ASSOCIATION OF GLOBAL CUSTODIANS

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Re: UCITS V, AIFMD and CSD Regulation: Treatment of Central Securities Depositories

Dear Mr Gentner, Ms Dragomir, Mr Planta, Mr Stobo:

The Association of Global Custodians (the "AGC")[1] is writing to you as a follow-up to our letter of 22 December 2015 to add a number of clarifications regarding our concern about depositary requirements and liability under UCITS V[2] and the AIFMD, including whether central securities depositories ("CSDs") should be considered 'custody delegates' of the depositary. As stated in our recent letter, clarification is needed in respect of inconsistencies among the provisions of UCITS V Level 1 Art. 22a(4), Recital 21 of the same legislation ("Recital 21") and a recent ESMA Q&A issued in connection with the AIFMD[3]. In this respect, we have also compared the relevant provisions of UCITS V/AIFMD with those of the CSD Regulation[4] and the recently issued Draft Regulatory Technical Standards on CSD Requirements[5].

This letter is intended to provide more background regarding our concerns, and describes a number of options and potential solutions. We are of course happy to elaborate more on these points in a face-to-face meeting.

THE UCITS V/AIFMD PROVISIONS

According to Recital 21, those CSDs operating securities settlement systems ("SSSs") which, at the same time, perform the service of initial recording of securities by initially crediting or

[1] The members of the Association of Global Custodians are: 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] Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions ("UCITS V Level 1").
[3] *ESMA Questions and Answers, Application of the AIFMD* ("ESMA Q&A"), 1st October 2015.
[4] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 ("CSDR").
[5] EBA/RTS/2015/10, *Final Draft Regulatory Technical Standards on certain prudential requirements for central securities depositories under Regulation (EU) No 909/2014*, 15th December 2015 ("Draft RTS").

providing and maintaining securities accounts at the top-tier level, are not treated as delegates. Recital 21 provides in relevant part:

> "*When a Central Securities Depository (CSD), [... provides the services ...] as specified in Section A of the Annex to that Regulation [CSDR], the provision of those services by that CSD with respect to the securities of the UCITS that are initially recorded in book-entry system through initial crediting by that CSD should not be considered to be a delegation of custody functions.*"

Recital 21 however goes on to provide (in the last sentence of the Recital) that "*entrusting the custody of securities of the UCITS to any CSD, or to any third-country CSD should be considered to be a delegation of custody functions.*" This would seem to contradict the prior sentence and thereby create uncertainty as to when and under what circumstances a CSD would and would not be considered a 'delegate'.

Meanwhile, UCITS V, Article 22a(4), provides:

> *"For the purposes of this Article, the provision of services as specified by Directive 98/26/EC of the European Parliament and of the Council . . . by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement system shall not be considered to be a delegation of custody functions."*

Art 24 of UCITS V provides:

> ". . . *the depositary shall be liable to the UCITS and to the unit holders of the UCITS for the loss by the depositary or a third party to whom the custody of financial instruments held in custody in accordance with point (a) of Article 22(5) has been delegated."*

Finally, we note ESMA's recent response in its AIFMD Q&A which can be interpreted as indicating that any CSD is considered a delegate where financial instruments of an AIF are "provided" to it in order to be held in custody.[6]

Regarding the foregoing provisions, two key questions arise:

a) Should CSDs be considered "third parties to whom custody is delegated" and, if so, would these include all CSDs or just certain CSDs - such as CSDs maintaining certain types of links to provide access to securities held at other CSDs?
b) If there is a loss of securities by a CSD (or by third-party provider within its network), should such loss be considered due to "external events"?

OUR CONCERNS

a) Liability mismatch within the custody chain for securities held at CSDs

The members of the AGC acknowledge that CSDs are a critical component of overall market infrastructure. Indeed, key (core) functions of a CSD include:

[6] See, ESMA Q&A, Response to Question 8 [New]. For the sake of brevity we will not restate the parallel provisions regarding depositary duties and liability under the AIFMD.

(i) providing safekeeping of securities,
(ii) providing securities accounts,
(iii) providing securities settlement services (i.e. acting as a securities settlement system), and
(iv) ensuring to participants and to the market the 'integrity of the issue'.

CSDR includes both measures that require that securities to be deposited at a CSD (e.g., the requirement that all transferable securities traded on EU trading venues be recorded in book-entry form in a CSD) and measures that aim to minimise the risk of loss of securities deposited at a CSD.

