

## THE ASSOCIATION OF GLOBAL CUSTODIANS

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2 December 2009

Frederick Reinfeldt  
Prime Minister of Sweden  
President of the European Council  
60, Rue Wiertz  
B-1047 BRUSSELS  
BELGIUM

RE: **Proposed Re-draft of Article 17 – Alternative Investment Fund  
Managers Directive**

Dear Mr. President:

We write on behalf of the members of the Association of Global Custodians (“Association”)<sup>1</sup> further to our earlier correspondence on the proposed Alternative Investment Fund Managers Directive (“AIFMD”) and in response to Council members’ expressed interest in receiving specific recommendations for legislative language concerning the depositary function. As you recall, the Association’s previous commentary conveyed members’ concerns about the impact of the AIFMD on the existing depositary framework and specifically the potential negative consequences to investors and asset managers that could result from the imposition of an inappropriately structured liability framework. Members continue to have strong concerns regarding

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<sup>1</sup> The Association is an informal group of eight global custodian banks that provide securities safekeeping services and related asset servicing functions to institutional 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 either directly or indirectly through European branches and subsidiaries and, in so doing, play substantial roles in European markets. Members of the Association, listed on the letterhead above, hold assets under custody that in the aggregate approximate 30 Trillion Euro in value.

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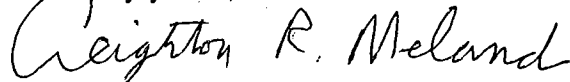
legislative provisions for AIFM that could change standards of care or liability, impose new obligations, or introduce new risks in ways likely to harm EU investors and financial markets.

We note your Office's significant efforts to address these and similar concerns through proposed revisions to the text of Article 17, and members appreciate your leadership in responding to the recommendations of the financial industry. To facilitate further progress in developing workable legislation and to best respond to Council members' requests for support, Association members have prepared the attached re-draft of Article 17, together with explanatory commentary. The attached extract takes as its basis the compromise text released by your Office on November 12, 2009 (the "Compromise Text"), and the extract and commentary includes various points on which members believe further legislative details could be appropriately developed, including in the Level 2 process. The extract represents members' collective effort to advance the Compromise Text, though we are aware that other legislative versions have begun to emerge. We anticipate that Association members may determine individually to suggest supplemental drafting on specific points, and the Association may provide further suggestions and commentary on subsequent legislative drafts.

We appreciate your consideration of Association members' views and stand ready to discuss these recommendations with your Office and other legislative officials as may be helpful.

If you have any questions or would like to discuss the attached recommendations with Association members, please contact the undersigned at 312.861.2990 as an initial matter.

Sincerely yours,



Creighton R. Meland  
Baker & McKenzie LLP  
Counsel to the Association

Cc Listing: Ministers of Finance and Staff

ATTACHMENT – Alternative AIFMD Text Proposal

Proposal for a

**DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL**

**on Alternative Investment Fund Managers and amending Directive (...) 2009/65/EC**

***(Text Extracted for Relevance to Depositaries)***

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 47(2) thereof,

[...]

Whereas:

