries and global custodians as a minimum, harmonised baseline, to ensure consistency across all Member States.

In that regard, the due diligence duties of a depositary might include:

- Exercising reasonable care, prudence and diligence in selecting subcustodians, after considering all factors relevant to the safekeeping of such assets in the local market;
- Incorporating in written contracts with subcustodians provisions that afford fund assets appropriate levels of care and protection, including proper segregation;
- Sustaining a system to monitor the ongoing appropriateness of maintaining assets with appointed subcustodians;
- Reporting when assets are held with a subcustodian and any material changes in such arrangements;
- Withdrawing assets from the subcustodian as soon as reasonably practicable if the subcustodian no longer meets the requirements of the AIFMD.

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 II** for a summary of the main principles proposed.

Question 2: While the AGC would like to emphasise that it would not be appropriate enumerate a comprehensive list of criteria to be considered by depositaries, we again refer to **Appendix II** for a summary of the main principles proposed.

III.5 **Issue 15 – The segregation obligation**

With regard to the obligation contained in Article 21(10)(d)(iv) of the AIFMD, whereby the depositary is to ensure that third parties segregate the assets of the depositary's clients from its own assets and from the assets of the depositary, the AGC wishes to draw ESMA's attention to securities holding structures in certain jurisdictions which require the relevant subcustodian to hold both the depositary's securities and the depositary's

client's securities (here the AIF) in a single account with the relevant central securities depositary.

In such case, while the relevant subcustodian may segregate the depositary's assets from the depositary's client's assets on its own books, it may not be possible to do so at the level of accounts held with third parties such as central securities depositaries. The AGC would therefore welcome clarification in the implementing measures to the effect that the Article 21(10)(d)(iv) segregation obligation is intended to apply at the level of the subcustodian's own books and records only.

III.6 **Issue 16 – Loss of financial instruments**

The AGC believes that the word "loss" should be given its ordinary meaning, or that it should be clarified, if necessary, that it means that the depositary or its subcustodian has been dispossessed of the relevant financial instruments and it is unable to recover them or would be unable to recover them despite making all reasonable efforts to the contrary. This would help to clarify that financial instruments which have been detained temporarily because of the operation of national laws, markets or insolvency procedures are not to be regarded as "lost".

The Case Studies previously provided to the Commission in May 2010 set out several examples of the types of circumstances in which financial instruments may be considered either unavailable or "lost", but which are beyond the reasonable control of the depositary. We have provided the Case Studies by way of separate attachment in order to supplement this response, however, the Case Studies should not be considered an exhaustive list of the circumstances leading to loss or unavailability of financial instruments. As mentioned under Issue 13.2 above, the AGC would be happy to update the Case Studies as appropriate to reflect the final AIFMD text or to elaborate on additional points of interest to ESMA.

III.7 **Issue 17 – External events beyond reasonable control**

The AGC believes that the language of the AIFMD is sufficiently clear in relation to external events beyond the reasonable control of the depositary, and that further elaboration is not required. Whether a particular event is beyond the reasonable control of a depositary needs to be determined by reference to a particular set of facts and circumstances, and it is neither necessary nor practicable to try to enumerate in advance all possible scenarios and attendant risks which could be addressed by the application of this principle. Whilst depositaries must anticipate future risks in order to build appropriate risk controls and legal arrangements, sufficient flexibility must remain in order to permit latitude to respond in a crisis. If a depositary is judged according to a "test of conduct", so that the reasonableness of its actions are judged in the context of the relevant facts and circumstances which may or may not have been predicted without the benefit of hindsight, it is less likely to be driven to rash actions in order to avoid strict liability for failing to satisfy a "test of results". Such considerations are most critical in times of market stress, when depositaries and their subcustodians provide critical liquidity to each other in order to ensure timely settlement of securities transactions and

other transactions. Despite our concerns about anticipating future crises, market events, market infrastructure problems, or other risks which may be unpredictable ***or which may be predictable but nevertheless may be taken into account by the AIFM as a risk of investment in a particular asset***, we have provided non-exhaustive examples to illustrate the kinds of circumstances leading to "loss" of financial instruments that are beyond the reasonable control of the depositary in the form of the attached Case Studies.