The AGC is fully supportive of this dual approach. However, while CSDR contains significant and important measures that indeed help reduce the risk of loss of securities, the risk of such loss can never be completely eliminated.

Consequently, a very important question arises as to what will happen if a CSD loses some of the securities that have been entrusted to it. Neither in the main CSDR text nor in the draft CSDR RTS is there a specific provision regarding the level of liability CSDs should assume for the loss of securities caused by them or by a third-party within their custody networks.

Substantial differences can therefore arise in the level of liability taken among different CSDs. While, in general, CSDs do take liability for their own negligence or wilful misconduct, liability provisions vary among individual CSDs, are subject to conditions, and are also capped in a number of cases. In addition, CSDs generally do not take responsibility for their own underlying networks.

This contrasts sharply with the very strict and high level of liability that depositaries are required to assume under UCITS V and the AIFMD.

As a result, there is a potential mismatch of liability standards between depositaries and their custody delegates (custodians and sub-custodians) on the one hand and, on the other hand, CSDs. In case of loss of securities caused by a CSD or its underlying network (over which the depositary has no oversight, control or selection authority), a depositary may be held liable in restitution under Art 24 of UCITS V or Art 21.12 of the AIFMD and may not even have recourse against the CSD or its network who caused the loss. In most cases, there is no alternative to providing access to securities maintained, ultimately, at CSDs: the depositary therefore would have to assume liability for a loss caused by another party over which it has no control, and for which there is no alternative.

This mismatch in liability standards creates risk both for depositary banks and for the UCITS / AIFs themselves to the extent depositaries are required to absorb risk inappropriately. This mismatch in liability standards therefore has no prudential justification.

The logic of CSDR is precisely that CSDs - in carrying out their critical function of providing for safekeeping of securities – are to be held to the highest possible standards. Accordingly, CSDs should be held to a high level of responsibility for the services they provide and be required to be held appropriately accountable.

b) Level playing field concerns

Under CSDR, CSDs are allowed to provide additional services relating to settlement such as collateral management, securities lending, enhanced asset servicing, IT services, banking services, etc. (see, Annex B to CSDR), many of which are also provided by commercial providers such as custodians. Securities could be lost in the course of providing these services. For example, a collateral agent may allocate securities incorrectly, may commit an error in a margin calculation (e.g., to support securities lending) which results in an understated collateral requirement, or other errors may be made.

While the AGC does not oppose competition by CSDs, the latter must compete on equal terms: neither custodians nor CSDs should be advantaged solely as a result of a regulation. If depositary banks/custodians are held responsible in restitution for the loss of held-in-custody financial instruments pursuant to the provisions of Art 24 of UCITS V Level 1 or Art 21.12 of the AIFMD and, as a consequence, are compelled to maintain capital/cover themselves against such a contingency, while CSDs are not required to do the same, a distortion arises in the form of a regulatory arbitrage opportunity for end-users (e.g., fund managers acting for UCITS / AIF). Meanwhile, ***depositaries have no ability to be contractually discharged from liability (as in the AIFMD) in case a UCITS insists on maintaining its investments with particular providers or in particular jurisdictions.*** Investors' interests are best served through competition that avoids such artificial distortions; the EU's growth agenda – embodied in the European Commission's capital markets union project – similarly is best advanced with post-trade service providers competing openly on a level playing field.

In 2011, in its "Final Report" issued in connection with AIFMD the Level 2 process[7], ESMA wrote:

> *". . . there may be situations where an AIFM insists on maintaining its investment in a particular jurisdiction despite warnings by the depositary of the increased risk this presents . . . This is a clearly a judgement for the AIFM to make based on its role as the investment manager; however, in such circumstances ESMA is of the view that the depositary could reasonably be seen as having no choice but to delegate its custody to a third party."*

This eventuality was cited as an example of where contractual discharge from depositary liability would be appropriate because investment managers should be held accountable for risks knowingly taken in pursuit of return for investors.

UCITS funds have the same ability to insist on maintaining investments in a particular jurisdiction (or with a particular CSD). However, in contrast to the AIFMD, the depositary has no ability to be contractually discharged from restitution liability. Instead, the depositary is left with only the – very impactful - option to terminate the contract in case the UCITS (or its investment manager) continues to insist. This in turn creates a dilemma because, typically, fiduciaries such

[7] ESMA's technical advice to the European Commission on possible implementing measures of the AIFMD (ESMA/2011/379).

as "depositaries" are not in a position to unilaterally "terminate" their services due to overriding duties to investors.

