



September 13th, 2011

European Securities and Markets Authority

www.esma.europa.eu

Consultation paper on ESMA's draft technical advice to the EU Commission on possible implementing measures of the AIFM Directive

Dear Madam, Dear Sir,

The European Trustee and Depositary Forum ('ETDF') was created in 2008 to represent the interests of EU Member State depositaries of Collective Investment Schemes (covering both harmonised funds (ie. UCITS) and non-harmonised funds). ETDF currently includes professionals representing national depositary associations from Austria, France, Germany, Ireland, Luxembourg, Spain, Sweden and the UK.

We welcome the opportunity to comment on the ESMA's draft technical advice to the EU Commission on possible implementing measures of the AIFM Directive and appreciate the openness and willingness to engage with the industry that has been displayed by ESMA, evidence of which includes both the industry workshops and the extensive consultation process.

ETDF does share and support the overall objectives of the ESMA advice i.e. :

- **Striking an appropriate balance between the AIFM Directive objectives of ensuring a high level of investor protection while refraining from putting unjustified liabilities on the fund depositaries** at the expense of the stability of the entire banking and fund industries,
- Proposing **pragmatic and flexible** implementing measures at reasonable costs for the industry,
- Clarifying and ultimately contributing to the **harmonisation of the fund depositaries duties and liabilities in the context of EU regulated funds**.

Consequently, when clarifying the duties of the fund depositary, ETDF expects the implementing measures to take into account the following over-arching principles with regard to :

- a) The organisation and the accountability at the level of the different stakeholders :
- Recognition of the **accountability** of the first level of controls performed by the AIFM (or the AIF) i.e. no requirement for duplication of tasks and controls already carried out at the first level,
 - **Proportionality** of controls performed by the depositary based on the characteristics of the AIF and its environment,
 - Compliance with the **contractual** arrangements between the depositary and the AIFM (or the AIF),
- b) The definition of the liability regime applicable to the depositary :
- **The scope of “assets held in custody” should be clearly defined.** In this respect, “option 2” of the advice, amended for further clarification, should be retained,
 - Fund depositaries should not be put in a position where it **would interfere with the management decision and responsibilities**,
 - The loss of assets should be recognized as **a component of the investment risk** and should be borne in proportion by all actors, including the assets managers and the investors,
 - A clear recognition that due diligences duties imposed on the depositary **cannot go beyond the custodian tasks** performed by its delegates,
 - Fund depositaries **cannot be requested to provide legal** certainty on arrangements and procedures that pertain to national legal systems,
 - Fund depositaries **cannot be requested to compensate** for, or substitute, local regulators /supervisors that are in charge of the sound functioning of the financial and banking system.

Some of the proposed advices included in this consultation have raised major **concerns** within the depositary bank community.

This is particularly true with respect to the issue of insolvency of sub-custodians which should, in our opinion, be considered as an “external event” since it is beyond the possibility to foresee a situation of insolvency, whatever the nature of the “due diligences” carried out by the depositary. Making the European depositary bank community liable for the insolvency of sub-custodians would constitute a major and unjustified factor of risk to banking stability in Europe, at a moment when markets are already experiencing difficult times.

Therefore, ETDF urges ESMA to further develop the concept of proportionality in the advice in order to avoid the situation where depositaries would be treated as insurers for the fund industry.

In the consultation, ESMA is asking for comments and feedback with respect to likely costs if certain provisions relating to depositaries were to be implemented. Given the current level of uncertainty around the final rules, ETDF at this stage refrains from providing specific cost implications. Indeed, any cost estimates for addressing issues such as the risk of third party fraud which is perpetrated on an AIF and its depositary would be entirely speculative, as the risk arises from criminal activity which is intended to avoid detection and not from operational processes which are relatively well understood. However, wherever appropriate, ETDF makes reference in its responses to general cost implications of the suggested implementing measures.

ETDF trusts that ESMA will find value in this contribution and remains at your entire disposal should you want to discuss it further. Should you have any questions or comments, please feel free to contact Franck Wassmer.

Yours sincerely



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On behalf of the other ETDF members



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V 7.4 AIFMD WG – DEPOSITORIES

AIFM – Level II rules

Article 21 of the AIFMD sets out an extensive set of requirements on the depositaries of AIFs. In line with the implementing measures foreseen in that article, the draft advice in this area covers the following elements:

- i. Appointment of the depositary
- ii. The depositary's duties
- iii. The depositary's liability regime

Appointment of a depositary

1. In line with the request from the Commission, the draft advice on this point sets out ESMA's proposals on the content of the contract evidencing the appointment of the depositary, which must at least regulate the flow of information necessary to enable the depositary to perform its functions. The particulars required in the contract to be signed between the depositary and the management company in the UCITS Directive was taken as a starting point with a view to ensuring consistency across the industry.
2. Due to the very diverse nature of the entities subject to the Directive, it has not been considered appropriate to develop a model agreement. This is also in line with the approach taken in CESR's advice on the UCITS IV Directive in relation to depositaries.

