THE ASSOCIATION OF GLOBAL CUSTODIANS

THE BANK OF NEW YORK MELLON CORPORATION
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NORTHERN TRUST
RBC DEXIA INVESTOR SERVICES
STATE STREET BANK AND TRUST COMPANY

COUNSEL AND SECRETARIAT TO THE ASSOCIATION:
BAKER & MCKENZIE LLP
815 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006

TELEPHONE: 202/452-7000
FACSIMILE: 202/452-7074

WWW.THEAGC.COM

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European Commission Services – DG Market
B-1049 BRUSSELS
BELGIUM

Re: Commission Services (DG MARKT) Consultation Paper on the UCITS Depositary Function

Ladies and Gentlemen:

We write on behalf of the members of the Association of Global Custodians ("Association")[1] to express members' initial views concerning the Working Document of the Commission Services (DG MARKT) Consultation Paper on the UCITS Depositary Function (hereinafter referred to as the "UCITS Paper"). The Association recently expressed its views to the European Council concerning the depositary provisions of the proposed AIFM directive, and we note that the UCITS Paper refers to the AIFM directive's proposed liability standards as one of the bases for the UCITS depositary consultation. The Association welcomes the Commission's public consultation via the UCITS Paper in advance of legislative proposals, and Association members welcome

[1] The Association is an informal group of eight global custodian banks that provide securities safekeeping services and related asset servicing functions to investors worldwide. Members provide custody-related services to most types of investment funds based in Europe and also service non-European institutional clients that invest in European-based investment funds. Members act in those capacities, including as UCITS depositaries, either directly or through European branches and subsidiaries and, in doing so, play substantial roles in European markets. Members of the Association, listed on the letterhead above, hold assets under custody that in the aggregate approximate US$40 trillion in value.

the Commission's goals of harmonizing standards in this area across Europe and more fully defining the role and liability of depositaries in the European asset management market. As an industry, we support a public review of current depositary standards with a view to achieving consistency and predictability throughout Europe, including at national levels.

We are providing the Commission at this time with the Association's initial comments on various questions set out in the UCITS Paper that are of particular concern -- notably questions 13 and 14 of the UCITS Paper and the related text discussion, which focus on the nature of the depositary liability regime, and questions 15 through 17 and the related text discussion, which focus on a depositary's selection and monitoring of subcustodians, including various potential conditions and limitations. As custody practitioners experienced with fund markets globally, including UCITS funds, Association members believe that a practical and informed understanding of depositary functions and operations in today's intermediated securities markets should guide the Commission's policy recommendations in these core areas. Given that perspective, Association members would be particularly concerned about any change in the existing UCITS depositary regime that adopts the liability standards currently proposed in the AIFM directive. Change of that sort would not improve investor protection or market efficiency; instead, as described below such changes would adversely affect the existing UCITS depositary/subcustodian framework and would have potential negative consequences for both investors and asset managers. Indeed, such change in the current liability standards, with the resulting re-allocation of losses, could create systemic risk to global financial markets by producing claims of such magnitude to depositary banks that financial stability is materially compromised.

As the Association reviews the UCITS Paper further, we anticipate that Association members will convey additional views in subsequent communications.

I. Background and Context for Association Comments

The Association supports a public review of depositary duties and liabilities that looks to assure:

- Segregation of client assets from the assets of the depositary, the investment manager and others providing services with respect to client assets;

- Safekeeping and administration of client assets with due care and appropriate diligence;

- Consistent and equivalent definition and interpretive treatment of depositaries' responsibilities in each of the EU jurisdictions; and,

- Clear and objective custody standards that are coordinated with other bodies of relevant regulation, including capital markets regulation.

To achieve these goals, we believe, any approach to re-regulation should be crafted with a view to the following market realities:

- The vast majority of fund assets are represented not by physical property that may be held by a depositary subject to a simple duty of return, but instead by entitlements recorded in a complex chain of book-entry records that includes issuers, central banks, central securities depositories ("CSDs") and various intermediaries.

- In providing depositary services to fund clients – and custody services to investors generally -- a custodian/depositary acts in most respects as the client's agent. In so acting, a depositary is customarily required by market circumstances to engage numerous local market agents in respect of which the depositary assumes a duty of careful selection and ongoing supervision. A depositary also must interact with other entities that are *not* its agents, such as brokers, market infrastructure facilities like CSDs and central banks, administrators of investment funds, registrars and transfer agents. Parties that are not selected and retained by the depositary, or that are retained at the direction of a UCITS fund, are generally not subject to the depositary's choice or control; and the well-established view in today's markets is that bank custodians, including when acting as UCITS depositaries, are not responsible for the actions or omissions of parties which they did not select and over which they have no control.