III.8 **Issue 18 – Objective reason to contract a discharge**

The AGC considers that "objective reasons" should be judged against standard market practice and should include reasons such as cost efficiency and local market requirements. As such the mere fact of an AIF investing in another country than its country of establishment and consequently that of the depository could be constituting an objective reason, as it would be unjustifiable from an economic or client risk perspective to expect a depository to open branches or subsidiaries in various countries. For the same reason it should not be mandatory that if a depositary or another corporate group entity is present in such a country that such local presence does hinder delegation and discharge, if taking up such business is not justified by its business model and transaction volumes. Allowing depositories to systematically select (best) subcustodians both from a quality and cost point of view is a much stronger guaranty of both asset protection and cost efficiency whatever the country. The AGC is of the opinion that implementing measures should not attempt to set out an exhaustive list of reasons for which the depositary may contract a discharge which are to be considered objective, rather, the implementing measures should set down a legal test for objectivity on the basis of market practice.

III.9 **Issue X – Resolution of Conflicts of Interest**

The AGC considers it essential to clarify the requirements for a "functional and hierarchical separation" of functions; in particular, in relation to Articles 21(4)(b) and 21(9) of the AIFMD.

Article 21(9) provides that, "a depositary may not carry out activities with regard to the AIF...that may create conflicts of interest between the AIF, its investors, the AIFM and the relevant entity acting as depositary, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest or properly identified, managed, monitored and disclosed to the investors of the AIF."

Depositaries which are EU credit institutions often provide services to AIFs or AIFMs on behalf of AIFs, on a commercial, arms-length basis, for which the depositary receives a reward. For example, depositaries which are EU credit institutions are often called upon to provide credit to support settlement of the AIF's transactions. The decision to extend credit and the monitoring of the credit arrangements are part of the global custody services provided by the depositaries, which comprise the "safekeeping" responsibility of the depositaries. In order to enhance yields on financial instruments held by them in

custody, EU credit institutions acting as depositaries also typically offer securities lending services to AIFs and AIFMs acting on behalf of AIFs. While depositaries are clearly in a position to ensure that any conflicts of interest arising (such as the rights of a creditor to recover debts owed by a debtor) are "properly identified, managed, monitored and disclosed to the investors of the AIF", the requirement that there is "functional and hierarchical separation" of depositary functions (which, it should be recalled, include safekeeping) from the "other potentially conflicting tasks" of the depositary could become unduly problematic if it required the credit teams evaluating the requests of AIFs or AIFMs acting on behalf of AIFs for credit to be in different entities or business units than those comprising the oversight functions of the depositary.

The AGC suggests that the way to clarify the meaning of "functional and hierarchical separation" is that, in relation to Article 21, it means that:

> "adequate and proportional organisational arrangements are made by depositaries to ensure that its personnel engaged in discharging the responsibilities of the depositary pursuant to Articles 21(6)-(8) are not subject to undue influence by other business units within the depositary or its corporate group which would prevent them from properly discharging or supervising the discharge of the responsibility of the depositary, pursuant to the first paragraph of Article 21(9), to act 'honestly, fairly, professionally, independently and in the interest of the AIF and the investors of the AIF'".

APPENDIX I
EXTRACT FROM SECTION 6.3.3 OF CASS, UK FINANCIAL SERVICES AUTHORITY CLIENT ASSETS HANDBOOK

"A firm should consider carefully the terms of its agreements with third parties with which it will deposit safe custody assets belonging to a client. The following terms are examples of the issues firms should address in this agreement:

6.3.3

1. that the title of the account indicates that any safe custody asset credited to it does not belong to the firm;

2. that the third party will hold or record a safe custody asset belonging to the firm's client separately from any applicable asset belonging to the firm or to the third party;

3. the arrangements for registration or recording of the safe custody asset if this will not be registered in the client's name;

4. the restrictions over the third party's right to claim a lien, right of retention or sale over any safe custody asset standing to the credit of the account;

5. the restrictions over the circumstances in which the third party may withdraw assets from the account;

6. the procedures and authorities for the passing of instructions to or by the firm;

7. the procedures regarding the claiming and receiving of dividends, interest payments and other entitlements accruing to the client; and

8. the provisions detailing the extent of the third party's liability in the event of the loss of a safe custody asset caused by the fraud, wilful default or negligence of the third party or an agent appointed by him."

APPENDIX II
PROPOSED APPROACH FOR SELECTION, SUPERVISION AND OVERSIGHT OF FOREIGN SUBCUSTODIANS

1. **General Requirements**

In general, the following requirements may be prescribed:

1.1 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.

1.2 If securities are to be placed onward with third parties, such as with subcustodians, 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.

