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25 June 2012

Jonathan Faull
Director General, Internal Market and Services
European Commission
1049 Brussels
BELGIUM

**RE: Your Letter of 30 May to the Association – AIFMD Level 2 Issues**

Dear Mr. Faull:

We write on behalf of the Association of Global Custodians (the "Association")[1] in response to your letter of 30 May ("Letter"), in which you replied to the Association's 23rd April letter expressing members' concerns about problematic provisions governing depositaries as proposed in the European Commission's ("Commission") draft Level 2 Regulation implementing the AIFM Directive. Although the Association thanks you for your Letter reply, members fundamentally disagree with some of the views expressed and the assumptions underlying various statements in your Letter regarding the workability of particular implementation measures and the nature and extent of the measures' probable impact on markets and investors. Indeed, while the Association shares most of the AIFM Directive's fundamental objectives, members believe the current draft text fails to recognize and take into account basic operational realities, and disregards the risks of industry realignments and market disruptions the draft text will generate.

Below we first set out a sampling of key types of disruptive impacts the problematic draft provisions seem likely to produce. We then reply to the statements in your Letter and their implications.

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1 Association members provide safekeeping and asset-servicing functions to institutional cross-border investors, and in so doing serve, among other things, as depositaries for EU-originated investment funds. Members of the Association are listed on the letterhead above.

Summary of Probable Impacts of the Four Draft Provisions in question, which continue to generate concern: (a) third party entities as custody delegates; (b) assets held at prime brokers; (c) third party fraud; and (d) 'at-risk markets'.

***Enhanced systemic risk***

- By making depositaries responsible for assets held with third party entities over which they have no measure of control, risk is shifted from other parts of the financial industry to the banking system at a time when prudential regulators are trying to de-risk banks. By ignoring legal and operating realities in shifting to banks risks over which they have no control, and for actions as to which they are not the decision-makers, the Level 2 draft text increases the risk of moral hazard – rather than reducing it.
- The increased liability and related costs faced by depositaries could reduce the number of companies providing depositary services, thereby reducing competitive choice for investors and increasing concentration of risk among fewer market participants. By forcing depositaries to act as *de facto* guarantors in respect of collateral-related risk, the Level 2 Regulation seems to undermine the G20 commitment to adopt mandatory clearing for OTC derivative contracts.

***Reduced investor choice/ investor returns***

- As a result of expanded liability, depositaries may not be able or willing to provide services in developing/emerging markets, thereby making it more difficult for these markets to attract foreign investors. Expanded liability risk may also serve to exacerbate downward spirals in 'at-risk' markets.
- A withdrawal of depositary services in certain more risky markets and/or in respect of certain assets classes will reduce investors' choice of investment venues, their use of certain trading strategies, and broad diversification of their portfolios.
- The increased liability is also likely to result in an increase in depositaries' balance sheet risk and associated capital, which will translate into higher costs and therefore lower returns for the end investor.

***Damage to the competitiveness in financial services and in the funds industry***

- The AIFMD implementing measures, as drafted, along with the anticipated UCITS V text, could have a negative impact on the entire European funds sector. By imposing rules that are costly to implement and inconsistent with standards in other developed markets, such as those applicable to U.S. mutual funds, the European fund industry risks losing competitiveness as a platform for global investment. Other financial centers, including those in Asia and the US, are likely to be able to offer less costly and more flexible offerings, with what regulators in those jurisdictions find to be satisfactory levels of transparency and consumer protection.
- All of this is expected to have the net effect of financial services jobs leaving the EU. Investment managers and related financial service providers will find it easier and more

cost effective to operate outside the region when servicing non-EU clients, and this will clearly impact potential investment and economic growth within the EU.

Comments on your Letter Statements

Recognizing the above concerns, Association members have regularly expressed interest in holding constructive, collaborative discussions with the Commission in order to find the right balance between maximizing investor protection and avoiding undue disruptions in existing business conventions and market models. In the spirit of that dialogue, the following commentary addresses statements in your Letter and various apparent underlying assumptions.

***Treatment of third party entities as delegates of the custody function***

We understand from your Letter's statements on this topic that the Commission's objective is to encourage depositaries to hold in their custody assets that are subject to collateral received or granted by the AIF (except for title transfer collateralized assets). Your highlighted option for depositaries to appoint a broker or other third party entity holding AIF collateral as a sub-custodian does not reflect the current standard business and operating model. Moreover, the appointment of a third party to act as collateral keeper would expose the depositary to such party's negligence, errors or fraud – events that no depositary can reasonably control on a daily basis.