This situation arises not only in certain jurisdictions, but also in respect of the choice of CSDs through which securities are held. For practical, commercial or service reasons, an investment manager may insist on keeping securities with an investor CSD ("(I)CSD"), instead of via the depositary's own custody network. This is particularly the case with respect to ICSDs offering services (such as collateral management) that are not easily found elsewhere, and/or acting as a hub for market liquidity. The result is that the securities are held via an ICSD's own network, which falls outside of the control of the depositary.

c) Segregation concerns

As set out in our responses to the December 2014 ESMA consultation on "Guidelines on asset segregation under the AIFMD" and to the recent European Commission "Call for Evidence on the EU Regulatory Framework"[8] (the "Call for Evidence"), the AGC is highly concerned that a future interpretation by ESMA of the asset segregation requirements under both AIFMD and UCITS will lead to obligations for unnecessary and counterproductive segregation of AIF and UCITS financial instruments throughout the custody chain.

The topic of segregation is conceptually distinct from the topic of delegation, but there are potentially linkages, as any obligation to segregate throughout the custody chain would also apply to CSDs if CSDs are deemed to be "delegates".

This letter, which focuses on the topic of delegation, therefore calls attention to segregation requirements to the extent they are applied to CSDs that are considered "delegates" under the various solutions we offer below.

d) Accuracy concerns

As we also noted in our response to the Call for Evidence, we understand that the characterisation of a third-party as a "delegate" has been a key rationale for holding depositaries fully responsible for anything that might go wrong at the level of the third-party – as an "internal event" – which causes a "loss" of held-in-custody financial instruments.

In this connection – and in a crucial way - confusion has been created through the use of the words "entrusted to" or "provided by" in both the AIFMD and UCITS regimes in the sense that book-entry securities are considered "entrusted" or "provided" by depositaries to delegates:

- Article 21.8(a) of the AIFMD, Level 1, provides: "The assets of the AIF or the AIFM acting on behalf of the AIF shall be ***entrusted*** to the Depositary for safe-keeping . . ."
- Recital 42 of AIFMD, Level 1, provides:
    - ***Entrusting*** the custody of assets to the operator of a securities settlement system as designated for the purposes of Directive 98/26/EC of the European

[8] 30th September 2015.

Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (2) or ***entrusting*** the provision of similar services to third-country securities settlement systems should not be considered to be a delegation of custody functions.

- Article 14(2) of UCITS V, provides:
    - "A depositary's liability as referred to in Article 16 [regarding the depositary's 'liability for unjustifiable failure to perform its obligations, or its improper performance of them'] shall not be affected by the fact that it has ***entrusted*** to a third party all or some of the assets in its safe-keeping."

Meanwhile, as we have noted above in relation to the question of whether central securities depositories (CSDs) are or are not considered "delegates" of a depositary, Recital 21 of UCITS V, in the last sentence, provides that "***entrusting*** the custody of securities of the UCITS to any CSD, or to any third-country CSD should be considered to be a delegation of custody functions" (which, as we have also noted, would seem to contradict the previous sentence).

In a similar vein, we note ESMA's recent response in its AIFMD Q&A indicating that a CSD is considered a delegate where assets of an AIF are considered to be "provided" to it in order to be held in custody.[9] ESMA's response to Question 8 is framed on the basis that securities of the AIF are being "***provided by***" the depositary to a CSD (we again note that this response would seem inconsistent with ESMA's prior advice in its 2011 Final Report[10] as well the express terms of Article 21.11 of the AIFMD, Level 1.[11])

The rationale for these views seems clearly predicated on a presumption that a depositary will have exercised discretion in 'choosing' to appoint the "delegate" and therefore should be held fully accountable for any internal events giving rise to a loss of held-in-custody financial instruments by the delegate.

This rationale, though now apparently accepted as conventional wisdom, has had no basis in the law or precedent prior to the adoption of AIFMD. In particular, it contradicts applicable national law treatment of securities held on a cross-border basis as "property" through the indirect holding system and it contradicts the premise underlying the role of CSDs under CSDR.[12] There is no "entrustment" or "provision" of securities to a CSD by a depositary: this is not what happens in practice. Depositaries provide access to property rights in - and the exercise of shareholder and similar rights to - securities which in the first instance are deposited and immobilised (or dematerialised altogether) with CSDs by issuers and their agents. It is not

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[9] *AIFMD Q&A,* Response to Question 8 [New], 1 October 2015.

