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

RE: Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers [2009/0064 (COD)]; Provisions on Depositaries

Dear Mr. President:

We write on behalf of the members of the Association of Global Custodians ("Association")[1] to express members' views concerning the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers (hereinafter referred to as the "Proposed Directive"), principally Article 17 thereof, which sets out provisions that govern the selection and operation of Alternative Investment

[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 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.

Fund ("AIF") depositaries. Members welcome the Council's efforts to recognize and define the role of depositaries in the European asset management market. As an industry, we support a review of custody standards under current regulation with a view to consistency and predictability across Europe.

At the same time, the Association is concerned that the proposed provisions on depositaries could have significant impact on the existing depositary framework as well as potential negative consequences for both investors and asset managers. Of particular concern are the provisions concerning depositary liability when losses occur. As practitioners with substantial expertise in providing custody-related services to European investors and with a demonstrated record of best practices, Association members wish to provide the Council with this initial summary of their core views concerning those adverse impacts and consequences.

The Association is continuing to review the issues raised by the Proposed Directive and anticipates that members will convey their full range of views in subsequent communications. These may include a fuller discussion and analysis of matters of particular concern.

I. Background and Context for Concerns

The Association supports a review of custody standards that looks to assure:

- Segregation of client assets from the assets of the custodian, 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 investor protection in each of the EU jurisdictions; and,
- Clear and objective custody standards that are coordinated with other bodies of regulation, such as bank capital adequacy and capital markets regulation.

To achieve these goals, we believe, any approach should take into account the following market realities:

- The vast majority of client assets are represented not by physical property that may be held by a custodian 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 intermediaries.

- In providing custody services to investors, a custodian acts in most respects as the investor's agent. In so acting, a custodian is typically required by market circumstances to engage numerous local market agents to which the custodian assumes a duty of careful selection and ongoing supervision. A custodian also must interact with other entities that are *not* agents of the custodian, 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 custodian, or that are retained at the direction of the investor, are not subject to the custodian's choice, supervision, or control; and the well-established view in today's markets is that bank custodians are not responsible for the actions or omissions of parties which they did not select and over which they have no control.

- A custodian's selection of local market subcustodians is not an outsourcing event or activity, but rather a market necessity based on the need to procure an appropriate intermediary in a given market.

II. Main Concerns with Article 17 of the Proposed Directive

Applying the foregoing, we believe the Proposed Directive as currently drafted would produce a number of uncertain and potentially adverse consequences. Of special concern, Article 17 appears to impose new, unclear and unprecedented standards of liability on depositaries. Article 17.5 in particular would make a depositary responsible for "any loss of financial instruments" that occurs unless it can prove that it "could not have avoided the loss". Under some possible readings of Article 17, this new standard might be viewed as imposing strict liability on depositaries, which would be particularly inappropriate where investor entitlements in book-entry securities are "held" through the records of a chain of interconnected intermediaries. The same Article imposes liability for failure to perform the duties of the depositary without the qualification found in UCITS 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.

Such new standards would depart from established law and current practice that apply to UCITS funds; would increase systemic risk to depositaries without considering alternative risk mitigation approaches under current UCITS standards; would require investors and intermediaries to re-work or possibly discontinue contracts and arrangements governing intermediation globally; and would likely lead to the curtailment of important intermediary services, thereby harming investors. Indeed, we believe the new standards would create such a range of varying potential outcomes that it will be difficult for custodians and investors to assess their relative risk in complex cross-border activities and will complicate efforts to achieve consistency in application across national regulatory regimes.

Instead of introducing such change, we believe the Council should replace the new and uncertain liability standards in Article 17 with the long-standing 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 custodians, as described below.

III. A Depositary's Methods and Approaches to Selecting and Monitoring Subcustodians

Among its duties, a depositary is responsible to appropriately select and monitor subcustodian banks that provide local market settlement and custody services. Contrary to some misconceptions, selecting local market subcustodians is not an event or incident of outsourcing, but rather a by-product of the need to secure experts in local market practices who have access to necessary facilities. 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.

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

The Association believes the Proposed Directive and any subsequent implementing measures could well benefit by incorporating relevant elements of suitable performance standards, which we are prepared to discuss with the Council and submit separately. Such references would establish compliance benchmarks, would protect investors, and would enable depositaries to conduct business with full awareness of the prescribed performance requirements.

IV. Unanticipated Impact on Investors

The Proposed Directive as currently drafted may create unanticipated harm to investors. The uncertain and potentially difficult liability standard, particularly when applied to intermediated and immobilized/uncertificated securities, would expose depositary balance sheets to losses caused by third parties outside of its control. Such exposure -- and indeed any requirement that banks act as insurers or guarantors – will be of concern to bank supervisors and regulators, and it should be anticipated that depositaries will not conduct business as usual after enactment.

Anticipated changes in behavior may 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 AIFs, which would reduce or eliminate AIF service options.

The end result across Europe could well be reduced investment, lower returns, greater uncertainty and higher costs; in short, reduced welfare for all market participants and markets.

V. CONCLUSION

The Association would like to thank the Council for its consideration of members' comments. As the co-legislators' deliberations on the Proposed Directive progress, the Association would welcome and encourage the Council to engage in dialogue with the Association and other stakeholders to ensure that the Proposed Directive does not produce unintended consequences that would undermine its intended benefit. We stand ready to submit more detailed, technical comments if it would be of aid to the Council or its staff.

If you have any questions or would like to discuss these comments with Association members, please contact the undersigned at 1 312 861 2990 as an initial matter.

Sincerely yours,

Creighton R. Meland

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Baker & McKenzie LLP
Counsel to the Association

Cc Listing: Ministers of Finance (by e-mail)