1.3 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 Subcustodians"**

In respect of securities held via non-EEA subcustodians ("**Foreign Subcustodians**") appointed by the account provider:

2.1 The EEA account provider should be required to determine that securities held via Foreign Subcustodians 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 Subcustodian'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 Subcustodian has the requisite financial strength to provide reasonable care for the securities;
- The Foreign Subcustodian's general reputation and standing; and

- Whether the account holder will have jurisdiction over and be able to enforce judgments against the Foreign Subcustodian, 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.

2.2 The EEA account provider should also be required to establish a system to monitor the appropriateness of maintaining the securities via a particular Foreign Subcustodian and to monitor performance under the contract appointing the Foreign Subcustodian.

2.3 Holdings with Foreign Subcustodians should be verified on a periodic basis, either directly or by qualified, reputable, independent auditors.

2.4 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 subcustodians 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.

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE:

Case Studies Illustrating the Inadequacy of Exculpation of Depositaries from Liability for Loss of Financial Instruments

EXECUTIVE SUMMARY

Under article 17.5 of the Alternative Investment Fund Managers ("**AIFM**") directive, Depositaries are liable to the AIFM, the AIF and its investors for any loss of financial instruments, except where such loss is unforeseeable or could have been avoided by the expenditure of unlimited resources.[1] Such limited exculpations from liability fail to take account of a myriad of circumstances leading to loss of financial instruments that are not reasonably within the control of a Depositary, but which may nonetheless be foreseeable.

Such circumstances include losses resulting from:

1. Settlement System Rules	• Settlement failures in non-DVP markets; • Non-exclusive control of accounts under client-specific account structures; • Compulsory liens and transaction reversals imposed by central securities depositaries.
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 Depositary's duty of supervision.
3. Local Market Conditions	• Market volatility • Widespread defaults • Market closures and currency devaluations.
4. Appointment of Counterparties by AIFM	Failure of the AIFM's chosen counterparty in the context of: • Securities lending and repo arrangements; • Prime brokerage arrangements involving rehypothecation of AIF assets; or • Derivative transactions.
5. Investment Decisions of AIFM	The decision to invest in: • Markets where infrastructure does not meet EU standards; • Highly volatile or unstable markets.

[1] To avoid confusion, depositaries responsible for holding the assets of AIFs, as defined in the AIFM Directive, are referred to as "Depositaries". Terms not defined herein have the meaning given to them in the AIFM Directive.

This list, and the more detailed case studies that follow, are by no means exhaustive. Attempts to enumerate specific exculpations based on these examples would therefore run the risk of excluding other circumstances, which are not covered herein, but which would (with the benefit of hindsight) have been thought "foreseeable". In order to avoid the legal uncertainty and systemic risk consequences that could result from the proposed liability regime, the directive should provide for a general exclusion of strict liability in cases where the Depositary is not at fault.

INTRODUCTION

Article 17.5 (first paragraph), in the second sentence of the consolidated compromise text of 06/05/2010 provides:

"In case of any loss of financial instruments which the depositary safe-keeps, the depositary can only discharge itself of its liability if it can prove that the loss has been caused by an external event, that it was not foreseeable and that the depositary could not have avoided the loss which has occurred."

The liability regime provided for in Art 17.5, when applied in practice, is likely to give rise to significant legal uncertainty as well as systemic risk. By excluding depositary liability only where an event is unforeseeable, or where the event could not have been avoided by the expenditure of unlimited resources, the text fails to take account of a myriad of events that are not reasonably within the control of a Depositary, but which may nonetheless be foreseeable.

The potential consequences of this liability framework are set out in the Systemic Risk Paper. The following case studies illustrate additional scenarios which the current wording fails to take into account, notwithstanding their forseeability as the consequence of an AIFM's investment decision.

1. **SETTLEMENT SYSTEM RULES**

1.1 ***Settlement risk in non-DVP markets.*** The greatest financial risk, to which Depositaries and their clients are exposed in the clearing and settlement process, is the risk that the seller of a security could deliver but not receive payment or that the buyer of a security could make payment but not receive delivery ("**settlement risk**"). In markets, particularly outside the EU, where no such mechanism (delivery versus payment or "**DVP**") exists, settlement risk may cause Depositaries and/or their clients to lose the full value of the securities transferred. Paragraphs 1.2 to 1.5 illustrate examples of markets in which settlement does not take place on a strictly DVP basis, and in which an AIF may therefore be exposed to the risk of loss of its financial instruments, or their value, for reasons wholly outside the control of the Depositary. In addition, transactions concluded off-exchange are also likely to give rise to increased settlement risk as they will often be settled on a non-DVP basis.