Forcing depositaries to keep collateral assets in their own books and records is technically possible but would substantially disrupt current market practice and pose operational difficulties, risks and costs. The Level 2 draft text would compel significant changes in the way collateral is held today and the way market participants interface. Such dramatic changes in market arrangements and norms with respect to agents and brokers have not been subject to a thorough impact assessment and market consultation to date, though they should have been.

In addition, despite the Commission's position that agents appointed by depositaries for investment and settlement reasons are internal to the appointing depositary, the reality is that appointed agents remain *de facto* third parties, operating independently under their own managers and governors. Indeed, third party brokers that hold collateral related to market activities cannot be considered equivalent to agents appointed as sub-custodians by the depositary. While a link to depositary settlement and custody activities might provide a form of logic for holding depositaries liable for errors of subcustodians they appoint, that logic cannot extend to liability for losses caused by third parties, such as brokers serving AIFs that are involved in non-custodial activities and are not appointed by the depositary. (See our supplemental comments concerning Prime Brokers in the following section.)

We note with relief your confirmation that assets held with CCPs would under no circumstance be subject to depositary liability. However, this point needs to be adequately reflected and enshrined in the Level 2 measures.

***Assets held with prime brokers***

We understand from your Letter that the Commission envisions different options relative to prime brokers:

a) You note that no rule prevents a prime broker from being appointed as the AIF's depositary by the AIF(M). This is true *provided that* those prime brokers have the capacity and would agree to undertake the full spectrum of a depositary's regulatory duties and functions as imposed by the AIFMD (including cash monitoring, asset record keeping and oversight functions) in addition to performing the asset-custody safekeeping function. We would expect this to represent a fundamental change in the prime broker business model, likely posing substantial challenges; or

b) Alternatively, the prime broker could be appointed by the depositary as its sub-custodian for the assets subject to custody. Under this sub-custody arrangement, the depositary would retain full responsibility for the return of any lost assets. Whether appointed or not, prime brokers remain third parties technically and legally, and, most important, any appointment of a prime broker is made upon the direction of the AIF(M), which has the relationship with the prime broker, in contrast to depositary appointments of sub-custodians.

Moreover -- and specifically with reference to the following statement in your Letter -- *"[b]ecause a prime broker that receives collateral pledged by an AIF without an outright transfer of ownership must either act as depositary for the AIF or should be appointed as a sub-custodian in respect of collateralized assets belonging to the AIF, it is incorrect to state that the AIF's depositary has no 'control' over the collateralized assets or that these assets are 'held outside the custody chain'"* -- we respectfully submit that this view cannot be correct under current law and legal principles. Under most applicable laws, a prime broker that takes custody of assets of an AIF as collateral in order to secure a financing arrangement *typically must have "control" of the assets* to ensure a validly perfected security interest where the arrangement is in the nature of a security financial collateral arrangement (i.e., where legal title does not pass to the collateral-taker) as contemplated under the Financial Collateral Directive (the "FCD").

The importance of the element of "control" to the perfection of security interests under the FCD is to ensure that the Directive does not interfere with the requisites of perfection under the laws of individual member states. *". . . the only perfection requirement regarding parties which national law may impose in respect of financial collateral should be that the financial collateral is under the control of the collateral taker or of a person*

*acting on the collateral taker's behalf [e.g., an "agent"] . . .*" (See Financial Collateral Directive, Recital 9.) Indeed, the requisites contemplated by the FCD were intended to reduce systemic risk -- the Directive was supposed to equalize as much as possible the position between the two main types of collateral arrangements [i.e., title transfer versus security financial collateral arrangements], by not making certain specific rules applicable to security arrangements so that parties could choose whichever sort of arrangement would be most appropriate rather than for purposes of avoiding the burdens of the rules.

Notably, this issue applies not just in respect of prime brokerage arrangements but all arrangements involving the provision of assets of an AIF as collateral. Legal opinions supporting the validity of security arrangements obtained by the International Swaps and Derivatives Association ("ISDA") refer to "control" being vested in the collateral-taker as an assumption underlying the validity of the legal opinions; or

c) The depositary can keep all collateral in its own books and records, only releasing on a day to day basis those assets that are subject to effective ownership transfer. This will heavily disrupt current market practice, will materially increase operational complexity and risk, will limit access to financing, and will increase the overall cost of the funds, to the detriment of end investors. We note, incidentally, that most collateral arrangements under New York law or English law do not provide for title transfer.

