Communication of the Association of Global Custodians
European Focus Committee
Subject to Supplemental Commentary

26 June 2018

European Commission
Directorate-General for Financial Stability, Financial Services and Capital Markets Union
Unit C3 – Securities Markets
1049 Bruxelles/Brussels
Belgium

(submitted via European Commission "Have your say" portal)

Re: **Ares(2018)2778673 / Draft Delegated Regulation amending Delegated Regulation (EU) No 2016/438 as regards safe-keeping duties of depositaries for UCITS funds, and**

Ares(2018)2778659 / Draft Delegated Regulation amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries for Alternative Investment Funds

Dear Sir/Madam:

The European Focus Committee of the Association of Global Custodians[1] ("AGC-EFC") is grateful for the opportunity to share its views on the European Commission's draft Delegated Regulations (collectively, the "Draft Amendments") each amending the current EU 2013/231 ("AIFMR") and EU 2016/438 ("UCITSR") Delegated Regulations with regard to safe-keeping of AIF and UCITS clients' assets respectively. We note that the Commission's Draft Amendments follow on from the opinion of the European Securities and Markets Authority ("ESMA") on asset segregation (the "ESMA Opinion").[2]

Established in 1996, the Association of Global Custodians (the "Association") is a group of 12 global financial institutions that each provides securities custody and asset-servicing functions primarily to institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory and market structure. The member banks are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses. Clients of member custody banks may include regulated pension funds, asset managers and investment funds, life assurance companies, other banks (who themselves may act as custodians for underlying clients) and other forms of regulated investors, all of whom are likely to have a duty to ensure the safety and security of the funds and assets committed to their care. Assets held in custody by members of the Association – the vast majority of which consists of

[1] The members of the Association of Global Custodians are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.
[2] Opinion of ESMA, 20.07.2017, 34-45-277.

securities subject to settlement and clearing, directly and indirectly, through post-trade market infrastructure - exceed USD$110 trillion in value[3].

The AGC-EFC strongly supports the Commission's continued efforts to improve legislation where warranted and welcomes proposals promoting investor protection and systemic stability that are cost effective and efficient. In the case of the current proposed Draft Amendments, the AGC-EFC welcomes the Commission's agreement with ESMA - expressed in the Draft Amendments - that a third-party custodian should be able to hold assets of UCITS and AIFs clients and other clients of one depositary in the same omnibus account, provided its own assets, proprietary assets of the depositary and assets belonging to other clients of the third-party custodian are held in segregated financial instruments accounts. The AGC-EFC has emphasised the importance of omnibus accounts to market structure, efficiency, safety and investor interests and we are gratified that the Commission has responded to the ESMA opinion in agreement, albeit with related proposals which we will address in more detail below.

Although the AGC-EFC welcomes the proposed Draft Amendments, we wish to provide some comments, and alternative drafting, to address a number of concerns and to provide greater clarity.

Our comments and drafting focus on the following issues:

- Frequency of reconciliation between account holders and account providers through the custody chain
- Financial instruments registered in a "Financial Instruments Account" and whether the depositary may rely on its delegate (the "Reliance Model")
- Contract requirements as between the depositary and its Delegate(s)
- Technical drafting issues regarding segregation obligations
- The requirement to obtain legal opinions in local markets and impact of harmonising the AIFMD with the UCITS Directive in this respect
- Treatment of CSDs as "third-parties"
- Implementation timing concerns

Specific comments are set out as follows:

1. **Frequency of reconciliation:**

   Article 1(1)(a) of the Draft Amendments, amending UCITSR Article 13/AIFMR Article 89: Safekeeping duties with regard to assets held in custody, paragraph 1

   We note the proposals clarify further the required frequency of reconciliation between the depositary's "internal accounts and records" and those of any third party to whom custody functions are delegated. In particular, we note that reconciliations are to be conducted "as often as necessary" and the determination of the trading frequency reconciliations are to be determined on the basis of:

   (a) the normal trading activity of the AIF;
   (b) any trade occurring outside the normal trading activity;

[3] Source: Institutional Investor, October 2016. This figure captures publicly available figures of ten out of twelve members of the AGC.