1.2 ***Gross settlements of securities and net settlement of funds.*** Although securities settlement systems involving "gross settlements of securities transfers followed by net settlement of funds transfers" ("**Model 2 DVP**") have been identified by the Committee on Payment and Settlement Systems of the Bank for International Settlements ("**BIS**") as one of three broad structural approaches to achieving DVP, such structure may still leave market participants exposed to significant settlement risk. Under Model 2 DVP, the system will settle securities transfer instructions on a trade-by-trade (gross) basis, with final transfer of securities from the seller to the buyer (delivery) occurring throughout the processing cycle, but settlement of funds transfer instructions will occur on a net basis, with final transfer of funds from the buyer to the seller (payment) occurring at the end of the processing cycle. Although corresponding funds transfers

are irrevocable (i.e. committed), until funds have actually been received into the AIF's account at the relevant Depositary, an AIF selling securities in a Model 2 market, having already transferred the securities, will be exposed to the risk that its counterparty buyer and/or the counterparty's settlement agent may fail to transfer the funds, resulting in a loss of the value of the AIF's securities.

1.3 As a variation on Model 2 DVP, in certain markets (e.g., Jordan, the UAE), book-entry securities settled through the local depository ("**CSD**") are transferred to the buyer gross on trade date ("**T**") and cash is multilaterally netted on trade-date-plus-two (T+2), and electronically transferred between banks via the local CSD's settlement bank. Securities are reflected by the sub-custodian in "pending" status until settlement date. On T, when the CSD receives matched trade instructions, the stock exchange immediately transfers shares from the seller's broker trading account to the buyer's broker trading account, at which time title is considered to have passed and the shares may be sold or otherwise used via the local broker's trading account. Under this model, in addition to settlement risk, the AIF is also exposed to the risk that the relevant broker, in accordance with market practice, re-uses the securities credited to its account, notwithstanding that such securities are beneficially owned by the AIF. While steps may be taken to prevent such re-use of securities, such safeguards are dependent on the mechanisms employed by the relevant buyer's broker (acting on instruction from the buyer, who may be an AIFM acting for the AIF) and are not within the control of the Depositary.

1.4 ***Client specific registration markets.*** In certain markets securities must be registered in the name of the beneficial owner in a client-specific account at the central securities depositary, rather than being held in the Depositary's nominee account at the CSD. Theoretically these accounts belong to the client, however, operationally such client-specific accounts are linked to the Depositary, who should be the only authorised operator of the account. Under such arrangements, clients should only be able to instruct such accounts through the Depositary, however, in practice there may be instances where the client can instruct the movement of such securities independent of the Depositary, and outside the Depositary's control. This may occur in certain Middle Eastern markets where trades executed by a client through a broker are binding and settlement on behalf of the broker occurs automatically, without instructions from the Depositary (see above). In such markets therefore, an AIFM could execute a trade away from the Depositary, and the movement of such securities would be outside the Depositary's control. Under the directive, the Depositary would be liable for restitution of the securities and for ensuring that the AIFM does not carry out disposals of the AIF's securities in this manner.

1.5 ***Non-linked securities and cash movements.*** In some markets (again, Jordan and the UAE being examples) securities and cash movements are not linked for broker-custodian transactions, such that cash settlement for trades on particular exchanges settle between brokers on a net basis, without any direct involvement of the sub-custodian. In respect of securities purchases, the sub-custodian must transfer funds to the broker's cash account at the central bank, while in respect of sales, the proceeds

are settled into the broker's cash account at the central bank, following which the broker must transfer the funds to the sub-custodian in order to credit the client's account. In the event that securities were re-used as described in example 1.3 above, the corresponding proceeds would be credited to the broker's cash account and not the sub-custodian's cash account.

1.6 ***Liens imposed by settlement systems.*** Conditions of participation in a central securities depository ("**CSD**") or international central securities depository ("**ICSD**") require compliance by Depositaries or their sub-custodians with rules that are not negotiable. In many cases (but not all), these rules are incorporated into local law, one example being the rules of the Depository Trust Company, which are incorporated into New York law. These rules are intended to ensure certainty of settlement and reduce systemic risk that may arise in relation to pending transactions. To this end, these rules usually require participants, such as Depositaries, to satisfy their obligations absolutely. To ensure compliance with the rules, CSDs and ICSDs enjoy broad enforcement rights and remedies, including the ability to impose liens over the accounts, as well as other powers intended to eliminate the CSD or ICSDs exposure to settlement risk in respect of the transactions of the participants and their clients. As a consequence, a CSD or ICSD may withhold client assets held in the participant Depositary's account until the relevant trade is settled. CSDs will often have no visibility of individual client positions, such that an AIF may be deprived of access to its assets due to a CSD exercising its rights under a compulsory lien, notwithstanding that the relevant pending settlement obligations do not relate to the AIF's own trading positions.