Duties of the depositary

The depositary has two primary functions: to safekeep the AIF's assets and to oversee its compliance with the AIF's rules and instruments of incorporation and with applicable law and regulation. The Directive further assigns the depositary with a requirement to ensure the AIF's cash flows are properly monitored.

Safekeeping

The duty to safekeep consists either of custody or of record keeping, depending on the type of asset. In line with the Commission's request, the draft advice addresses the types of financial instrument which should be included in the scope of the depositary's custody functions and the conditions upon which the depositary can fulfil its obligation to safekeep the assets. The 'other assets' subject to the recordkeeping obligation are then defined as all assets not covered by custody. The advice sets out a number of different options in this area, each of which has potentially different consequences for the scope of the custody duty.

Oversight function

The AIFMD contains the same provisions regarding the depositary's oversight functions as those set out in the UCITS Directive. However, in light of the differences in interpretation of the five oversight duties of a depositary across Member States, the draft advice aims to clarify each task.

Cash monitoring

The draft advice considers the depositary's cash monitoring function as a general requirement to have a full overview of all cash movements of the AIF which should be read alongside its oversight duties. The advice acknowledges that an AIF may have cash accounts at various entities outside the depositary; as such, the aim is to have a strong requirement on the AIFM to ensure the depositary has access to all information related to each cash account opened at a third party.

The draft advice sets out two options regarding the tasks which would be expected of a depositary when implementing its cash monitoring obligations. One option would be to consider the depositary as a central hub where all information related to the AIF's cash flows is centralised, recorded and reconciled in order to ensure an effective and proper monitoring of all cash flows. The second option identified would require the depositary to ensure there are procedures in place to appropriately monitor the AIF's cash flows and that they are effectively implemented and periodically reviewed. In particular, the depositary would be required to look into the reconciliation procedure and monitor that remedial action is taken without undue delay whenever a discrepancy is identified.

Under its cash monitoring function, the depositary is also required to ensure that payments made by investors upon subscription have been received by the AIF. ESMA has put forward advice with a view to clarifying that the depositary is not expected to interfere with the distribution channels of the AIF but simply to verify the information at the level of the AIF's register.

Due diligence duties

Article 21(11) of the Directive provides significant detail as to the conditions to be met for the depositary to be able to delegate any of its safekeeping functions. ESMA has been asked to provide further guidance in relation to the specific tasks the depositary would be expected to carry out in order to comply with its due diligence duties and, if possible, to provide a template of evaluation, selection, review and monitoring criteria to be considered. The advice focuses on what the depositary is expected to do when delegating custody tasks given the potentially significant implications for the AIF and its investors.

Segregation

The third party to which the depositary wishes to delegate custody tasks must segregate the assets belonging to the depositary's clients from its own assets and from assets of the depositary in such a way that they can at all times be clearly identified as belonging to clients of a particular depositary. The Commission has asked ESMA to clarify what the specific requirements should be to make sure the subcustodian effectively meets that obligation. The draft advice is based on Article 16 of the MiFID implementing Directive (2006/73/EC), adapted to reflect that sub-custodians may, as the AIFMD acknowledges, use 'omnibus accounts'.

Depositary liability

The depositary's liability regime is a central issue of the AIFMD. The advice aims to strike the appropriate balance between the Directive's objective of ensuring a high level of investor protection while refraining from placing the entire responsibility on depositaries. With this objective in mind, the proposed advice attempts to provide clear definitions of what would constitute: (i) the loss of a financial instrument; (ii) an external event beyond the reasonable control of a depositary, the consequences of which would have been unavoidable despite reasonable efforts; and (iii) the objective reason which could enable a depositary to discharge its responsibility by transferring it to a sub-custodian.

VI Appointment of a depositary

1. The AIFMD requires every AIFM to ensure that, for each AIF it manages, a single depositary has been appointed, appointment which must be formalised in a written contract regulating at least the flow of information necessary to enable the depositary to perform its functions. The European Commission has asked ESMA to provide guidance on the content of such a contract and to the extent possible to provide a model agreement.
2. In order to define the elements which should be required in the written agreement evidencing the appointment of the depositary, ESMA has used the particulars required in the contract to be signed between the depositary and the management company in the UCITS framework as a starting point with a view to ensure consistency across the industry. ESMA has then suggested some amendments or new provisions to take into account the specificities of AIFs.
3. For instance, the contract will need to include provisions on the depositary's liability and the conditions under which it may transfer its liability to a sub-custodian²¹, on the possibility to re-use the assets it has been entrusted with, or a description of the type of assets it will have to safekeep, given that unlike for UCITS there is no harmonisation as to the type of assets in which an AIF can invest and the AIFMD covers an extremely wide spectrum of funds.
4. Precisely because the Directive regulates AIFM which manage very different types of funds, ESMA suggests not elaborating a model agreement and provides a detailed explanation of the reasons why it has not considered that an appropriate means to improve harmonisation or investor protection.

1 Contract evidencing the appointment of a depositary

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying: (a) the particulars that need to be included in the standard agreement as referred to in paragraph 2;...