(c) any trade occurring on behalf of any other client whose assets are held by the third party in the same financial securities account as the assets of the AIF.[4]

These "trading" related factors are highly problematic.

The custody industry effectively exists on the basis of scalability and standardisation of operational processes. Standardisation is a core component of maximising safety, predictability and efficiency. Standardisation for example ensures like-for-like reconciliation processes across all accounts as between intermediaries in a chain of custody, which reduces the likelihood of error and allows systems to operate efficiently. The introduction of individualised bespoke reconciliation requirements with different frequencies would fundamentally undermine the architecture of this globalised, highly interconnected system.

Central Securities Depositories ("CSDs"), custodians and depositaries do not maintain books and records on the basis of trading activity, but on the basis of settled activity, which typically occurs two days after trade date (see, e.g., Art 5 CSDR). Once settlement occurs, securities are credited and allocated accordingly to account holders through the chain of custody so that they are ultimately reflected in the accounts of the beneficial owners (e.g., a UCITS fund). Processes occur independently at each intermediary throughout the custody chain, with final positions determined typically during or at some time at the end of each business day. Reconciliations in the ordinary course therefore tend to be carried out on an "end-of-day" basis between intermediaries. However, even this is not always possible: reconciliations between the last intermediary in the chain and a CSD are subject to the requirements and market practices of the CSD's jurisdiction and whilst they tend to be carried out on an "end-of-day" basis, there are instances in which end-of-day data is not available or provided from the CSD (e.g., in Kenya daily reports are not provided for government securities).

It is not expected that there is a realistic way to change these processes for any one individual beneficial owner.

It should also be noted that financial instruments that are not dematerialised/immobilised (e.g., physical securities, private equity interests, etc.) are often not susceptible to daily reconciliation. Typically, this is due to the relative infrequency of transfer and/or availability (e.g., private equity funds often are not open for investment, redemption or transfer instructions more frequently than monthly).

The AGC-EFC therefore recommends that existing risk-based approaches be preserved which focus on ensuring that the right kinds of segregation of positions are ensured.

Given the variety of circumstances that can influence the requirement for, and the feasibility of, reconciliations, we suggest changes to UCITS Art. 13(1)(c) / AIFMR Art. 89(1)(c), which would require the depositary to determine the frequency of reconciliations having regard to its overall oversight obligations. This is sensible since the information that is relevant to making such a determination is available to the depositary and includes, for example, fund objectives, fund risk profile, markets (including settlement timings) and the nature of, and obligations of, third parties appointed as delegates.

[4] Proposed in the Draft Amendments to be added as a new sub-paragraph to UCITS Art. 89(1)(c) / AIFMR Art. 89(1)(c).

Recommended Change

We therefore recommend that:

a. Proposed new UCITS Art. 13(1)(c) / AIFMR Art. 89(1)(c) should be revised so that the depositary's obligation regarding reconciliation frequency be specified in the Draft Amendments "as often as the depositary considers reasonably prudent in view of circumstances relevant to the [UCITS/AIF]".
b. Proposed new UCITSR 13(1) / AIFMR Art. 89(1) should be revised to NOT add the new sub-paragraph to UCITS Art. 89(1)(c) / AIFMR Art. 89(1)(c) (referenced in footnote 4, above), since frequency of reconciliation of settled securities bears no relation to trading activity.
c. Deletion of the reference to frequency in proposed new UCITS Art. 16(1)(e) / AIRMR Art. 99(1)(e) because this paragraph should refer to the depositary's obligation to verify that the third party is conducting reconciliations. The frequency of the third party's primary obligation to conduct a reconciliation is already covered in UCITSR Arts. 13(1)(c) and 13(2) / AIFMR Arts. 89(1)(c) and 89(2).