1.7 ***Reversals of payments of principal and income at ICSDs.*** Whereas settlement risk covers the risk of a transaction not being finally settled, under the rules of certain ICSDs, there is also a risk that transactions once effected, will be reversed. Under their rules, ICSDs may reverse credits related to interest payments or principal redemptions to participants in order to correct payment/credit errors at the ICSD or to correct errors or adjustments initiated by issuers through their paying agents or common depositaries. These reversals are made without prior authorisation from the affected participants, and may be carried out several weeks or more after the original credit.

1.8 As a consequence, Depositaries who are ICSD participants are required to make adjustments to their clients' accounts, which are disruptive of settled investment/income expectations and often affect fund valuations reported in prior months. Although ICSDs customarily pre-advise their participants about imminent reversals of principal, there is effectively no way for Depositaries to control or limit the financial risk attributable to payment reversals. The risk posed by these reversal practices should be borne by issuers and their investors, not by Depositaries who have no control over such reversals.

2. MARKET INFRASTRUCTURE DEFICIENCIES

2.1 The sophistication, stability and reliability of market infrastructure vary significantly across financial markets. Even in highly developed markets, there may be instances where market infrastructure will fail, albeit temporarily, causing settlement delays and resultant losses to its participants and their clients.

2.2 In less sophisticated financial markets, a lack of developed financial infrastructure together with inadequate regulation will significantly impair the functioning of the settlement system and the integrity of title to securities. While Depositaries may agree to provide services in such markets, the decision to invest in these markets must be assumed by the AIFM, insofar as risks involved are outside the control of the Depositary.

2.3 The following examples provide some illustrations of the risks posed by a failure in, or inadequate, market infrastructure, which are beyond the control of Depositaries.

2.4 ***SWIFT messaging system.*** Depositaries rely on the global messaging network, SWIFT, in order to receive and send instructions and other information from and to their clients, other financial institutions and market infrastructures. If SWIFT becomes unavailable, this may delay or prevent settlement or the processing of corporate actions taking place, or delay the making of payments or instructing the disposition of securities, and could lead to losses, either of financial instruments, or consequential loss of their value as a result of market movement and volatility. The current liability framework of the AIFM Directive appears to hold the Depositary liable to investors for the financial consequences of a failure in the functioning of SWIFT. Depositaries should not be held liable for such losses which, although foreseeable, are beyond their reasonable control.

Also of significance is that many investment management firms may not have full SWIFT functionality, which in itself heightens the risk of instruction error due to the need to find manual work-arounds or other solutions to provide an instruction functionality.

2.5 ***Securities registration systems.*** In certain less sophisticated markets, there is no central securities depositary and securities registration systems are poorly regulated by comparison with the EU. By way of example, Russian securities registers are maintained by the issuers themselves or by licensed registrars located across Russia. Due to inadequate supervision of registrars and inadequate enforcement of licensing regulations, transfers of securities may be inaccurately recorded leading to a loss of securities or distributions related thereto through fraud, negligence or oversight by registrars, who are often poorly capitalised, do not generally have adequate insurance cover, and are therefore unable to compensate the affected shareholders. These risks are beyond the control of Depositaries providing custody services within these markets and should not therefore be borne by such Depositaries. The risks should instead be borne by the AIFM who has chosen to invest in the relevant market.

2.6 ***Sub-standard sub-custodian***. In many markets, Depositaries may be obliged to use a sub-custodian in order to gain access to the local CSD or central bank. In some markets, particularly in certain emerging markets, although all available sub-custodians may fail to meet EU standards, the AIFM may nonetheless wish to invest there. In such cases, Depositaries will habitually only provide services where the relevant client assumes the responsibility for its choice of sub-custodian, and the Depositary will agree with the client to limit its liability contractually. Under the directive, a Depositary's liability is unaffected by the appointment of such sub-custodians such that a Depositary would be liable to the AIFM to replace any financial instruments lost as a result of such sub-custodian's failure, notwithstanding that it was the AIFM's informed choice to use such sub-custodian. The directive should make clear that Depositaries are not liable when appointing sub-custodians in markets where, although no sub-custodian meets the required standards, the AIFM has nonetheless chosen to invest there.