- A depositary's selection of local market subcustodians is not an outsourcing event or activity, but rather a market necessity based on the need to procure essential, specialized intermediaries in each given market.

II. UCITS Depositary Liability Standards should Not be Configured like those in the proposed AIFM Directive; Standards instead should be Configured to Promote Harmonization throughout Europe and should take Fully into Account the Demands of Market Structure and Existing Regulation and Related Bank Disciplines (UCITS Paper Qs 13 and 14)

Applying the foregoing to the discussion in Part II A 2 of the UCITS Paper (page 6), we believe the Commission should not change the standards of liability for a UCITS depositary or the applicable burden of proof in ways that would shift the existing UCITS standards toward those proposed in the AIFM directive. Such a shift would produce a number of uncertain and potentially adverse consequences.

As underscored in the UCITS Paper, page 6, the current UCITS Directive imposes depositary liability "as a result of [the depositary's] *unjustifiable failure* to perform obligations or its *improper performance of them."* In contrast, under the proposed AIFM directive, a depositary would incur liability "for any losses suffered... as a result of its *failure to perform its obligations*", and a depositary could discharge itself of liability only *"if it can prove that it could not have avoided the loss* which has occurred." (Emphases added.)

In our view, the proposed AIFM directive text appears to impose new, unclear and unprecedented standards of liability on depositaries. Under some possible readings of the relevant AIFM directive text, this new standard might be viewed as imposing strict liability on depositaries without regard to the nature or locus of the loss, which is particularly inappropriate where investor entitlements in book-entry securities are "held" through the records of a chain of interconnected intermediaries. Further, with respect to a depositary's failure to perform its duties, the AIFM directive would impose liability *without the qualification found in the UCITS Directive -- that such failure must reflect the improper performance or unjustifiable failure to perform the duties.* This change would transfer risk to the depositary beyond what is reasonable or appropriate – for UCITS as well as non-UCITS, the subject of the proposed AIFM directive.

Such new standards, which would depart from established law and current practice that apply to UCITS funds, would materially increase risk of loss to depositaries without providing typical exceptions or recognizing mitigating actions; would require investors and intermediaries to re-organize and re-align arrangements governing intermediation globally; and would likely curtail important intermediary services, thereby harming investors. Indeed, AIFM-type standards would create such a range of varying potential outcomes that it will be difficult for depositaries and investors to assess their

relative risk in complex cross-border activities and will further complicate efforts to achieve consistency in application across national regulatory regimes in Europe.

Instead of introducing such broad, expansive change, we believe the Commission should in general retain the long-standing and widely-recognized standard of due care for depositaries (in UCITS terms, responsibility for the "improper performance" or "unjustifiable failure to perform" the depositary's duties). The due care standard is based on decades of market experience with the mechanisms of intermediated global securities and the commercially-practicable allocation of risks among participants. It has proven effective in protecting all classes of securityholders and has led to the development and obligatory use of detailed due diligence mechanisms for selecting and monitoring skilled subcustodians and other agents to provide local market services to depositaries, as described in the following section.

To the extent that clarifying changes to UCITS terminology would advance harmonization, those changes should be made. In particular, we would encourage the Commission to clarify the phrase "improper performance or unjustifiable failure" in the current UCITS directive, taking particular care to avoid imposing a strict and general restitution duty for losses. Achieving effective harmonization generally – including in respect of this circumstance – would discourage interpretive variances among member states' competent authorities during implementation at national level, which would do much to advance market predictability and consumer welfare.

In addition, we encourage the Commission to clarify duties and liabilities where assets are not held by a depositary but instead are held through parties selected and appointed by a fund or its management company at the insistence of the fund or management company. These assets, which typically are governed by bilateral agreements to which the depositary is not party, include: third party cash products (term deposits, loans, repos); OTC derivatives; investment funds not held in ICSDs; assets held through other agents. Clarification of the respective duties of the bilateral parties, as distinct from those of the depositary, would usefully further harmonization.

As a general matter, the Association would welcome legislative clarification in respect of depositary activities with a view toward legal harmonization across Europe. Indeed, the Association encourages the Commission to use the UCITS framework as an opportunity to continue to evaluate how best to achieve effective harmonization. Harmonization will not only reduce the room for national level differences that commonly materialize during transposition of EU law by national authorities into national law, but would also lay a foundation for the eventual development of a well-tailored depositary passport regime, thereby increasing pan-European economies of scale for depositaries.

We therefore encourage the Commission to revisit its efforts relating to a depositary passport, and we urge the Commission to make needed clarifying changes that take into account existing market structure realities and the detailed nature of existing regulatory and operational disciplines applicable to bank custodians acting as depositaries.