<b><i>PROPOSED REVISED TEXT</i></b>	<b><i>EXPLANATION</i></b>
<p style="text-align: center;"><i>Recitals</i></p> <p style="text-align: center;">....</p> <p>(12) It is necessary to ensure that AIFM operate subject to robust governance controls. AIFM should be managed and organised so as to minimise conflicts of interest. Recent developments underline the crucial need to separate asset safe-keeping and management functions, and segregate investor assets from those of the manager. Although AIFM manage AIF with different business models and arrangements for (...) <i>inter alia</i> asset safe-keeping, it is essential that a depositary separate from the AIFM is appointed to provide depositary functions with respect to AIF. The depositary will be responsible for the booking of investor money (...) on (...) segregated accounts, the safe-keeping of financial instruments (...), including the holding in custody of financial instruments that can be kept (...), and the verification of whether the AIF or the AIFM on behalf of the AIF has obtained ownership of all other assets. A depositary may maintain a common segregated account for several AIF.</p>	<p><b><i>[CONSEQUENTIAL CHANGES TO BE MADE WHEN ART 17 FINALISED]</i></b></p>
<p>(27) In particular the Commission should be empowered to adopt the measures necessary for the implementation of this Directive. In this respect, the Commission should be able to adopt measures determining the procedures under which AIFM managing portfolios of AIF whose assets under management do not exceed the threshold set out in this Directive may exercise their right to be treated as AIFM covered by this Directive. These measures are also designed to specify the criteria to be used by competent authorities to assess whether AIFM comply with their obligations as regards their conduct of business, the type of conflicts of interests AIFM have to identify, as well as the reasonable steps AIFM are expected to take in terms of internal and organizational procedures in order to identify, prevent, manage and disclose conflicts of interest. They are designed to specify the risk management requirements to be employed by AIFM as a</p>	<p><b><i>[CONSEQUENTIAL CHANGES TO BE MADE WHEN ART 17 FINALISED]</i></b></p>

function of the risks which the AIFM incurs on behalf of the AIF that it manages (...). They are designed to specify the liquidity management systems and procedures that AIFM shall employ (...). They are designed to specify the requirements that originators of securitisation instruments have to meet in order for an AIFM to be allowed to invest in such instruments issued after 1 January 2011. They are as well designed to specify the requirements that AIFM have to comply with when investing in such securitisation instruments. They are designed to specify the procedures for the proper valuation of the assets and shares or units of AIF (...). (...) As regards depositaries, they should specify the modalities for the segregation of payments in different accounts, the notions of safe-keeping and custody, including the modalities for the segregation of financial instruments in different accounts, the determination of when financial instruments can be kept, are subject to regular trading and when there is a loss of financial instruments, the supervisory duties of depositaries, the conditions for delegation, including the due diligence duties of depositaries and the need for cooperation agreements with other jurisdictions and the conditions for approval of depositaries, including an assessment of whether the depositary can furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depositary functions and meet the commitments inherent in those functions. They are designed to specify the conditions under which the delegation of AIFM functions should be approved and the conditions under which the manager could no longer be considered to be the manager of the AIF in case of excessive delegation. They are designed to specify the content and format of the annual report that AIFM have to make available for each AIF they manage and to specify the disclosure obligations of AIFM to investors and reporting requirements to competent authorities as well as their frequency. They are designed to specify the disclosure requirements imposed on AIFM, particularly with (...) regard (...) to leverage and the frequency and format of reporting to competent authorities and of disclosure to investors. The measures should specify when leverage is considered to be employed on a systematic basis. The measures should also specify the principles competent authorities should use when considering implementation of limits on leverage. (...) (...) (...) They are designed to specify the modalities,

<p>content and frequency of exchange of information regarding AIFM between the competent authorities of the home Member State of the AIFM and other competent authorities where the AIFM individually or collectively with other AIFM may have an impact on the stability of systemically relevant financial institutions and the orderly functioning of markets. They are designed to specify the procedures for on-the-spot verifications and investigations.</p>	
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<p style="text-align: center;"><i>Article 3</i> <i>Definitions</i></p>	
<p>(ic) 'Home Member State of a depositary' means</p> <p>(i) if the depositary is a credit institution authorised under Directive 2006/48/EC, the home Member State as defined in Article 4(7) of that Directive;</p> <p>(ii) if the depositary is an investment firm authorised under Directive 2004/39/EC, the home Member State as defined in Article 4(1)(20)(a) of that Directive;</p> <p>(iii) if the depositary is a legal person referred to in Article 17(3)(c) or (d) which is established in the Community, the Member State in which it has its registered office;</p>	<p><b><i>[CONSEQUENTIAL CHANGES TO BE MADE WHEN ART 17 FINALISED]</i></b></p>
<p>(jb) 'Competent authorities of a depositary' means</p> <p>(i) if the depositary is a credit institution authorised under Directive 2006/48/EC, the competent authorities as defined in Article 4(4) of that Directive;</p> <p>(ii) if the depositary is an investment firm authorised under Directive 2004/39/EC, the home Member State as defined in Article 4(1)(22) of that Directive;</p> <p>(iii) if the depositary is a legal person referred to in Article 17(3)(c) which is established in the Community, the national authorities of its home Member State which are empowered by law or regulation to supervise such legal persons;</p>	<p><b><i>[CONSEQUENTIAL CHANGES TO BE MADE WHEN ART 17 FINALISED]</i></b></p>
<p style="text-align: center;"><i>Article 17</i> <i>Depositary</i></p>	
<p>1. For each AIF it manages, the AIFM shall ensure that a depositary is appointed to fulfill, where relevant, the following (...) depositary functions: <sup>1</sup></p>	<p>The following changes to paragraph 1 are intended to present a logical framework addressing assets of the AIF: (a) cash assets of the AIF; (b) AIF financial instruments delivered to the custodian and certain AIF entitlements; and (c) other AIF assets.</p>