Your explanatory statements unfortunately validate members' expressed concerns regarding undue disruption of market practices and conventions, including disruption of brokers' collateral control arrangements and practices, as well as depositary exposure to errors and fraud by third parties that are not sub-custodians, are not involved in custodial activities, and over which depositaries have no practical control.

***Third party fraud***

The view, re-emphasized in your Letter, that appointed sub-custodians should be deemed under the depositary's control for all internal processes, does not sufficiently take into account business reality or market conventions, and effectively places depositaries in the role of insurers for losses they cannot control. The test depositaries must meet to avoid liability in cases of loss occurring at a third-party sub-custodian goes far beyond the "reasonable efforts" standard in the Level 1 text. In practice, the additional requirement to show that a loss could not have been prevented by the overbroad standard of "rigorous and comprehensive due diligence" will expose depositaries to claims that would otherwise not meet legal standards.

Appointing agents in each of the many markets that members' clients choose to invest in, both inside and outside the EU, is an inescapable operating necessity in order to facilitate settlement of the client's obligations. Those necessary appointments do not change the degree

of practical operating and oversight distance between the depositary and its many selected agents, however, and cannot appropriately lead *per se* to depositary liability for matters such as subcustodian fraud. Furthermore, appointing or being deemed as having "appointed" an AIF's prime broker as the depositary's "subcustodian" -- in order to establish the depositary's "control" over AIF assets -- is in members' view neither feasible nor sensible. As described above, the prime broker is itself obliged to "control" collateral assets, and to do so in accordance with *the AIF's standard appointment arrangements.* Members accordingly urge the Commission to adopt the changes to the draft text that are set out in the attachment.

***"At-risk" markets***

Your Letter correctly points out that Art. 21 (13) of AIFMD allows depositaries to contractually discharge their liability, but members remain very concerned about the strict and impracticable conditions that this discharge entails. It can only apply in practice in anticipated circumstances or markets identified in advance as being of "high risk", and it requires the availability of sufficient time to negotiate and manage the transfer of liability and a willingness on the part of the subcustodian or other third party entity to accept that liability. In the context of market stress, it is inevitably unpredictable how much time will be required to negotiate and contractually arrange such a transfer – if even possible -- and this unpredictability is amplified where the depositary must terminate an agreement because the AIFM chooses not to act upon the depositary's advice. In that circumstance, under the draft measures, the depositary remains liable for an undefined and uncontrollable period of time during which the identified risk could expand – a scenario likely to happen in stressed market situations that call for quick reactions.

Members thus reiterate that under the current wording of the Level 2 draft text, depositaries, despite fulfilling all their duties, have no realistic way of discharging their liability notwithstanding strict adherence to the Directive's due diligence standards. Given that, depositaries will be obliged to either limit at the outset those markets they are willing to make available to investors or exit such markets at early signs of trouble. Neither option significantly advances investors' interests, market stability or global investment opportunities.

Members remain very concerned about the extent to which the current Level 2 draft text disregards market realities. Members also remain concerned about the dramatic changes the draft text will generate, and the dislocations that will flow as the industry works through these ramifications. For your reference, we re-enclose drafting suggestions that in the Association's view will help to improve the current text's wording without undermining legislative intent.

* * * * *

The Association appreciates the ongoing dialogue with the Commission and welcomes the opportunity to continue to provide members' expert advice on the foregoing topics. Members remain ready to offer the Commission collaborative proposals that strike the right

balance among maximizing investor protection, recognizing operational and investment market realities, avoiding systemic disruptions, and supporting access to global investment markets.

Sincerely yours,

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

ATTACHMENT: Recommended AIFMD L2 Drafting Changes

Attachment to the AGC letter of 25 June 2012 to
Jonathan Faull, European Commission:
Drafting Suggestions
*(based on the latest inter-institutional draft of the European Commission's delegated regulation supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision)*

**Recital 93**

[...]
*The contract should also contain details concerning an escalation procedure. For example, the depositary should alert the AIFM of any material risk identified in a particular market's settlement system. Where the AIFM insists on maintaining an investment in a particular jurisdiction despite warnings by the depositary as to the risk this presents, the depositary shall be deemed to have met the "reasonable efforts to the contrary" standard in Article 21(11). With respect to the termination of the contract the relevant provisions should reflect that terminating the contract is the depositary's ultimate recourse in case that it is not satisfied that the assets are sufficiently protected; the depositary's responsibility for loss of assets being discharged by such termination . It should also prevent moral hazard whereby the AIFM would make investment decisions irrespective of custody risks on the basis that the depositary would be liable in most cases. In order to maintain a high level of investor protection the requirement setting the details of monitoring third parties should be applied in relation to the whole custody chain.*