Extract from Level 1 Directive

2. The appointment of the depositary shall be evidenced by a written contract. The contract shall, inter alia, regulate the flow of information deemed necessary to allow the depositary to perform its functions for the AIF for which it has been appointed as depositary, as set out in this Directive and in other relevant laws, regulations or administrative provisions.

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the necessary particulars to be found in the standard agreement evidencing the appointment of the depositary. In its advice, ESMA should take into account the consistency with the respective requirements in the UCITS Directive.
2. ESMA is encouraged to provide the Commission, if possible, with a draft model agreement.

1.1 Particulars of the contract appointing the depositary

Box 74

(Recommended Revisions as Marked)

Particulars to be included in the written agreement evidencing the appointment of a single depositary and regulating the flow of information deemed necessary to allow the depositary to perform its functions pursuant to Article 21 (2) of the AIFMD.

The depositary on the one hand and the AIFM and / or the AIF on the other hand shall draw up a written agreement setting out the rights and obligations of the parties to the contract.

This agreement should include at least the following elements:

1. A description of the services to be provided by the depositary and the **high level** procedures to be adopted for each type of asset in which the AIF may invest and which may be entrusted to the depositary; **The details of such procedures should be described in this agreement or set out in the service level agreement or similar document;**
2. **An enumeration** of the types of assets that will fall within the scope of the depositary's function which should be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents, regarding the assets in which the AIF may invest;
3. A statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with the requirements of Article 21 (13) or (14); and where applicable, the conditions under which **the depositary will pursue recovery of any loss from its sub-custodians on behalf of the AIF or AIFM. the AIF or the AIFM may allow the depositary to transfer its liability to a sub-custodian including the objective reasons that could support that transfer.**
4. The period of validity, and the conditions for amendment and termination of the contract; and, if applicable, the procedures by which the depositary should send all relevant information to its successor;
5. The confidentiality obligations applicable to the parties in accordance with prevailing laws and regulations; these obligations should not impair the ability of Member States competent authorities to have access to the relevant documents and information;
6. The means and procedures by which the depositary will transmit to the AIFM or the AIF all relevant information that the latter needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate situation of the accounts of the AIF. The details of such means and procedures should be described in this agreement or set out in the service level agreement or similar document;
7. The means and procedures by which the AIFM will ensure the depositary has access to all the information it needs to fulfil its duties, including the process by which the depositary will receive information from other parties appointed by the AIF or the AIFM; **The details of such means and procedures should be described in this agreement or set out in the service level agreement or similar document;**
8. Information regarding the possibility for the depositary or a sub-custodian to re-use the assets it was entrusted with or not and where relevant the conditions related to the potential re-use;
9. The procedures to be followed when a modification to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary

should be informed, or where a prior agreement from the depositary is needed to proceed with the modification;

10. All necessary information that needs to be exchanged between the AIF, the AIFM and the depositary related to the sale, subscription, redemption, issue, cancellation and re-purchase of units or shares of the AIF;

11. Where the parties to the contract envisage appointing third parties to carry out their respective duties, an undertaking to provide, on a regular basis, details of any third parties appointed; and upon request, information on the criteria used to select the third party, the steps taken to monitor the activities carried out by the selected third party;

12. All information regarding the tasks and responsibilities in respect of obligations relating to anti-money laundering and combating the financing of terrorism;

13. Information on all cash accounts opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and procedures by which the depositary will be informed prior to the effective opening of any new account opened in the name of the AIF or in the name of the AIFM on behalf of the AIF;

14. Details regarding the depositary's escalation procedure(s), including the identification of the persons to be contacted within the AIF and / or the AIFM by the depositary when it launches such a procedure.

Subject to national law, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIF managed by that AIFM to which it applies.

The parties may agree to transmit part or all of this information electronically. Proper recording of such information shall be ensured.

The agreement shall include the procedures by which the depositary, in respect of its duties has the ability to enquire into the conduct of the AIFM and / or the AIF and to assess the quality of information transmitted including by way of on-site visits. It shall also include a provision regarding the possibilities and procedures for the review of the depositary by the AIFM and / or the AIF in respect of the depositary's contractual obligations.

The law applicable to the agreement shall be specified.

ETDF comments: The ETDF has in general terms a positive opinion of the proposed advice based on the requirements defined in chapter V (articles 30-37) of Directive 2010/43/EC implementing Directive 2009/65/EC (the UCITS Directive) which are further adapted in the context of the AIFM Directive.

We would like however draw ESMA's attention on the following points.

Point 3: In the light of our comments relative to box 92 (ETDF opted for option 2), we would recommend to amend ESMA proposal as suggested above

Point 7: In order to give parties a high degree of flexibility and remain consistent with the UCITS framework and point 6 of box 74, we propose that the requirements as set in paragraph 7 follow the same principle i.e. could be met if the necessary information is included in a service level agreement rather than the agreement itself.

Although in the first bullet point of section 10 of the explanatory note, “termination of the contract” is explicitly mentioned as one of the items amended “in comparison with the UCITS requirements”, asking for a more elaborated text of the contracts in this regard, actually the wording of Box 74.4 is very succinct and clearly insufficient.