2.7 ***Fraud by a sub-custodian beyond the Depositary's duty of supervision.*** It is appropriate that Depositaries comply with certain duties of supervision in respect of sub-custodians or other delegates which they choose to appoint, which may include certain periodic reviews and reconciliations of accounts designed to prevent fraud. However, it would be inappropriate to impose liability on Depositaries beyond such duties, where loss of financial instruments is caused by a delegate or sub-custodian acting fraudulently, as in the Madoff example, but which could not have been discovered by the Depositary acting reasonably and in compliance with such standard of care. The details of such supervisory duties could be appropriately addressed in Level 2 legislation, rather than in the Level 1 directive.

2.8 ***Subscription/Redemption Accounts Held with sub-custodians.*** From time to time a Depositary is appointed by an AIF to receive all payments made by, or redemption proceeds to be paid to, investors in a particular market subscribing in units or shares of the AIF, but the Depositary does not have access to the local central bank so must use a local sub-custodian bank to hold such cash. In the event of the collapse of the local banking system, as was the case in Iceland, the local bank may become insolvent, following which its operations cease to function normally. As a result, the local bank's records do not show that the funds invested reached its account at the central bank.

2.9 In such circumstances, under article 17(1)(a) of the Spanish Presidency Compromise text of 11 March 2010, the Depositary would be obliged to "ensure" that payments made by or on behalf of investors have been correctly booked in a segregated account in the name of the AIF, however, it is unclear whether the Depositary's own books are a sufficient record. If they are not, the Depositary will be liable to the AIF and its investors for failure to ensure correct booking, in response to which there is no defence. If the Depositary's books are sufficient, the Depositary, as deposit taker or agent, will be liable to the investors for the receipts, unless it is permitted to adjust its books to reflect the loss at the local bank level. Whether such action is permitted under the directive is unclear.

3. **LOCAL MARKET CONDITIONS**

3.1 ***Market volatility.*** The liability provisions in the directive effectively expose Depositaries to market risk over which they have no control and which could lead to significant systemic risk. By way of example, an AIF may have a large exposure to Greek government bonds, the price of which has in recent months been volatile. At a particular moment, the Depositary and the Valuator disagree on the value of the AIF's holdings, the Depositary considering that the immediate sale of the bonds would be the only sensible way to protect itself against the liability risk associated with the increasing divergence of views between the independent professionals. Obviously, given that the Depositary is only the custodian, not the owner of the assets, it cannot order their sale, yet due to the strict liability regime imposed by the directive, the Depositary is nonetheless effectively exposed to the assets and therefore needs to hedge this risk by taking a short position in the bonds. Assuming shorting is permitted, this would drive down the price of the bonds further contributing to increased market turmoil. In the event that shorting is not permitted, this would leave the Depositary exposed to the investment risk.

3.2 The situation above may further deteriorate where a particular market is affected by severe economic difficulties, such as Greece in recent months. This may have a consequential effect on the stability of local financial institutions and market infrastructure, particularly where such entities are government-owned. Instability of Greek financial institutions and market infrastructure would threaten access to securities held in local depositories and settlement systems, thereby exposing Depositaries to liability if they were called on to replace any securities lost as a consequence. This is likely to prompt such Depositaries to withdraw from the Greek market to avoid liability, which could provoke a generalised exit from the market leading to the further vulnerability of the Greek economy.

3.3 ***Securities Market Closure.*** The imposition of emergency measures by governments in times of economic crisis has in the past led to the loss of financial instruments in cases of expropriation, or to loss of access to, or the ability to trade such assets, effectively equating to the loss of the asset itself. Examples include the economic policies adopted by a number of Southeast Asian governments during the Asian Financial Crisis of 1997-99, effectively closing their markets.

3.4 In Malaysia, for example, in 1998 the Government adopted capital controls prohibiting licensed offshore banks from trading in *ringgit* assets, suspending all domestic credit facilities for overseas banks and stockbrokers and requiring the retention of the proceeds of the sale of Malaysian securities in the country for a year. Similar market closures which have had the effect of preventing client access to their assets for extended periods have occurred in Latin American countries, North Korea, Russia and China. Should similar circumstances arise in the future, under the current liability provisions of the directive, without provision for exculpation, the Depositary would be liable to AIFs, AIFMs and investors who have invested in such markets and suffered loss due to these foreseeable, but unpreventable, cases of asset non-availability.