**Note:** These changes are suggested to support the suggested changes below.

**Recital 98**

*[Chapter IV, section 2 – depositary functions] The depositary has to: ensure 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 according to Article 21(7) of Directive 2011/61/EU; ensure there is an appropriate reconciliation performed between the subscription orders in the AIF's register and the subscription proceeds received; ensure there is an appropriate reconciliation performed between the number of units / shares issued and the subscription proceeds received; and check (regularly) the consistency between the total number of units / shares in the AIF's accounting records and the total number of outstanding units / shares in the AIF's register.* Therefore, the AIFM should ensure that the depositary is provided with the relevant information it needs to properly monitor the reception of investors' payments. *~~The AIFM has in particular to ensure that the depositary gets this information without undue delay the third party receives an order to redeem or issue shares or units of an AIF. Therefore the information should be transmitted at the close of the~~*

*~~business day from the entity which is responsible for the subscription and redemption of shares or units of an AIF to the depositary in order to avoid any misuse of investors' payments~~*

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**Note:** The above changes are suggested to support the further suggested changes below.

**Recital 99**

*[Chapter IV, section 2 – depositary functions] Depending on the type of assets to be safe-kept, assets are either to be held in custody, as is the case for financial instruments which can be registered in a financial instruments account or can be physically delivered to the depositary according to Article 21(8)(a) of Directive 2011/61/EU, or to be subject to ownership verification and record-keeping. The depositary should hold in custody all financial instruments of the AIF or of the AIFM acting on behalf of the AIF that could be registered or held in an account directly or indirectly in the name of the depositary or a third party to whom custody functions are delegated according to Article 21(11) of Directive 2011/61/EU, at the level of the Central Securities Depositary. In addition to these situations those financial instruments are to be held in custody that are only directly registered with the issuer itself or its agent in the name of the depositary or a third party to whom custody functions are delegated according to Article 21(11) of Directive 2011/61/EU. Moreover, all financial instruments which could be physically delivered to the depositary should be held in custody. Financial instruments which are issued or held in dematerialised form shall not be regarded as being capable of being physically delivered, for the purposes of Article 90, so long as they remain in dematerialised form. Provided that the conditions upon which financial instruments are to be held in custody are fulfilled, also those financial instruments which are provided as collateral to a third party or are provided by a third party for the benefit of the AIF have to be held in custody as long as they are owned by the AIF or the AIFM acting on behalf of the AIF, except, in the case of financial instruments provided as collateral by the AIF, to the extent such financial instruments are required to satisfy bona fide margin or other similar requirements imposed by the third party which specify a value of financial instruments to be pledged. ~~Also, financial instruments owned by the AIF or the AIFM on behalf of the AIF, for which the AIF, or the AIFM on behalf of the AIF has given its consent to re-use by the depositary, remain in custody as long as the right of re-use has not been exercised.~~*

**Note:** These changes are suggested to support the suggested changes below.

**Article 88**

*The AIFM shall ensure that the depositary is provided with information about payments made by or on behalf of investors upon the subscription of units or shares of an AIF at the close of each business day the AIFM, the AIF or a party acting on*

*behalf of it, such as a transfer agent receives the payments or an order from the investor. ~~The AIFM shall ensure that the depositary gets all further relevant information it needs to make sure that the payments are then booked in cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary according to the provisions set out in Article 21(7) of Directive 2011/61/EU.~~ The depositary shall: ensure there is an appropriate reconciliation performed between the subscription orders in the AIF's register and the subscription proceeds received; ensure there is an appropriate reconciliation performed between the number of units / shares issued and the subscription proceeds received; and check (regularly) the consistency between the total number of units / shares in the AIF's accounting records and the total number of outstanding units / shares in the AIF's register. Therefore, the AIFM should ensure that the depositary is provided with the relevant information it needs to properly monitor the reception of investors' payments.*

**Note:** We would suggest that, rather than providing for the delivery of information to the depositary, which it might not be able to use meaningfully, the functions of the depositary with respect to the supervision of subscriptions and associated funds should be clarified, as shown above.