[10] ". . . ESMA believes that the event of, for instance, a market closure or of a technical failure at the level of the Central Securities Depositary or any other settlement system should be considered 'external'." *Final report, ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379, 16 November 2011, Box 92, *Explanatory Text Note 26, p. 184.*

[11] Article 21.11, Level 1, of the AIFMD provides that the provision of services as specified by [the Settlement Finality Directive] by securities settlement systems or the provision of similar services by third-country securities settlement systems are not to be considered a delegation of its custody functions.

[12] "CSDR includes both measures that require that securities to be deposited at a CSD (e.g., the requirement that all transferable securities traded on EU trading venues be recorded in book-entry form in a CSD) . . ."

possible for depositaries to "provide" book-entry securities to CSDs or "entrust" them to any third party under a "delegation" arrangement or otherwise unless they are delivered to the custody and safekeeping of the third party, in which case the depositary no longer holds them in custody itself.

POTENTIAL SOLUTIONS AND ALTERNATIVES

The AGC recognises that the European Commission and ESMA are bound by the provisions of the relevant legislation. At the same time, the AGF supports legislation intended to provide a high level of protection to UCITS and AIF investors and which promotes open access and fair competition.

With the above considerations in mind, we see several alternatives which could potentially address some of the issues we have identified while furthering the policy goals of the Commission and more clearly delineating and aligning the scope of UCITS V, the AIFMD and the CSDR. Below, we attempt to set out some of these alternatives, and list the main impacts, advantages and disadvantages. We are keen to discuss these points in more detail at your convenience:

a) Loss by any CSD is considered an external event beyond the Depositary's reasonable control

Under Article 24 of UCITS, the depositary "*shall not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.*"

In the AIFMD Level 2, the EC helpfully provided additional clarification on what constitutes an external event, notably at Art 101:

> *2. The requirements referred to in points (a) and (b) of paragraph 1 may be deemed to be fulfilled in the following circumstances:*
> *(a) natural events beyond human control or influence;*
> *(b) the adoption of any law, decree, regulation, decision or order by any government or governmental body, including any court or tribunal, which impacts the financial instruments held in custody;*
> *(c) war, riots or other major upheavals.*
> *[...]*

An analogy could be made regarding the role of CSDs. In many cases, CSDs are an intrinsic part of the overall financial framework of a country, and a CSD's ability to avoid a loss of securities (whether through legal, operational, technical or other causes) is in many cases dependent on the overall robustness of a country's financial and legal system, which cannot be influenced by a depositary/custodian, and thus could be considered an external event beyond reasonable control of the depositary. Moreover, many CSD processes are highly automated with limited or no human intervention. In addition, CSDs' "General Terms and Conditions" (terms of participation) are typically non-negotiable. As a result, participants must rely on the actions of CSDs and the ability to conduct onsite inspections or due diligence visits. CSDR,

meanwhile, does not prescribe how CSDs are to involve participants in their governance structures, business planning and operational procedures. Participants therefore typically have very little influence on the standards by which CSDs operate. In most cases, CSDs naturally act as sole final entities (the "top-tier level") for the safekeeping of securities: as such, a depositary cannot avoid the consequences of a loss by the CSD despite all reasonable efforts.

Depositaries/custodians cannot be expected to assume full responsibility for what is essentially market infrastructure risk. Providing full transparency regarding these risks is crucial, and in this respect the provisions of the CSDR Art 38 and the obligations imposed in the CSDR RTS on analysis of legal, operational and other risks become very important.

In short, one alternative would be to expand or clarify the interpretation of "external events beyond reasonable control" to include instances where the loss is caused by an event at the CSD or within its network: we note that ESMA in its Final Report on AIFMD wrote:

> *". . . ESMA believes that the event of, for instance, a market closure or of a technical failure at the level of the Central Securities Depositary or any other settlement system should be considered 'external'."*[13]

Pro: This would align the requirements of AIFMD with UCITS and therefore create certainty for depositaries and for asset managers and investors. At the same time, as per the AIFMD and UCITS liability tests, to avoid restitution liability it still would require the depositary to prove - despite the loss being considered due to an external event - that the loss was beyond the depositary's reasonable control and could not have been prevented despite all reasonable efforts. The playing field between CSDs and custodians would still not be even as CSDs could still continue to offer services in areas where they compete with Custodians (and not vice versa). Nevertheless, custodians' concerns about being forced to underwrite risks beyond their control would be mitigated and this approach would more accurately align with the reality that depositaries do not "entrust" or "provide" securities to CSDs (i.e., securities are deposited and immobilised or dematerialised at CSDs in the first instance) .