2. **Financial Instruments registered in a Financial Instruments account**

Article 1(1)(b) of the Draft Amendments amending UCITSR Article 13/AIFMR Article 89: Safekeeping duties with regard to assets held in custody, paragraph 2

The proposed replacement of paragraph 2 would require the depositary – when delegating its custody functions to a third party – to comply with point (a) in addition to the existing requirement to comply with points (b) to (e) of paragraph 1. We note "(a)" is the requirement for the depositary to "properly register" financial instruments respectively in accordance with Article 22(5)(a)(ii) of the Level 1 UCITS V Directive and Article 21(11) of the Level 1 AIFMD. These provisions each require the depositary to: (i) "hold in custody all financial instruments that may be registered in a financial instruments account opened in the depositary's books and all financial instruments that can be physically delivered to the depositary" and (ii) "ensure that all financial instruments that can be registered in a financial instruments account opened in the depositary's books are registered in the depositary's books within segregated accounts in accordance with the principles set out in Article 16 of Directive 2006/73/EC, opened in the name of the [AIF or UCITS, or the management company acting on their behalf, as applicable], so that they can be clearly identified as belonging to the [AIF/UCITS] in accordance with the applicable law at all times".

We understand the Commission based this proposed change in part on relevant views expressed by ESMA in its opinion, notably paragraphs 76-78, referring to "some structures [tending] to open securities and cash accounts of fund clients directly at the level of the delegate of the depositary, notably when the delegate in question is the parent entity of the appointed depositary".[5] ESMA expressed the view that in such cases, "the responsibility for ensuring that the financial instruments are properly registered . . . seems to be neither the responsibility of the depositary nor that of the third-party delegate". We believe this view is expressed based on a misunderstanding of the facts and wish to present the facts correctly here.

[5] ESMA Opinion, paragraph 76.

First, it is somewhat misleading to describe the depositary's reliance on the delegate's books and records as occurring when "the delegate in question is the parent entity of the appointed depositary". This kind of arrangement can arise in a wide variety of circumstances, mandating its use. Depositaries may appoint third-party global custodians as investment managers (who retain fiduciary responsibility for the investment fund) may direct. Third-party collateral agents – holding fund assets as collateral in connection with Repo, OTC derivatives, securities lending or margin – are appointed per direction of the investment manager as well. In the latter cases, the investment managers will enter into arrangements by which they are required to instruct collateral agents directly. In all these cases, depositaries must rely on the books and records of the "delegate".

Second, while the existing relevant provisions of the AIFMR and UCITSR do not actually require the depositary to register financial instruments in its own internal books and records where there is a delegation, the depositary is still required pursuant to Article 89 AIFMDR/13 UCITSR to ensure the interests in these financial instruments are "properly registered" and "accurately maintained". For a more detailed explanation of the safety and reliability of the "reliance model" or "delegation model", and the legal and regulatory basis for it, we recommend the response of Irish Funds to this consultation.

By delegating custody to the third-party the depositary relies on the books and records of the third-party as if these were its own. While the depositary retains responsibility for (and liability for the loss of) these financial instruments, the operational reality is that the delegate under the above-described arrangements performs necessary asset servicing functions, including debiting and crediting relevant securities accounts (associated with settlement), processing income payments, facilitating withholding tax and facilitating the exercise of rights associated with the ownership of securities (e.g. corporate actions), and acting on the manager's instructions (e.g., trade instructions) in connection therewith. Most of these debits and credits of the books of the delegate mirror activity at the level of the CSD (T2S).

Moreover, in the cases described above, there is no practical reason for the depositary to maintain a custody record of Financial Instruments that is "independent" of that of the delegate. In practice, any such depositary record would simply duplicate that of the delegate's: any reconciliation inconsistencies arising would simply result from inaccuracies in the process of duplicating the delegate's records. A separate depositary record would do nothing to provide additional accuracy or investor protection, but it might introduce new risks arising from unnecessary operational complexity (maintaining a duplicate independent record).