III. A Depositary's Methods and Approaches to Selecting and Monitoring Subcustodians (UCITS Paper Qs 15 – 17)

Among its duties, a depositary is responsible to appropriately select and monitor subcustodians that provide local settlement and custody services in each market that funds choose to access. Contrary to some misconceptions, selecting local market subcustodians is *not an event or incident of outsourcing by a depositary*, but rather a by-product of the need to secure experts in local market practices who have access to necessary facilities. This comment is consistent with generally accepted interpretations of the custody and safekeeping provisions of MiFID,[2] and in our view it would be useful for the Commission to actively promote interpretive consistency across relevant European legislation concerning delegation of custody responsibilities.

Depositaries do not and cannot attempt to establish entities in all markets in order to provide local subcustody services. The number of markets available for investment exceeds the physical presence of any one depositary, and it would be inefficient and potentially risky for a depositary to establish a physical presence in every market solely for the purpose of holding fund investments using its own infrastructure. To ensure effective subcustodian performance globally, global custodians maintain an in-house team of market and subcustody experts who continuously perform the depositary's selection and monitoring responsibilities across the depositary's network.

Selection and monitoring typically covers both the core competence and the financial strength of the local subcustodians. Prior to the appointment of a subcustodian, a detailed review is conducted to ensure that the subcustodian can meet the required standards. Key review factors include: financial strength (including capital, credit standing, and liquidity); management and operational strength; transaction and safekeeping volume capacity; understanding of compliance requirements; expert

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2 http://www.mifidconnect.com/bba/jsp/polopoly;jsessionid=arWJ5NQ018L6?d=7151. See also, the Report of the High-Level Group on Financial Supervision in the EU, Jacques de Larosiere, Chariman, 25 February 2009, notably at p 26, para. 98.

staffing, technological sophistication, and suitably-structured contingency planning; insurance coverage and a SAS70, FRAG 21, or equivalent third party review.

A depositary also monitors the performance of subcustodians on a continuing basis, both in the ordinary course of business and to comply with various regulatory requirements. Some key elements monitored are: performance and timeliness of subcustodians regarding trade settlement, asset reconciliation, settlement confirmation, cash management, corporate actions, dividend processing, and fee management. In addition to monitoring performance, a depositary will also undertake a variety of activities to test the financial condition and performance of its subcustodians, including in respect of various risk issues.

The Association believes that the Commission could usefully consider incorporating in new UCITS depositary provisions elements of suitable performance standards such as those listed above. One example of such a prescriptive legislative model is Rule 17f-5 under the U.S. Investment Company Act of 1940, which sets out appointment, monitoring and performance standards and criteria for investment funds, custodians and local-market subcustodians and, in so doing, provides detailed guidance respecting eligible custodians and subcustodians. Such a legislative approach would protect investors, would promote harmonization across European markets, and would enable depositaries and remote, local-market subcustodians to conduct business with full awareness of the prescribed requirements, and would do so compatibly with international best practices, building on compliance and performance benchmarks currently recognized in most markets.

IV. Unanticipated Impact on Investors

In considering potential legislative changes to the UCITS depositary liability regime, care should be taken to avoid unanticipated and possibly negative consequences for investors. As one example, the proposed AIFM liability standards – if applied to either UCITS or non-UCITS funds -- pose difficulties, particularly when applied to intermediated and immobilized/uncertificated securities contexts. Those standards would expose depositary balance sheets to losses caused by third parties outside of the depositary's control, and such exposure -- or indeed any consequence that would compel banks as depositaries to act as insurers or guarantors – will be of concern to bank supervisors and regulators. In particular, those standards could impact the regulatory capital required of credit institutions under Basel II and may unintentionally mandate impermissible guarantor status. Thus, when considering legislative change that could lead to interpretive uncertainty or produce counter-intuitive

consequences, the Commission should anticipate that depositaries will not – or may not be permitted to -- conduct business as usual after enactment.

Anticipated changes in business practices could include:

a. Fee increases to compensate for the added risk or to purchase insurance or other financially-protective arrangements;

b. Exclusion of support for certain markets (which could include EU member states) deemed too risky or unreliable by depositaries, and

c. Elimination or curtailment of services to funds, including UCITS, which would reduce or eliminate fund service options.

The end result of substantial change in liability standards could well be reduced investment, lower returns, greater uncertainty and higher costs across Europe; in short, reduced benefits for all market participants and markets.

V. Conclusion

The Association thanks the Commission for including these comments in the public file in this matter and for considering members' views. The Association welcomes dialogue with the Commission and other stakeholders to ensure that legislative changes do not produce unintended consequences that undermine intended benefits.

If you have any questions or would like to discuss these comments with Association members, please contact the undersigned at 1.312.861.2620 as an initial matter.

Sincerely yours,

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

Cc: Commissioner Charles McCreevy