Contra: While depositary liability would not extend to losses by CSDs or within their networks as "internal events", the previously-described concern regarding the liability gap might not be addressed satisfactorily.

b) <u>A clear framework for determining under what circumstances CSDs are considered delegates and when they are not</u>

UCITS V Level 1, Article 22a(4) provides:

> *"For the purposes of this Article, the provision of services as specified by Directive 98/26/EC [Settlement Finality Directive – SFD) of the European Parliament and of the Council (1) by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement system shall not be considered to be a delegation of custody functions."*

[13] Id., paragraph 26, p. 184.

We understand this provision as excluding from the scope of delegation those CSD functions where "Transfer Orders" are executed via a Securities Settlement System (or equivalent, where relevant) regardless of whether the CSD is acting as an Issuer CSD or an Investor CSD – so long as the SSS (or equivalent) is designated. Very specifically, we understand this provision as excluding from the scope of delegation both the provision of a securities settlement service as such, and the provision of securities accounts on which securities settlement takes place.

This interpretation is supported by the CSDR; the CSDR identifies the operation of a Securities Settlement Systems as a core CSD service; as a consequence of this, the concepts of CSD and SSS become indistinguishable in the CSDR, as all CSDs must operate SSSs, and all SSSs must be operated by CSDs (as the CSDR prohibits non-CSDs from operating SSSs). In addition the CSDR explicitly links the operation of an SSS with the provision of securities accounts; the CSDR defines as a CSD ancillary service "providing, maintaining or operating securities accounts in relation to the settlement service".

The AGC believes that this interpretation should also be viewed in conjunction with the intentions of the CSDR to promote access and interoperability through the establishment of links between CSDs, while also promoting competition between CSDs by providing market participants a choice of CSD provider and access points to the European market infrastructure. This would create an integrated market for securities settlement with no distinction between national and cross-border securities transactions, and in turn, would increase the efficiency of the internal market, which is enabled by the CSDR together with the introduction of the European Central Bank's settlement system, TARGET2-Securities (T2S)[14].

Nevertheless, an alternative interpretation would be that the last sentence of UCITS V, Level 1, Recital 21 creates the possibility for some activities of a CSD to be considered a delegation. The challenge is to identify a coherent and sensible approach to delineating CSD activities that would be considered a delegation as opposed to those that would not.

A way to do this would be to adopt the following approach:

- Those CSDs providing access to other CSDs using links that are intermediated by non-SSS entities could be classified as delegation arrangements; and
- Those CSDs providing access to other CSDs using direct links between SSS entities should be classified as infrastructure access and not as delegation arrangements.

Pro: Such an approach would recognize the different link arrangements utilized by CSDs today and protect crucial settlement infrastructure. No law change would be required but ESMA/ EC could clarify scope through a Q&A document. Such an approach would help maintain a level playing field (relating to obligations to segregate throughout the custody chain) in the event that ESMA determined that more granular segregation obligations also apply throughout the custody chain (as CSDs that are considered delegates would also fall under these obligations).

[14] It should be noted that T2S envisions CSD-to-CSD links operating on the basis of omnibus accounts in order to facilitate cross-border settlement.

Contra: While this option may provide clarity on the question of which CSDs should be considered delegates and which should not, it does not address liability gap, accuracy or competitive level playing field concerns (relating to the liability mismatch); as such, this option would need to be combined with either option a) or option c).

c) CSDs assume an equivalent high standard of liability for loss of securities

In order to ensure the best possible protection of UCITS / AIF held-in-custody financial instruments, it is important that every actor – whether a depositary, custodian, or CSD - is held to high standards of care and liability. If these standards are uniform, competitive distortions based solely on typology of providers will be avoided.

One way to achieve this result is to align the high standard of care set out in Art 24 of UCITS V Level 1 and the AIFMD with the standard of care offered by CSDs, at least for UCITS and AIF financial instruments held CSDs. The CSDR RTS already sets out detailed measures designed to ensure the integrity of the issue, the frequency and amount of reconciliations and the quality of the links between CSDs, including the use of intermediaries.