Compounding the confusion is the statement by ESMA in its opinion that financial instruments should be "first registered" in the depositaries books, even in the event of any delegation.[6] Taken literally, this is not possible in practice because of the structural reality underpinning the cases mentioned above. Indeed, in most cases, the records of the delegate are continuously updated based on the result of settlement or asset servicing activity performed at the level of <u>the relevant financial market infrastructure</u> (CSD/T2S). Regulations such as CSDR and the SFD provide for a strict regulation of the timing of settlement finality and integrity of the issue, with the specific purpose of avoiding uncertainty or disputes. The governing principle is that the books and records of the CSD prevail in case of discrepancies.

[6] ESMA Opinion, paragraph 75.

As a result, the "first register" is literally (and in all cases) the CSD: a key function of custody delegates is to ensure that their own books and records are updated in line with the changes effected at the level of the CSD.

The creation of a separate set of books and records at depositary level would by definition be based on the same output (i.e. settlement and asset servicing messages generated by the CSD) as that driving the custody delegates' books and records. Any discrepancy would again be solved by looking at the same source (CSD-generated confirmations), and therefore would add no real value.

In summary, whilst the depositary is positioned at the top level of the custody chain from a responsibility and liability perspective, in the cases described above it is the delegate who maintains the primary record of holdings and dispositions of financial instruments held in custody. The depositary must therefore (in many cases) be able to rely on the record of its delegate.

Recommended Change:

We recommend that UCITSR Art. 13(2) / AIFMR Art. 89(2) should contemplate that in order to carry out its duties the depositary must ensure that financial instruments described in UCITS V Art. 22(5)(a) / AIFMD Art. 21.8(a) are to be registered either:

- By the depositary in the depositary's books and records; or
- By the first-level delegate (custodian) in that delegate's books and records;

but with the depositary retaining responsibility and liability as otherwise set out in the UCITS V Directive / the AIFMD.

Practical timing concerns

Notwithstanding our above concerns, if the Commission nevertheless requires the depositary to maintain its own independent record in all cases, then it will be necessary for the Commission to provide for a further period of time for depositaries and other parties in the relevant markets to make relevant adjustments to their systems and to reconsider their options with respect to current arrangements. This is particularly the case in respect of collateral arrangements. In order to avoid the potentially dangerous cliff-edge effect of a liquidity crunch in 2019, and to give time for markets to adjust to what would be a sub-optimal future state in so far as collateral management is concerned, it is critically important to provide for a significant transition period.

The Draft Amendments as proposed provide for a six-month implementation period. Six months is insufficient for significant systems changes and market adjustment changes (for example, contractual re-papering).

3. **Contract requirements as between the depositary and its Delegate(s)**

Article 1(2) of the Draft Amendments amending Art. 15 UCITSR/Art. 98 AIFMR

The Commission's proposals regarding contracts between the depositary and its delegate(s) require the depositary to be able to identify all the entities in the custody chain and secure access to all the relevant information in the third party's possession to be able to verify the quantity of the identified financial instruments kept in custody by the third party. Should the third party need to delegate the custody function to another third party, the proposed

provision requires the delegating third party contractually to secure equivalent rights from that another third party (equivalent to those granted to the depositary).

Substantive protection of investors already is built into existing legislation and is extended through the custody chain: the members of the AGC-EFC are concerned that requirements that are too prescriptive and inflexible will operate to prevent suitable adaptation as market practice and technology evolve. For example:

- The provisions regarding matching quantity of securities are not relevant to an omnibus account setting (omnibus accounts preclude this idea): this would be unnecessary, anyway, since any concerns about shortfalls or other mis-matches between intermediaries are handled in the reconciliation process.
- The requirement to obtain a "guarantee of the depositary's rights"[7] introduces a legal concept ("guarantee" is given particular meaning in respect of financial obligations) that does not accord with contractual rights and obligations. In our view, this misconstrues the concept of a "guarantee" (an agreement of one party to perform the primary obligation of a second party to a third party if the second party does not perform their obligation to the third party). There is no need to refer to a guarantee here in any case, as the contract is directly enforceable between the depositary and the custodian. The contract can specify exactly what rights the depositary has in relation to information, inspection and access to the relevant records and accounts of the third party, all of which would be contractually enforceable in their own right.
- New contractual requirements must also be considered in combination with segregation requirements (discussed below at No. 4). Proposed new paragraph 2a(a)(iii)[8] seems intended to provide tools to the depositary to verify and detect any shortfalls of securities in the custody chain: the proposed wording would require that the quantity of financial instruments held on the depositary's books 'matches' those held with the issuer CSD. This is clearly incompatible with the use of omnibus accounts (which hold assets of different clients/depositaries) and may create the impression that segregated accounts for each UCITS/AIF funds need to be held at the issuer CSD level (as only in that case would there be an exact matching of quantities): we believe this clearly is not the intention of the proposed regulation.

Broadly speaking, inflexible, inappropriate contractual requirements imposed throughout the custody chain could have significant disruptive effects: revising documents throughout the entire chain is a major exercise, affecting contractual relationships globally and indirectly. Global custodians typically maintain more than one sub-custody relationship in local markets, often as a contingency, partly to ensure that continued protection is afforded to investors in the event of a problem. To the extent these requirements would extend to any central security depositories ("CSDs") these requirements would become particularly

[7] Proposed new UCITSR Art. 15(2a) / AIFMR Art. 98(2a).
[8] The proposed paragraph 2a(a)iii article states that the depositary needs to be able to (iii")*verify that the quantity of the identified financial instruments, which are registered and held in a financial instruments account opened at the issuer's Central Securities Depository ('CSD'), or its agent, in the name of the third party on behalf of its clients, matches the quantity of the identified financial instruments recorded in the financial instruments accounts opened in the depositary's books in the name of its each UCITS or in the name of the management company acting on behalf of the UCITS.*"

problematic since, as market infrastructure, CSDs ordinarily prescribe their own requirements in participation agreements.

<u>Recommended Change</u>:

Due to our broad concerns above about the proposed language in the Draft Amendments regarding contractual requirements, we recommend that proposed new Article 2a should be replaced in its entirety with the following:

> "A contract by which the depositary appoints a third party (A) to financial instruments of that depositary's [UCITS/AIF] clients in custody, shall provide for the depositary's rights in relation to information, inspection and access to the relevant records and accounts of the third party (A) in respect of such financial instruments held in custody.
>
> "Where the third party (A) appoints a further third party (B) to hold such financial instruments held in custody, the contract between third-party A and third-party B shall provide for third-party A's rights in relation to information, inspection and access to the relevant records and accounts of third-party B in respect of such financial instruments held in custody; and so on for any further delegation."

We believe the foregoing language strikes the right balance by ensuring protection of investors based on existing best practices and operational realities.

4. **Segregation obligations**

Article 1(3) of the Draft Amendments amending Art. 16 UCITSR/ Art. 99 AIFMR, para 1

The AGC-EFC welcomes the following statement in the Explanatory Memorandum to the Draft Amendments:

> "[Article 16 / Article 99] of this Regulation has been interpreted by some as requiring separate accounts per depositary and per type of fund to be created at each level of the custody chain. However, this proposal clarifies that assets of UCITS, AIFs and other clients can be comingled at the level of the first custodian provided that they are initially held by the same depositary (or are initially held by the same custodian where the latter further delegates the custody of assets down the custody chain). …
>
> "[Article 16 / Article 99] is amended to clarify the asset segregation requirements for the third parties (custodians) to which the custody of [UCITS' / AIFs] assets has been entrusted. A custodian can hold assets of UCITS and AIFs clients and other clients of one depositary in the same omnibus account, provided its own assets [i.e., the custodian's own assets], proprietary assets of the depositary and assets belonging to other clients of the third party [i.e., assets belong to other clients of the custodian] are held in segregated financial instruments accounts."