In our opinion the following elements should be mentioned:

- “The conditions which are necessary to facilitate transition to another depositary”. This item is specifically mentioned in article 33.c) of Directive 2010/43/CE and it has a wider scope than “the procedures by which the depositary should send all the relevant information to its successor” only aspect contemplated in the current ESMA text.
- How the transfer of liability between the two depositaries works in this scenario.

Finally, and in order to be consistent with our position on the meaning of the expression “objective reason to contract a discharge of liability”(see below,V.IV.3),the sentence “including the objective reasons that could support the transfer” should be deleted from the end of paragraph 3 in Box 74.

1.2 ESMA’s justification for not providing a model agreement

ETDF comments: Considering the very broad scope of strategies and products falling under the scope of the AIFM directive, the ETDF supports ESMA’s conclusion that there is no need to define a model agreement.

V.II. Duties of the depositary

According to the AIFMD and in line with the UCITS framework, the depositary has two primary functions: to safekeep the AIF's assets and to oversee its compliance with the AIF rules and instruments of incorporation and with applicable law and regulation. The Directive further assigns the depositary with a requirement to ensure the AIF's cash flows are properly monitored.

Cash Monitoring

ESMA has considered the depositary's cash monitoring function as a general requirement to have a full overview of all cash movements of the AIF which should be read along with its oversight duties. ESMA has acknowledged that an AIF may have cash accounts at various entities outside the depositary and therefore defined a pre-requisite for the AIFM to ensure the depositary has access to all information related to each cash account opened at a third party.

Further ESMA is consulting on two options to specify the tasks which would be expected of a depositary when implementing its cash monitoring obligations. One option would be to consider the depositary as a central hub where all information related to the AIF's cash flows is centralised, recorded and reconciled in order to ensure an effective and proper monitoring of all cash flows. The second option contemplated would require the depositary to ensure there are procedures in place to appropriately monitor the AIF's cash flows and that they are effectively implemented and periodically reviewed. The depositary would in particular be required to look into the reconciliation procedure and monitor that remedial action is taken without undue delay whenever a discrepancy is identified.

Under its cash monitoring function, the depositary is also required to ensure that payments made by investors upon their subscription have been received by the AIF. ESMA acknowledges the need for clarification in relation to the scope of such a requirement and has therefore put forward an advice with a view to clarifying that the depositary is not expected to interfere with the distribution channels of the AIF but simply to verify the information at the level of the AIF's register.

Lastly, the depositary is responsible to ensure the AIF's cash is properly booked which ESMA takes to mean that cash accounts have only been opened with entities authorised under Article 18 (1) (a) to (c) of MiFID or any bank or credit institution in the non EU countries where the AIF has had to open an account in relation to an investment decision.

Safekeeping

The depositary is responsible for safekeeping the AIF's assets. Depending on the type of assets, they are to be either 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 in line with Article 21 (8) (a) - or in record keeping. ESMA has been asked to provide advice on the type of financial instruments which should be included in the scope of the depositary's custody functions and on the conditions upon which the depositary can fulfil its obligation to safekeep the assets.

ESMA has suggested setting out a clear definition of the financial instruments to be held in custody and adopting an *a contrario* approach to define the 'other assets' as referred to in Article 21 (8) (b) which shall be subject to record keeping. Such a definition is a key element of the implementing measures regarding Article 21 since it conditions the scope of the depositary's custody functions and consequently the scope of its liability. Therefore ESMA is consulting on various options to seek industry input on the workability of the definition elaborated and its potential consequences.

As a first step of the definition, there is a consensus within ESMA to define financial instruments as transferable securities, money market instruments and units of collective investment undertakings in reference to the first items of Annex 1, Section C of Directive 2004/39/EC. Further ESMA considers that should be held in custody those financial instruments that the depositary is in a position to instruct the transfer of. Two options are put forward to translate that. One would be to consider that all financial instruments registered or held directly or indirectly in the name of the depositary should be in custody. The second considers that custody should be limited to financial instruments with respect to which the depositary can instruct the transfer of title by means of a book entry on a register maintained by a settlement system as defined in Directive 98/26/EC or a similar non European securities settlement system. The last component of the definition concerns financial instruments provided as collateral. ESMA is consulting on three different options regarding collateral.

As to what is specifically expected of a depositary to comply with its custody function, ESMA considers the depositary should ensure the financial instruments are properly segregated in its books and where relevant in those of its sub-custodians, are subject to due care and protection and should assess and monitor relevant custody risks

With regard to the depositary's record keeping function which applies to all other assets (i.e. which do not comply with the definition of financial instruments to be held in custody), the AIFMD imposes two obligations on the depositary. The first one is to verify the ownership of the AIF / AIFM of such assets and the second is to maintain a record of those assets for which it is satisfied the AIF / AIFM holds the ownership. ESMA recommends clarifying that maintaining a record could mean registering the assets in its name in the first instance or where the assets are registered in the name of the AIF or in the name of the AIFM acting on behalf of the AIF, to ensure it is able at any time to provide a comprehensive and up to date inventory of all the AIF's assets. To enable the depositary to meet that requirement, ESMA has specifically imposed an obligation on the AIFM to ensure the depositary has access to all relevant information it needs including from third parties (e.g., administrators, prime brokers, etc.) to ensure it can fulfil its obligations. ESMA is consulting on two options to reflect the means by which the depositary can ensure it is able to provide such an inventory. It can either rely on information provided to it by the AIF / AIFM or third parties on a timely basis or it can mirror every transaction in a position keeping system.