<sup>1</sup> Important to be clear that the depositary is commonly appointed by, and owes its duties to, the AIF not the AIFM. If this wording were interpreted as requiring the AIFM to be party to the document AIFMD, Swedish Presidency Proposal, Depositary Provisions Extracted, Alternates Version, AGC, 2-12-09  
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<p>(a) (...)verify that AIF cash placed on deposit is held with the one or more Approved Bank(s)<sup>2</sup>, including the depositary if it is an Approved Bank.</p>	<p>To ensure coherence in paragraph 1 (per above), sub (a) should solely address cash that is an asset of the AIF but not cash which is not an asset of the AIF. Cash booked outside the AIF in connection with subscriptions and redemptions is sufficiently addressed in points (a) and (c) of paragraph 1a below.</p> <p>It is recommended that the placing of fund cash as deposits should be subjected to a regime that is similar to that required for Client Money under MiFID. Scope is allowed for more detailed requirements (if necessary) at Level 2.</p>
<p>(b) safe-keep any financial instruments (...) which belong to the AIF, namely:</p>	
<p>(i) hold in custody all financial instruments that are physically delivered to it; and,</p> <p>(ii) maintain all entitlements in financial instruments credited to it through an established system of registration or indirect holding;</p> <p>all such financial instruments are to be segregated from the assets of the depositary or any custodian and clearly identified on the books of the depositary as belonging to the AIF;</p>	<p>Changes made to conform with applicable legal systems in which “safe-keeping” obligations of a custodian apply to financial instruments that are physically held and entitlements in financial instruments, such as “book-entry securities” held for example via central securities depositories (CSD) or on the books of registrars of issuers. This is to be further addressed in Level 2.</p> <p>Segregation requirements should be covered in Level 2.</p>
<p>(bb) ensure that the financial instruments referred to in point b of this paragraph may not be re-used without the prior consent of the AIFM, and such consent has not been withdrawn.</p>	<p>Reference to (i) deleted to reflect that this requirement covers both physical and book-entry assets.</p>
<p>(c) maintain records evidencing ownership of assets of the AIF other than those referred to in points (a) and (b) of this paragraph.</p>	<p>Change made in recognition of the absence of the depositary from the chain of ownership of such assets. The depositary will maintain records which provide useful evidence, but cannot be expected to confirm the validity of title. The</p>

appointing the depositary, or meaning that the depositary was accountable to the AIFM, this would create conflicts of interest which are undesirable.