However, no explicit provision regarding CSDs' liability for loss of assets is included in the draft CSDR Level 2 RTS. Moreover, there is no precise definition of which "custody risks" are actually covered by the CSD capital requirements proposed by EBA. If these standards can be (i) established through the promulgation of an exhaustive list of risks, (ii) brought into line with the UCITS V /AIFMD standards (at least for UCITS/AIF financial instruments held at CSDs), and (iii) harmonised across CSDs, the liability gap (at least for EU CSDs) can be mitigated, investor expectations can be harmonised and a level competitive playing field can be achieved, not just between commercial providers and CSDs, but also between CSDs themselves.

The AGC notes that ESMA has contemplated provision for operational risk insurance to be maintained by CSDs should internal processes prove insufficient.[15] In any case, since liability standards have been introduced under UCITS/AIFMD, any extra capital/insurance cost would need to be reflected somewhere. It seems most sensible to do this at the level of the entities where the risk actually arises. We believe that, similar to the EMIR's requirement that CCPs have 'skin in the game,' CSDs should also be required to be fully responsible for a loss of assets falling under their care.

Pro: The standard of liability for the actions of CSDs would be aligned to the requirements imposed on custodians and depositaries. In simple terms, if CSDs lose securities, they would be liable for restitution towards their participants. Such a standard would be in line with the approach of CSDR which tries to ensure that CSDs do not create risk for their participants and it would accurately align with the reality that securities are placed with CSDs in the first instance by issuers or their agents (and not by depositaries).

Such a standard could be implemented as part of a delegated act issued by the European Commission for UCITS V / AIFMD and/or as part of the respective capital regulatory standards for CSDs as part of CSDR. This approach would address the concern that CSDs might be

[15] Draft RTS, 4.23-4.24.

competing with their participants on uneven terms. By making CSDs responsible for losses occurring due to their own errors or omissions (similar to the way in which depositories, custodians and sub-custodians are responsible for losses caused by them), liability would be evenly distributed so that it aligns to where problems arise, avoiding moral hazard concerns.

Contra: CSDs as market infrastructure tend to have only limited capital available. The risk of being liable for restitution of lost securities may affect capital levels or create additional costs through alternative coverage via insurance (as permitted by CSDR). While this could affect pricing towards participants, it is justified by an extra protection (insurance) for a loss of assets.

CONCLUSION

The AGC believes that all proposed solutions have benefits but also potential down-sides. To arrive at conclusions we have considered the following criteria:

- Addressing the issue of investor protection and potential liability gaps;
- Viability of implementing within current legislation (existing or pending);
- Complexity stemming from the implementation of each solution;
- Level playing field considerations for competing entities in the securities value chain; and
- Accurately describing the relative roles of CSDs, depositaries and securities custody providers.

Based on the above considerations, the AGC considers establishing an equivalent standard of liability for UCITS' and for AIFs' loss of securities the most practicable approach in the current environment. Accordingly, we suggest that of the three options set out above option (c) be selected.

However, we add that option (c) should be combined with a clear statement as to which CSDs are considered custody delegates and which are not. Option (b) sets out some possibilities in this regard, together with a discussion as to their advantages and disadvantages.

We also note that the determination of whether CSDs should be considered delegates is also dependent on the interpretation of the segregation requirements under AIFMD and UCITS V. If sub-custodians are to be subject to restrictive segregation requirements, and if investor CSDs are not subject to such requirements (by reason of not being considered delegates), then this would have serious level playing field consequences. We believe that it is important that ESMA and the Commission clarify that AIFMD and UCITS V segregation obligations do not apply up the chain of custody, so that it is possible to arrive at a sound conclusion with respect to the determination of whether CSDs are delegates unencumbered by this particular level-playing field concern.

In any case, it is essential that the answer to the question as to whether CSDs are delegates or not is complemented by a clear statement on the liability of CSDs for losses: this would address level playing field and accuracy concerns.

We trust that you find our comments useful and remain at your disposal for further discussions on the subject. Please do not hesitate to contact John Siena, Chair of the AGC's European Focus Committee, who can be contacted at john.siena@bbh.com (+852.3756.1799).

Sincerely,

D.W.S. by John Siena, Attorney

Dan W Schneider,

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