**Article 89**

*1. Financial instruments belonging to the AIF or the AIFM acting on behalf of the AIF which are not able to be physically delivered to the depositary shall be included in the scope of custody duties of the depositary if they fulfil all of the following criteria:*

*[...] (b) They are ~~capable of being~~ registered or held in an account directly or indirectly in the name of the depositary.*

**Note:** Technically, anything is "capable" of being registered in an account, since an account is simply a list, and anything that can be named in capable of being put into a list. We note that ESMA had suggested that this category should refer to any financial instrument which "is" registered in an account. The difference is meaningful, in order to ensure that the Regulation correctly and precisely identifies which assets are intended to be held in custody.

**Article 89**

*2. Financial instruments which fulfill the criteria set out in paragraph 1 should not be held in custody if they are only directly registered with the issuer itself or its agent,*

*such as a registrar or a transfer agent, in the name of the AIF. Financial instruments which are provided by either party to either market participants or market infrastructure in support of trading, clearing or settlement activities, undertaken on behalf of the AIF or the AIFM acting on behalf of the AIF, shall not be deemed as held in custody.*

*Financial instruments held by a prime broker or any other third party entity acting as a counterparty to the AIF or the AIFM acting on behalf of the AIF are regarded as being outside of the scope of assets held in custody to the extent such financial instruments are required to satisfy bona fide margin collateral or security or other similar requirements imposed by the third party which specify a value of financial instruments to be pledged. Financial instruments which have been re-used or passed to a prime broker or any other third party entity acting as a counterparty to the AIF or the AIFM acting on behalf of the AIF using title transfer collateral arrangements are also outside of the scope of custody.*

**Note:** These suggestions are intended to make clearer that brokers and CCPs are not subcustodians of the depositary.

They also clarify that collateral which is provided to prime brokers is not treated as a custody asset, so long as it is being held by the prime broker for legitimate and good faith security purposes (irrespective of the method by which security is taken – e.g., statutory pledges, contractual pledges, title transfer arrangements, English-law floating charges, etc.). We suggest that this is a reasonable approach, which does not over-reach and convert assets into collateral unnecessarily.

**Article 89**

*3. Financial instruments belonging to the AIF or the AIFM acting on behalf of the AIF which are able to be physically delivered to the depositary shall always be included in the scope of custody duties of the depositary. Financial instruments which are issued or held in dematerialised form shall not be regarded as being capable of being physically delivered, for the purposes of this Article 90, so long as they remain in dematerialised form.*

**Note:** This suggestion is to clarify that financial instruments which are held in book-entry form are not also in the category of financial instruments capable of physical delivery, only because there is a technical possibility that they could be turned into certificated assets.

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**Article 90**

*1. In order to comply with the obligations set out in Article 21(8) (a) of Directive 2011/61/EU with respect to financial instruments to be held in custody the depositary shall at least observe the following requirements: [...]*

~~*(g) The depositary shall verify the AIF's ownership right or the ownership right of the AIFM acting on behalf of the AIF over the assets.*~~

**Note:** This provision in the proposed Regulation appears to go beyond the requirements of the Directive, since verification of ownership rights is expressed in the Directive to apply to the assets which are part of the record-keeping obligation.

**Article 91**

*4. The depositary shall set up and implement an escalation procedure for situations where an anomaly is detected including the notification of the AIFM and of the competent authorities if the situation cannot be clarified and/or corrected. Where the AIFM insists on maintaining an investment in a particular jurisdiction despite warnings by the depositary as to the risk this presents, the depositary shall be deemed to have met the "reasonable efforts to the contrary" standard in Article 21(11).*

**Note:** The Regulation could be clearer on the consequences of the depositary warning the AIFM that maintaining investments of an AIF in a particular market is unduly risky. If the depositary's only remedy is to resign its appointment, then there is a practical problem: the assets of the AIF will remain within the custody network of the depositary until another depositary is able to take over and the assets can be transferred; but another depositary is unlikely to be willing to assume the appointment in such circumstances. The result will be that the AIF will need to close and the assets be used to return value to investors, but no depositary will be in place to supervise that process.

The solution would be to provide for the discharge of the depositary's liability for financial instruments which continue to be held, despite the depositary's warnings to the AIFM. If the depositary is not in harm's way, as a result of investment decisions made by the AIFM for specific assets, then the depositary might well be able to retain its appointment to supervise any steps to wind up the AIF, or the prospects for the appointment of a new depositary would be significantly improved.