<sup>2</sup> To be defined consistent with MiFID



	nature of the evidence to be obtained should be specified in Level 2.
1a. In addition to the tasks referred to in paragraph 1, the depositary shall verify that:	<p>Amended to reflect depositary's supervisory duties (of monitoring and record-keeping). Although the depositary has responsibility for oversight of compliance with these functions, the performance of such functions (for example valuation) are not an obligation of the depositary. The steps to be taken for verification purposes should be specified in Level 2.</p> <p>Due consideration should be given to the way the industry supports alternative investment funds today, and whether the application of all of these responsibilities, as a default position, is appropriate in that light.</p>
<p>(a) the sale, issue, re-purchase, redemption and cancellation of shares or units of the AIF are carried out in accordance with the applicable national law and the AIF rules or instruments of incorporation;</p> <p>(b) the value of the shares or units of the AIF is calculated in accordance with the applicable national law and the AIF rules or instruments of incorporation;</p> <p>(c) in transactions involving the AIF's assets any consideration is remitted to it within the usual time limits;</p> <p>(d) AIFM instructions have not been in conflict with the applicable national law or the AIF rules or instruments of incorporation.</p> <p>By way of derogation from the paragraphs 1a(a) to (d), the competent authorities of the home Member State of the AIF may provide that any of 1a(a) to (d) do not apply where the AIF is solely marketed to professional and/or sophisticated investors.</p>	<p>Change to (d) in recognition of depositary's investment compliance oversight responsibilities which are imposed by national law, etc.</p> <p>Since these provisions are copied from the UCITS Directive, it would be appropriate to allow Member States to disapply such requirement for non-retail AIFs.</p>
2. An AIFM shall not act as depositary of an AIF which it manages.	The limitation should only operate to prevent

	conflicts: there is no reason to prohibit an AIFM from serving as a depositary for an AIF for which it is not a manager if it is otherwise eligible to serve as a depositary.
2a. In the context of their respective roles, the AIFM and the depositary shall act honestly, fairly, professionally, independently and (...) in the interest of all the investors of the AIF collectively (...).	It is important to clarify the depositary's duties are to all the AIF investors collectively and not to "the AIF or the investors" as this might suggest conflicting loyalties.
3. The depositary shall be either:	
(a) a credit institution having its registered office in the Community and (...) authorised in accordance with Directive 2006/48/EC of the European Parliament and Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) <sup>3</sup> ;	
(b) an investment firm authorised in accordance with Directive 2004/39/EC to provide ancillary services in accordance with Section B(1) of Annex I to that Directive, having its registered office in the Community; or	
(c) an institution which is subject to prudential regulation and ongoing supervision and which can furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depositary functions and meet the commitments inherent in those functions	This permits firms which are appropriately regulated by member states to act as depositaries, such as trustee companies which have no reason to seek to engage in investment activities requiring status as MiFID investment firms.
(d) Notwithstanding points (a), (b) and (c) of this paragraph 3, for AIF which have no redemption rights exercisable during a period of 5 years following the date of constitution of each AIF and which, according to their investment strategy and objectives, make investments and divestments solely on a non-frequent basis, the depositary may be either:	Change made to clarify this is a new category of eligible depositary and to correspond with the addition of (c) above.
(i) an institution which is subject to prudential regulation and ongoing supervision and which can furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depositary functions and	Clarifying change

<sup>3</sup>

OJ L 177, 30.6.2006, p. 1.

AIFMD, Swedish Presidency Proposal, Depositary Provisions Extracted, Alternates Version, AGC, 2-12-09

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meet the commitments inherent in those functions; or	
(ii) an institution which carries out depository functions as part of professional or business activities in respect of which it is subject to mandatory professional registration recognized by law or to legal or regulatory provisions or rules of professional conduct and which can furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depository functions and meet the commitments inherent in those functions.	Clarifying change
4. The (...) depository may delegate to third parties the (...) tasks referred to in paragraph 1 (...).	There is no reason to prohibit delegation of any of the tasks set out in paragraph 1.
<p>When the depository utilises the services of a sub-custodian in furtherance of the task set out in point (b) of paragraph 1, it must determine that the following conditions are satisfied:</p> <p>(a) the sub-custodian is subject to the required level of supervision in the jurisdiction concerned;</p> <p>(b) it has determined the sub-custodian has structures and expertise that are adequate and proportionate to the nature and scale of the entitlements in financial instruments belonging to the AIF;</p> <p>(c) the sub-custodian is subject to periodic audit to ensure that the financial instruments are in its possession;</p> <p>(d) the sub-custodian segregates the financial instruments from its own assets; and</p> <p>(e) the sub-custodian may not make use of the financial instruments without prior consent of the AIFM (...), which consent has not been withdrawn.</p>	<p>This change more accurately reflects the conditions under which a depository should utilize sub-custodians as providers in the chain of intermediation.</p> <p>Level 2 should cover the detail underlying these requirements, in particular the extent of the due diligence appropriate to be carried out by the depository.</p>
4a. The depository shall exercise all due skill, care and diligence for the selection, appointment and periodic review of any third party as	