Oversight function

The AIFMD contains the same provisions regarding the depositary's oversight functions as those required under the UCITS Directive. However, in light of the major differences in interpretation of the five oversight duties of a depositary across Member States, ESMA has decided to provide a draft advice which suggests clarifications on each task.

Furthermore ESMA recommends defining general principles applicable to the depositary's oversight function. ESMA suggests for example that the depositary should assess, upon its appointment, the risks associated with the nature scale and complexity of the AIF and set up appropriate procedures. It also recommends that it should perform ex post verifications of procedures which are under the responsibility of the AIF, the AIFM or a third party. ESMA suggests that, when appointed as a third party to perform duties it has to oversee as AIF's depositary, the depositary must manage potential conflicts of interest as required by Article 21 (10). The proposed advice finally sets out a general requirement for the depositary to set up and implement an escalation procedure for all instances where it detects a potential irregularity while conducting its oversight procedures.

Due diligence duties

Article 21 (11) provides significant detail as to the conditions to be met for the depositary to be able to delegate any of its safekeeping functions. ESMA has been asked to provide further guidance in relation to the specific tasks the depositary would be expected to carry out in order to comply with its due diligence duties and if possible to provide a template of evaluation, selection, review and monitoring criteria to be considered.

ESMA suggests focusing mainly on the tasks to be implemented when delegating custody since that is where the implications can be material for the AIF and its investors. In its proposed advice, ESMA has highlighted the main steps the depositary should go through when appointing a sub-custodian and during its ongoing monitoring. The requirements have been based on the best market practices and with a view to ensuring the depositary takes into consideration all elements relevant to the consequences of the insolvency of the sub-custodian. ESMA has also assumed that, in light of its liability, the depositary would have a sufficiently strong incentive to take all appropriate measures to ensure the financial instruments will be subject to a high level of protection and care.

Segregation

One of the conditions the third party to which the depositary wishes to delegate custody tasks to must comply with on an ongoing basis is the requirement to segregate the assets belonging to the depositary's clients from its own assets and from assets of the depositary in such a way that they can at all times be clearly identified as belonging to clients of a particular depositary. The Commission has asked ESMA to clarify what the specific requirements should be to make sure the sub-custodian effectively meets that obligation.

ESMA has based its advice on Article 16 of Directive 2006/73/EC and has adapted the text to reflect that this requirement is to be met by sub-custodians for which the Directive acknowledges they can use 'omnibus accounts'. It has also been refined to address the specific concern this requirement is supposed to mitigate i.e. the consequences of the insolvency of the sub-custodian.

V.III. Depositary functions

1 Depositary functions pursuant to §7 – Cash monitoring

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

[...]

(c) the conditions for performing the depositary functions pursuant to paragraphs 7, 8 and 9

Extract from Level 1 Directive

'7. The depositary shall in general ensure that the AIF's cash flows are properly monitored, and shall in particular 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 that all cash of the AIF has been booked in one or more 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 acting on behalf of the AIF at an entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European

Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, or an other entity of the same nature as the entity referred to in Article 18 (1) (a) to (c) of that Commission Directive 2006/73/EC in the relevant market where cash accounts are required provided that such entity is subject to effective prudential regulation and supervision of the same effect as the provisions laid down in European Union law and which are effectively being enforced, and in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC

Where the cash accounts are opened in the name of the depositary acting on behalf of the AIF, no cash of the entity referred to in the first subparagraph and none of the depositary's own cash shall be booked on such accounts.'

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions for performing the depositary functions pursuant to Article 21(7). ESMA is requested to specify conditions for the depositary to ensure that:
 - the AIF's cash flows are properly monitored;
 - 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 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 acting on behalf of the AIF at an entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC.
 - where cash accounts are opened in the name of the depositary acting on behalf of the AIF, none of the depositary's own cash is kept in the same accounts. In its advice, ESMA should take into account the legal structure of the AIF and in particular whether the AIF is of the closed-ended or open-ended type.
2. ESMA is requested to advise the Commission on the conditions applicable in order to assess whether:
 - an entity can be considered to be of the same nature as the entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC, in the relevant non-EU market where opening cash accounts on behalf of the AIF are required;

- such an entity is subject to effective prudential regulation and supervision to the same effect as the provisions laid down in European Union law and which is effectively enforced.
3. ESMA is requested to advise the Commission on the conditions applicable in order to determine what shall be considered as the relevant market where cash accounts are required.