3.5 ***Asymmetric currency re-denomination.*** Short of closing securities markets, governments have in the past drastically affected the value of assets held in such markets through currency devaluation. For example, in Argentina the peso was convertible 1:1 to the USD for several years prior to January 2002. Due to USD capital flight, the Argentinian Government devalued the peso in January 2002, and redenominated locally held USD bank accounts into peso. This action caused huge losses for foreign banks as their USD holdings at the central bank of Argentina, and at Argentinian banks, were devalued, whilst they still had to meet their obligations to foreign USD account holders.

3.6 In the custody context, an AIFM could have claimed that it had deposited USD assets with the Depositary, expecting restitution of those USD, not peso, assets. A similar situation could arise in the European context where an AIFM invests in a eurozone country which later seeks to return to its old currency at a lower exchange rate. It would be unreasonable to expect the Depositary to assume liability for such loss of assets, as the Depositary would be powerless to prevent such loss.

4. **APPOINTMENT OF COUNTERPARTIES BY THE AIFM**

4.1 ***Over-arching concern.*** It is not appropriate to hold a Depositary liable for loss of financial instruments or other assets of the AIF where those assets are legitimately delivered out of the control of the Depositary in order to facilitate trading arrangements established by the AIFM. When assets are legitimately delivered out of the Depositary's control, whilst the selection, appointment, periodic review and ongoing supervision of a counterparty receiving the assets should be subject to the Depositary's duty of supervision, the counterparty, having been appointed by the AIFM, should not be seen as a delegate of the Depositary.

4.2 ***Securities lending and repo.*** AIFMs frequently "lend" securities held in long positions in order to enhance return to the AIF to "borrowers" such as broker-dealers who require those securities for various purposes, such as in order to cover shortages due to a settlement failure or to cover short sales for speculative or hedging purposes. Conversely, AIFMs might also "borrow" securities for the same purpose. Although referred to as "lending", securities loans – like sale and repurchase ("repo") transactions - will under some legal systems involve the transfer of legal title in the securities from the lender to the borrower in exchange for the borrower providing the lender with acceptable assets as collateral in the form of cash or other securities (in such cases, the services of third-party "lending agents" are often used in order to facilitate robust and controlled "lending programmes").

4.3 However, it is not always the case that legal title is transferred. By way of example, in transactions using the ISDA Credit Support Annex, under English law-governed transactions, which generally include most transactions involving non-US securities, title to the securities is transferred to the borrower. By contrast, under New York law, title to the securities remains with the lender. Consequently the legal position in terms of ownership may differ according to the domicile of the securities and the counterparty to the transaction. Nevertheless the securities provided by way of loan

will remain on the balance sheet of the lender (e.g., the AIF), even though legal title to such securities may have been transferred to the borrower (e.g., the AIF's counterparty) such that the securities are no longer registered in the name of the AIF, and are no longer in the control of the AIF's Depositary.

4.4 In the event that the borrower becomes insolvent, a securities loan will be terminated. Unless the securities can be "recalled" outside the insolvency of the borrower, lent securities may be "lost" in the sense that they cannot be returned to the lender. A prudently structured securities loan will provide for collateral to be given to the lender (often maintained by the lending agent), but there is no guarantee that the collateral will be sufficient to cover the loss.

4.5 ***Derivatives transactions.*** Another instance in which the AIF's assets may be transferred away from the Depositary at the instructions of the AIFM is in the context of derivatives transactions. In order to mitigate counterparty risk, parties to a derivative transaction will habitually enter into a Credit Support Annex ("**CSA**") which provides for collateral to be transferred from one party to another, according to each party's fluctuating credit exposure to the other party during the life of the derivative contract. As in the securities lending and repo example in 4.1 above, title to the collateral may be transferred to the collateral taker (under an English law CSA), or title to the securities may remain with the collateral provider (under a New York law CSA). Where AIFs enter into such arrangements, assets may be transferred away from the AIF's Depositary to the AIF's counterparty, or to a third party custodian by way of collateral. As in the securities lending and repo example above, although the securities provided by way of collateral will remain on-balance sheet for the AIF, legal title to such securities may have been transferred to the AIF's counterparty such that the securities are no longer registered in the name of the AIF, and are no longer in the control of the AIF's Depositary.

4.6 ***Rehypothecation of assets by AIFM's prime broker.*** The collapse of Lehman Brothers International (Europe) provides a real life example of the losses that may be suffered by an AIF as a result of the AIFM appointing a counterparty to whom the Depositary is instructed to transfer certain assets. Where an AIF instructs the Depositary to transfer assets to its chosen prime broker, here, LBIE, frequently, in accordance with the agreed terms of the contract between the AIF and its prime broker, such assets will be rehypothecated either in full or in part. In the event that the prime broker's records are inadequate, as was the case for LBIE, this could result in the AIF being deprived of such assets for an extended period, until it is determined whether such assets had been rehypothecated and whether they will be returned.