referred to in paragraph 4.	
<p>4b. In the case of loss of financial instruments held in custody in accordance with point (b)(i) of paragraph 1, or the depositary's unjustifiable failure to maintain entitlements to financial instruments according to point (b)(ii) of paragraph 1, the depositary shall return the assets or the corresponding amount to the AIF.</p> <p>This obligation shall not be affected by a delegation to a sub-custodian in accordance with paragraph 4.</p> <p>However, the depositary may, by contract with the appropriate counterparty, discharge itself of this obligation if it can prove that it has fulfilled its obligations pursuant to paragraphs 4 and 4a.</p>	<p>This recognizes an obligation to return property (financial instruments) held by the Depositary.</p>
<p>5. The depositary shall be liable to the investors of the AIF collectively for losses suffered by them as a result of its unjustifiable failure to perform its obligations pursuant to (...) paragraphs 1, 1a, 2a, 4 and 4a. Subject to paragraph 4b, the depositary's liability shall not be affected by any delegation referred to in paragraph 4. (...) Further, the depositary may, by contract with the appointing counterparty, limit or exclude particular categories of losses.</p>	<p>To conform with UCITS standards it is important to clarify that the depositary's duties are to all the AIF investors collectively and not to "the AIF or the investors" as this might suggest conflicting loyalties.</p>
	<p>Should be deleted because creates a risk of competing claims for losses. Moreover, standing to bring action for recovery of losses is determined according to national law.</p>
<p>6. Liability under paragraphs 4b and 5 shall not apply in circumstances beyond the control of the depositary, including inter alia, force majeure, market conditions, terms or conditions imposed by market infrastructure organizations or by participation in market infrastructure systems.</p>	<p>The phrase "market infrastructure systems" refers to facilities maintained and operated for financial institutions by entities such as clearing houses, settlement systems and central securities depositories.</p>
<p>7. The depositary shall make available on request to the competent authorities of its home Member State all information which it has obtained while undertaking its duties and that is necessary for the competent authorities to supervise the AIFM. If the home Member State of the AIFM is different from that of the depositary the competent authorities of the depositary home Member State shall</p>	

<p>share the information received without delay with the competent authorities of the AIFM home Member State.</p>	
<p>8. For an AIF established in the Community, the appointed depositary shall be established in the home Member State of the AIF. Any appointment of a depositary shall be subject to approval from the competent authorities of the home Member State of the AIF.</p> <p>[By way of derogation from the first subparagraph the competent authorities of the home Member State of the AIF may allow institutions fulfilling the requirements in point (a), (b) or (c) of the first subparagraph of paragraph 3 and established in another Member State to be appointed depositary.]</p>	
<p>9. The Commission shall adopt implementing measures further specifying:</p> <ul style="list-style-type: none"> <li>(a) the means and methods for placing deposits with Approved Banks;</li> <li>(b) the notions of safe-keeping and custody, including the means and methods for the segregation of financial instruments in different accounts and when there is a loss of financial instruments;</li> <li>(c) the supervisory (...) duties of depositaries;</li> <li>(d) the conditions for delegation, including the due diligence duties of depositaries and the need for cooperation agreements with other jurisdictions;</li> <li>(e) the conditions for approval of depositaries, including an assessment of whether the depositary can furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depositary functions and meet the commitments inherent in those functions.</li> </ul> <p>These measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 49(3).</p>	<p>To conform with revised 17.1. To conform with revised 17.1(b).</p>