1.1 Cash flow monitoring

Box 75
<u>(Recommended Revisions as Marked)</u>
<p>Cash Monitoring – general information requirements</p> <p>The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (7) including by third parties and particularly that:</p> <ul style="list-style-type: none"> • the depositary is informed, upon its appointment, of all existing cash accounts opened in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF; • the depositary is informed prior to the effective opening of any new cash account by the AIF or the AIFM acting on behalf of the AIF; • the depositary is provided with all information related to the cash accounts opened at a third party entity, directly from those third parties in order for the depositary to have access to all information regarding the AIF's cash accounts and have a clear overview of all the AIF's cash flows. <p>Where the depositary does not receive timely and accurate information, the AIFM will have been deemed not to have satisfied the requirements of Article 21 of the directive and the depositary shall be discharged from any liability so long as it has exercised its responsibilities on the basis of the information made available to it.</p>

ETDF comments: ESMA's advice in relation to article 21 has stressed the importance for the depositary to receive all the necessary on a timely manner from the various parties involved in the management and administration of the AIF in order to perform its supervision duties. On that basis, the ETDF would support that when those requirements have not been met, the depositary shall be discharged from its responsibilities and liability.

Box 76
<u>(Recommended Revisions as Marked)</u>
<p>Proper monitoring of all AIF's cash flows</p> <p><u>Option 1</u></p> <p>The depositary should act as a central hub to ensure an effective and proper monitoring of all cash movements and in particular, it should:</p>

~~1.ensure the cash belonging to the AIF is booked in an account opened at the depositary; or~~

~~2.where cash accounts are opened at a third party entity:~~

~~(a) ensure those accounts are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked)~~

~~(b) mirror the transactions of those cash accounts into a position keeping system and make periodic reconciliations between the cash accounts statements and the information stemming from the AIF's accounting records~~

~~(c) ensure the AIFM has taken appropriate measures to send all instructions simultaneously to the third party and the depositary~~

Option 2

To ensure the AIF's cash flows are properly monitored, the depositary should at least:

1. ensure that the cash belonging to the AIF in relation to financial instruments safe kept by the depositary is booked in an account opened at the depositary

2. ensure that cash accounts opened at a third party are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked);

3. ensure there are **appropriate** procedures to reconcile all cash flow movements and verify that they are performed at an appropriate interval;

4. ensure appropriate procedures are implemented to identify on a timely basis significant cash flows **and in particular those which could be inconsistent with the AIF's operations;**

5. ensure there are appropriate procedures at the AIF, or the AIFM level, which identify the cash flows that could be inconsistent with the AIF operations

6. review periodically the adequacy of those procedures ~~including through a full review of the reconciliation process at least once a year~~ and in particular that the relevant cash accounts opened in the name of the AIF are included in the reconciliation process;

~~6. monitor on an ongoing an anomaly basis the outcomes and actions taken as a result of those procedures and alert the AIFM if has not been rectified without undue delay.~~

When performing its monitoring task, the depositary should take into account the nature, the size and the complexity of the AIF, as well as the volume of operations ,

ETDF comments: ETDF strongly supports option 2 for the reasons highlighted in its response to question 29. This been said, and notwithstanding its oversight duties in relation to the compliance with the applicable national law or AIF articles of incorporation, we believe that the depositary should not be responsible for identifying any "inconsistent" transactions with the AIF's operations as the primary responsibility these controls lies on AIFM (or the AIF).

1.2 ESMA's justification for not providing further guidance in relation to the depositary's duties regarding subscriptions in the AIF

ETDF comments: We agree with ESMA's position

1.3 Conditions for ensuring the AIF's cash is properly booked

Box 77
No recommended revisions
<p>Ensuring the AIF's cash is properly booked</p> <p>The depositary should be required to:</p> <ol style="list-style-type: none"> 1. ensure that the AIFM complies on an ongoing basis with the requirements of Article 16 of Directive 2006/73/EC in relation to cash and in particular where cash accounts are opened at a third party entity in the name of the depositary acting on behalf of the AIF, take the necessary steps to ensure the AIF's cash is booked in one or more cash accounts distinct from the accounts where the cash belonging to the depositary or belonging to the third party are booked 2. ensure the AIF's cash is booked in one or more cash accounts opened at an entity referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or at a bank or a credit institution of the non EU country in which the AIFM / AIF has been compelled to open a cash account in relation to an investment decision

Q25: How difficult would it be to comply with a requirement by which the general operating account and the subscription / redemption account would have to be opened at the depositary? Would that be feasible?

ETDF Comments: The AIFMD Level 1 text explicitly provides for cash accounts to be opened with authorised entities different from the depositary and in the relevant market where cash accounts are required to be maintained. Such accounts are needed to facilitate the AIFs' investment activities as well as distribution activities. Imposing a requirement that both subscription/redemption accounts and investment related accounts must be opened with the depositary in one given jurisdiction for all investment and distribution settings would be detrimental to the AIF and thereby ultimately to the investor.