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**Article 101**

*4. In case of the insolvency of the third party to whom the custody of financial instruments held in custody has been delegated, the loss of a financial instrument held in custody shall be ascertained by the AIFM and the depositary, as soon as one of the conditions set out in paragraph 1 is met with certainty. There shall be certainty as to whether any of the conditions set out in paragraph 1 is fulfilled at the latest at the end of the insolvency proceedings. The AIFM and the depositary shall monitor closely the insolvency proceedings to determine whether all or part of the financial instruments entrusted to the third party to whom the custody of financial instruments held in custody has been delegated are effectively lost.*

**Note:** If AIFMs alone are responsible for determining when a loss has occurred, then there is a concern about the independence of the decision-making. While the determination of a loss occurring has consequences for the depositary, which has to demonstrate that it is not liable, in order to ensure that the determination is objective and in the interests of investors in the AIF, it would be preferable for both the AIFM and the depositary to jointly make the determination.

**Article 101**

*5. The ascertainment of a loss of a financial instrument held in custody shall be irrespective of whether the conditions listed in paragraph 1 are the result of fraud in relation to the custody function of the depositary, negligence or other intentional or non-intentional behaviour.*

**Note:** The change to this Article is for consistency with Article 103(1)(e), which it is recommended should be amended as shown below.

**Article 102**

*1. The depositary shall not be liable according to Article 21(12) second subparagraph of Directive 2011/61/EU provided it can prove that all the following conditions are met: [...]*

*(e) The requirements under points (a) and (b) shall not be deemed as fulfilled in the following situations but without being limited to: accounting error, operational failure, fraud in relation to the custody function of the depositary, or failure to apply the segregation requirements, in each case by ~~at the level of~~ the depositary or a third party to whom the custody of financial instruments held in custody in accordance with Article 21(8)(a) of Directive 2011/61/EU has been delegated.*

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**Note:** If collateral delivered to a clearing broker or CCP by the AIF/AIFM is treated as a custody asset, then the logical consequence is that the clearing broker or CCP will fall within the meaning of "a third party to whom the custody of financial instruments held in custody in accordance with Article 21(8)(a) of Directive 2011/61/EU has been delegated". In that case, if there is a loss due to operational failure or fraud, for instance, then the depositary would be strictly liable, with no possibility to avoid liability for the failure of that third party, notwithstanding that it has no realistic opportunity to prevent such problems from arising.

**Art. 103**

*2. There shall be objective reasons to contract discharge of the depositary's liability in accordance with Article 21(13) of Directive 2011/61/EU when:*

*(a) the depositary can demonstrate that it had no other option but to delegate its custody duties to a third party; ~~and~~or*

*(b) the AIF or the AIFM acting on behalf of the AIF has notified in writing the depositary that it considers the investment concerned by the delegation of custody to be in the best interest of the AIF and its investors.*

**Note:** ESMA had recommended that these be separate tests, and not cumulative tests. The change in the drafting from "or" to "and", typing sections (a) and (b) together, appears to have the effect of preventing hedge funds from making arrangements for the custody function to be delegated to prime brokers, with the prime broker assuming primary liability for the custody of the assets, unless it would be impossible for the depositary to perform the custody function itself.

If prime brokers are not able to offer the option of accepting to perform the entire custody function, while accepting the associated liability, as a commercial arrangement, then it raises very real concerns about efficiency: financial instruments would likely have to move between prime brokers and depositaries, in response to internal views about risk, with a reduction in the quality of service and increased costs to AIFs. Movement of financial instruments between prime brokers and depositaries typically would require the transfer of the financial instruments in the relevant market, since the depositary and prime broker may well use different subcustodians. Financial instruments delivered to depositaries would often need to be recalled by prime brokers to effect corporate actions (such as elective stock splits or the exercise of voting rights), and the need to effect the transfer at the subcustodian level would introduce risks of delays which could impair the ability of an AIF to exercise its ownership rights effectively.

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The solution is to revert to "or", so that impossibility of performance of custody functions by the depositary is not a pre-condition for hedge fund arrangements which are efficient (while still retaining the benefit of depositary oversight and supervision).

*3. The condition laid down in paragraph 2 point (a) may be deemed as fulfilled in the following indicative situations:*

*(a) Where the law of a third country requires that certain financial instruments be held in custody by a local entity and there are no local entities that satisfy the delegation criteria laid down in Article 21(11) of Directive 2011/61/EU; [...]*

**Note:** This appears to be a typo, compared to the ESMA text.