4.7 Insofar as a prime broker such as LBIE is holding an AIF's assets, the AIFM directive is unclear as to whether the prime broker is acting as a "delegate" of the Depositary or as a trading counterparty. If the prime broker is a delegate of the Depositary, the AIFM directive as proposed would appear to impose liability on the Depositary for strict (and possibly immediate) "restitution" of assets that are determined not to be "validly" rehypothecated. This in turn suggests that the depositary will be liable for

failure to "ensure" that the prime broker has segregated assets that could be lawfully rehypothecated from client assets that could not (i.e., outside the limits of the AIFM's consent). These claims, to which Depositaries have no defence under the current wording of the AIFM directive, represent a shift in the allocation of risk away from the AIF investors to Depositaries, even though such risk should more obviously be borne by the AIF investors themselves.

4.8 It is more sensible to consider the use of prime brokers as one of many forms of counterparty trading arrangements in which assets of the fund may be delivered as collateral to the counterparty. To do otherwise risks creating confusion around when a depositary must or must not consider a counterparty to be a "delegate": there is no universally agreed dividing line establishing when a counterparty is a "prime broker" and when it is some other form of OTC counterparty.

4.9 All counterparty trading collateral arrangements, therefore, should be treated in the same way. In this context, therefore, it makes more sense to exclude from the depositary's liability for restitution counterparty trading arrangements pursuant to which assets of the fund have been delivered as collateral (including where such collateral is subject to re-use / rehypothecation), subject to a duty of the depositary to "oversee" the adequacy of arrangements put in place by the AIFM in respect of assets of the fund that are delivered as collateral to such counterparties. This oversight duty might involve reviewing the selection, appointment and on-going use of the counterparty by the AIFM.

5. INVESTMENT DECISIONS OF AIFM

5.1 AIFMs may choose to invest in a wide variety of asset classes and markets. Although Depositaries play a role in verifying that asset purchase and sale transactions are carried out correctly, they cannot be held responsible for flaws in asset title or the assets themselves, beyond what is reasonable. Such risks flow from the AIFM's investment decisions and must therefore be borne by the AIFM and/or the investors in the AIF. Various examples cited above are of investment decisions: the choice of assets in countries with infrastructure or regulatory standards which fall short of the EU norms, or the choice of counterparties in transactions which may lead to loss of assets. These are not cases of failure of the Depositary's function but of the investment profile. It would not be right, as a policy matter, to shift responsibility for risk to Depositaries.

5.2 Depositary banks are quasi-market infrastructure, and as such should be risk averse. By transferring the investment risk to Depositaries, the liability provisions of the directive cause a misalignment of incentives, which could result in Depositaries turning away the business of AIFs in order to avoid shouldering the investment risk that would more appropriately be borne by the AIF's investors. In turn, this could lead to the decline of AIF activity - a legitimate business activity when duly regulated – which, as a matter of policy, is not the outcome which the directive purports to achieve.

6. **HOLDINGS RECORDED BY AN AGENT OF THE ISSUER, A REGISTRAR OR A TRANSFER AGENT**

6.1 Article 17(1)(b)(i) of the consolidated compromise text of 06/05/2010 provides that a Depositary appointed by the AIFM shall hold in custody all financial instruments that can be held in a Central Securities Depository, that can be credited into securities accounts or that are physically delivered to the Depositary. Although holdings recorded solely by an agent of the issuer, a registrar or a transfer agent cannot be held by the Depositary as such, the AIFM may request that a Depositary keep records of such assets for valuation and general record keeping purposes. For the avoidance of doubt, the directive should make clear that such position records do not amount to the holding of assets in custody nor do they evidence the integrity of those holdings, and as such there can be no liability on the part of the Depositary for loss of such assets.

CONCLUSION

The preceding list of exculpation scenarios demonstrates the complexity of circumstances in which Depositaries may be held liable under the current wording of the directive, notwithstanding the Depositary's diligence. Although already long, the above list is not exhaustive, and there will be other examples which we have not included, which would (with the benefit of hindsight) have been thought "foreseeable". It would therefore be more appropriate to provide for a general exclusion of strict liability in cases where the Depositary is not at fault, so that the Depositary is only deemed to be in breach of its custody duty in cases where its own processes or books are deficient, and this is the source of the fund's loss.