In some jurisdictions (e.g. Ireland, Luxembourg...) it would be typical for the fund's subscription/redemption account to be opened by the AIFM's delegate, the administrator/transfer agent. In some other jurisdictions (e.g. Germany), it is a regulatory requirement that subscription/redemption accounts are opened with the depositary. Certain administrators have a general cash collection account holding all subscription/redemption monies which is then moved to the custodian account once all checks are carried out, e.g. AML, etc. Alternatively certain administrators have separate subscription/redemption accounts for each client/fund. At all times proper segregation is ensured with fund monies being kept separate from administrator funds. There are also cases where a manager has multiple funds with different depositaries. Such managers may have only one pooled subscription/redemption account with a credit institution. It would be operationally complex if managers were to be required to open

subscription/redemption accounts at each individual depositary. It could have a damaging impact on distribution channels and could increase costs.

In line with the proposed custodian oversight of subscriptions advice by ESMA as set out below,

- 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;

it would not appear essential for the subscription/redemption account to be opened at the depositary and this would cause significant operational difficulty. In line with the Level 1 text, we would recommend having the flexibility to allow the administrator to open such accounts along with the AIF and the AIFM with the appropriate party that they warrant.

Q26: At what frequency is the reconciliation of cash flows performed in practice? Is there a distinction to be made depending on the type of assets in which the AIF invests?

ETDF comments: as an introduction remark, the ETDF would like to stress the point that the depositary should, in the first place and where relevant, be in the position to rely on the existing control environment as implemented by the AIF, AIFM and/or third party administrators. On that basis, the depositary should leverage the different reconciliation processes in place to monitor the cash flows as generated by either the shareholder cycle or the investment cycle and only perform reviews on periodical basis.

With this in mind, the typology of cash reconciliation can be described as follows:

- Investment cycle: reconciliation between on the one hand, the AIF records and on the other hand, the depositary or third party where the AIF hold an account. Those reconciliations should be performed by the AIF, the AIFM or its administrator at least at each net asset value calculation. The depositary should carry out periodical reviews to be defined based on the nature, scale and complexity of the fund. Any pre established frequency may therefore not be advisable.
- Shareholder cycle: reconciliation between on the one hand, the transfer agent records and on the other hand, the depositary or third party banking institution holding the cash accounts. Those reconciliations should be performed by the AIF, AIFM or its administrator/transfer agent at least at each dealing date. The depositary should carry out periodical reviews to be defined based on the nature and frequency of dealing. Any pre established frequency may therefore not be advisable.

The type of assets is only one parameter amongst others that should be considered when defining the frequency for reviewing the reconciliations as performed by the AIF or AIFM.

Q27: Are there any practical problems with the requirement to refer to Article 18 of MiFID?

ETDF comments: We do not foresee any practical problems with the reference to Article 18 of MiFID and note that for any entity established in a relevant third country that it should be considered 'of the same

nature' as those entities referred to in Article 18 (1)(b) of Commission Directive 2006/73/EC if it is a credit institution subject to prudential regulation and supervision to the same effect as the provisions laid down in EU law and we note that this includes central banks and any bank authorised in a third country.

Q28: Does the advice present any particular difficulty regarding accounts opened at prime brokers?

ETDF comments: Typically, and provided option 2 of box 76 is retained, sufficient reporting is received from the Prime Brokers to enable timely cash reconciliations to be reviewed by the depositary on a periodic basis. It is important to note that the depositary will be relying on the Prime Broker or the AIFM to present sufficient documentation to it to demonstrate that 'cash accounts opened at a third party are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked);' as the depositary will not have access to that information.

Q29: Do you prefer option 1 or option 2 in Box 76? Please provide reasons for your view.

ETDF comments: We strongly advocates to pursue the approach as set out in option 2 as it allows the depositary to focus on adequate supervision and monitoring of transactions. More importantly, option 1, in particular its requirement to "*mirror*" certain transactions would not only be costly but also operationally challenging and add unneeded layers of administration without further benefits to the investor. We question the role of the depositary in ensuring appropriate procedures are implemented to identify on a timely basis significant cash flows and in particular those which could be inconsistent with the AIF's operations; The depositary does not consider it appropriate to be tasked with this specific oversight duty and the depositary's role should be 'to ensure that appropriate procedures are implemented by the AIFM to identify.....'

Indeed, the depositary carries out a secondary level of control as the AIF or AIFM are responsible for primary levels of control. The importance of first levels of control should be reaffirmed as it is the first control in the chain of operations and controls. We are therefore of the opinion that the depositary's duties are to be limited to check the effectiveness reconciliation on a periodical basis for the accounts opened in the books of the depositary only.

As a consequence, cash accounts opened by the AIF or AIFM with third parties (e.g. clearing broker for derivatives transactions, entities involved in private equity and real estate related transactions) outside the custodian's books should be subject to the provisions for "other assets" i.e. only record keeping (please see further comments in this contribution).

In addition, we would like to draw ESMA's attention on the following points:

The depositary's duties regarding the monitoring of the AIF's cash flows are performed on an ex-post basis and this is in contradiction with the c) of Option 1 that introduces an ex-ante concept.

Moreover, the requirements of c) imply a "blocking action" from the depositary which could lead to some notable delay in carrying out the operation and could be detrimental to the investors.