The proposed new UCITS Arts. 16(1)(a) and 16(1)(b) / AIFMR Arts. 99(1)(a) and 99(1)(b) generally conform to the intention expressed in the Explanatory Memorandum (set out above) and the ESMA Opinion.

While as noted above the omnibus model is preserved, Art. 1(3) of the Draft Amendments (replacing Art. 16, paragraph 1 of the UCITSR/ Art. 99, paragraph 1 of AIFMR) more specifically sets out the kinds of segregation that must be ensured. These requirements are

well stated at the first level of delegation[9], however, unfortunately, they will not work beyond the level of the first delegate. This is due to the unchanged paragraph 2 of the of the relevant Articles in UCITSR/AIFMR, which mandate that the same requirements are imposed *mutatis mutandis* when safekeeping is further delegated through the chain by the third party to another third party (a "sub-sub custodian", or investor CSD). In a true omnibus structure, there is no way for a sub-sub custodian once-removed ("B") to know which assets are held for particular underlying clients of the party appointing it ("A"). Each account provider in a chain of custody (B in the example above) can only segregate based on the information made available to it by its proximate account holder (A), but not safely on the basis of underlying clients of that account holder (A) unless the account holder designates accordingly. If this becomes mandated, omnibus accounts in effect are no longer possible.

Recommended Change:

To provide greater clarity, we recommend some drafting amendments to proposed new UCITS Arts. 16(1)(a) and 16(1)(b) / AIFMR Arts. 99(1)(a) and 99(1)(b):

a. Article 99 often uses the word "it" or "its" when describing a party – but it is often unclear which party (depositary, delegate or sub-delegate) is being referred to. Accordingly, we recommend removing the word "it" or "its" and substituting it with a more specific reference to the party being referred to.
b. UCITSR Art. 16(1)(a) / AIFMR Art. 99(1)(a) should be revised to refer to "financial instruments" rather than "assets".
c. UCITSR Art. 16(1)(a) / AIFMR Art. 99(1)(a) should more clearly set out what must be excluded from the financial instruments account maintained by a delegate, particularly beyond the level of the first delegate, and should clarify that this account can be an omnibus account and hold in custody financial instruments belonging to any or all of its account holder's clients (whether or not that account holder itself is a delegate).

5. **The requirement to obtain legal advice and impact of harmonisation of the AIFMD with the UCITS Directive in this respect**

Article 1(3)(b) of the Draft Amendments amending Art. 99 AIFMR, new paragraph 2a

Art. 99 AIFMR is amended by introducing new obligations for AIF depositaries which delegate the custody of assets to third parties located outside the EU. Among other things, legal advice from independent parties on the insolvency laws of the third country is required. The legal advice is to confirm that applicable insolvency law recognises the following:

[9] The depositary is required to ensure and verify that the third party:
"(a) correctly records all identified financial instruments in the financial instruments account, which is opened in the third party's books, in order to hold in custody the financial instruments for the depositary's clients, which excludes proprietary assets of the depositary and of the third party and of the third party's other clients, to enable the depositary match the quantity of the identified financial instruments recorded in the accounts opened in the depositary's books in the name of each of its AIF/UCITS clients or in the name of the management company acting on behalf of the AIF/UCITS . . . "

> "(i) the segregation of the assets of the depositary's AIF clients from its own assets, from the assets of its other clients and from the assets held for the depositary's own account;
>
> "(ii) the assets of the depositary's AIF clients do not form part of the third party's estate in case of insolvency;
>
> "(iii) the assets of the depositary's AIF clients are unavailable for distribution among, or realisation for the benefit of, creditors of the third party to whom safekeeping functions have been delegated in accordance with Article 21(11) of Directive 2011/61/EU;"

A depositary is also to ensure that the above conditions are met initially and on an ongoing basis and that the third party communicates any changes to the insolvency laws which are a part of the legal system in which they are operating.

These new obligations broadly align with existing requirements set out in UCITS. This is of high concern to the industry since the UCITS directive's stricter requirements were viewed as an important basis of distinction from the AIFMD regime. For example, existing Art. 99.2 of AIFMR (which is not found in UCITSR) provides that if, according to the applicable law, including in particular the law relating to property or insolvency, the requirements laid down in paragraph 1 of Article 99 are not sufficient to achieve the objective of ensuring "that the financial instruments belonging to its clients are protected from any insolvency of that third party", the depositary "shall assess what additional arrangements are to be made in order to minimise the risk of loss and maintain an adequate standard of protection."

This distinction – the ability of the depositary to make such a determination in lieu of meeting the objective mentioned above – may form the basis of providing access to certain investment strategies by more sophisticated investors who are eligible to invest in AIFs. Certain countries may not provide for the kind of segregation protections set out in new proposed paragraph 2a in favour of other kinds of protections. Broker-dealers in the United States, for example, may not be read to strictly comply with (i), (ii) and (iii) of new proposed sub-paragraph (a) (as set out above) since the U.S. Securities Investor Protection Act provides for other kinds of protections for investors.

Recommended Change:

We recommend either not adopting proposed new paragraph 2a for the reasons explained or, if it is to be retained, amending paragraph 2 by replacing the second sentence thereof with the following:

> "If, according to the applicable law, including in particular the law relating to property or insolvency, the requirements laid down in paragraph 1 or paragraph 2a are not sufficient to achieve that objective, the depositary shall assess what additional arrangements are to be made in order to minimise the risk of loss and maintain an adequate standard of protection."

6. **References to 'Third Parties' and application to CSDs**

Throughout the text of the Draft Amendments, numerous references are made to the strengthening of the oversight by depositaries over third parties, including the need for reconciliation, oversight, 'guaranteed' information, delegation contracts,

compliance with the regulation, etc, to ensure that the third party to whom the custody functions are (sub) delegated should be subject to the rights and obligations and controls which are equivalent to those established between the depositary and the third party.

We are unclear however whether CSDs (in particular investor CSDs and their custody networks) are to be considered 'third parties' and as such the extent to which depositaries are able to enforce these provisions on CSDs. This is especially relevant given that many CSDs have standard "Terms and Conditions", standard reconciliation and reporting tools etc, which may not be adapted to the requirements set forth in the draft regulation. In addition, many investor CSDs do not allow inspection and access to their records and their sub-custodian network. There is a risk therefore that CSDs will not see themselves subject to the AIFMD/UCITS controls, and decline cooperation with custodians and depositaries to ensure compliance.

Though related to the wider topic of depositary liability for investor CSDs (which we understand will be addressed by the Commission at a later stage), the above question of whether CSDs are considered third parties needs to be clarified now so that depositaries can fulfil their regulatory obligations, including but not limited to any duty to obtain information or to conduct inspections and gain access to financial instruments accounts of third parties. This is true without regard to whether or not relevant proposed Draft Amendments are adopted in their current form.

Recommended Change:

Clarification that CSDs are to be considered 'Third parties'

7. **Timing**

Finally, timing of required implementation of the changes proposed in the Draft Amendments create broad concern. As we have noted above, the Draft Amendments as proposed provide for a six-month implementation period. Six months is insufficient for significant systems changes and market adjustment changes (for example, contractual re-papering). We strongly urge the Commission to consider a lengthier transition period depending on the effects of the final changes it decides upon. The AGC would be pleased to discuss considerations affecting timing further.

Please do not hesitate to contact John Siena (john.siena@bbh.com) should you wish to discuss any of the points raised in this response.

Sincerely,

John Siena
Chair, European Focus Committee
Association of Global Custodians