Point 8 of the explanatory text associated to option 1 reads that: 'the depositary could intervene immediately if it considers the cash flows inappropriate.' This would require the depositary to achieve a

real time monitoring of all cash transactions, and also to review the reason for all transactions (trade, deposit with credit institution, expense payment and potentially free cash transfer) to determine whether there are potentially inappropriate. In these circumstances, the depositary would be turned into a fund manager middle-officer.

Point 9 of the explanatory text suggests that if the reconciliations are performed daily, then the depositary would be expected to perform its verifications on a weekly basis. The suggested verification frequency does not take into account the nature, scale and complexity of the AIF, or the volume of transactions. Normally, the fund administrator would complete daily reconciliations for a daily valued fund, but the transactions may be minimal, and thus weekly verification by the depositary would not be cost effective.

Q30: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76?

ETDF comments: It is not possible to quantify costs but it is very evident that if option 1 was chosen, this would involve employing more people and significant systems enhancements to perform the tasks as set out, in particular mirroring the transactions of those cash accounts into a position keeping system and making periodic reconciliations between the cash accounts and the AIF's accounting records (see below). As a general comment, the proposals introduce unneeded additional layers of administration and controls which are not to the benefit of the investor and increase costs.

Option 2 requires strong oversight of the entire process and is less resource intensive while achieving the same level of protection. Moreover, it is principally in line with current best practice and additional cost should therefore be limited.

Q31: What would be the estimated costs related to the implementation of cash mirroring as required under option 1 of Box 76?

ETDF comments The suggestion that the depositary could 'mirror' the transactions of the cash accounts held with third parties that are already being accounted for by the administrator is completely unnecessary duplication and will involve increased costs to fund shareholders, to cover additional headcount and system enhancement costs without increasing the level of investor protection.

The cost for mirroring those cash transactions are extremely difficult to assess but would surely imply:

- Significant technology investments in system architecture in order to build a robust "transactions and positions record keeping" system as well as the messaging aiming at feeding that database. It is important to note that some third parties are unlikely to be able to provide this information electronically (e.g. no actual swift connectivity),
- Duplication of a part of the middle office and of the valuation functions with therefore additional costs onto the depositary for the extra valuation tasks
- Fundamental changes in the interactions between the depositary and the fund manager,

- Ongoing support from client service, IT maintenance, quality control teams... to ensure that the tool is fed with adequate data on a timely basis. Those additional running costs could well exceed 100% of the current costs base
-

2 Depositary functions pursuant to §8 – Safe-keeping duties

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

[...]

(c) the conditions for performing the depositary functions pursuant to paragraphs 7, 8 and 9, including:

- *the type of financial instruments that shall be included in the scope of the depositary's custody duties according to point (a) of paragraph 8;*
- *the conditions upon which the depositary may exercise its custody duties over financial instruments registered with a central depositary;*
- *and the conditions upon which the depositary shall safe keep according to point (b) of paragraph 8 the financial instruments issued in a nominative form and registered with an issuer or a registrar;*

Extract from Level 1 Directive

8. *'The assets of the AIF, or, as the case may be, the AIFM acting on behalf of the AIF, shall be entrusted to the depositary for safe-keeping, as follows:*

(a) Financial instruments that can be held in custody

(i) The depositary shall hold in custody all financial instruments that can 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;

(ii) For this purpose, the depositary shall ensure that all those 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 forth in Article 16 of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, opened in the name of the AIF or, as the case may be, the AIFM acting on behalf of the AIF, so that they can at all times be clearly identified as belonging to the AIF in accordance with the applicable law.

(b) Other assets

(i) For all other assets of the AIF, the depositary shall verify the ownership of the AIF, or, as the case may be, the AIFM acting on behalf of the AIF, of such assets and shall maintain a record of those assets for which it is satisfied that the AIF, or, as the case may be, the AIFM acting on behalf of the AIF, holds the ownership of such assets;

(ii) The assessment whether the AIF, or, as the case may be, the AIFM acting on behalf of the AIF, holds the ownership shall be based on information or documents provided by the AIF or the AIFM and, where available, on external evidence;

(iii) The depositary shall keep this record up to date.'

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on:

- the type of financial instruments that shall be included in the scope of the depositary's custody duties as referred to in point (a) of Article 21(8), namely (i) the financial instruments that can be registered in a financial instruments account opened in the name of the AIF in the

- depository's books, and (ii) the financial instruments that can be 'physically' delivered to the depository;
 - the conditions applicable to the depository when exercising its safekeeping custody duties for such financial instruments, taking into account the specificities of the various types of financial instruments and where applicable their registration with a central depository, including but not limited to:
 - the conditions upon which such financial instruments shall be registered in a financial instruments accounts opened in the depository's books opened in the name of the AIF or, as the case may be, the AIFM acting on behalf of the AIF,;
 - the conditions upon which such financial instruments shall be deemed (i) to be appropriately segregated in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC), and (ii) to be clearly identified at all times as belonging to the AIF, in accordance with the applicable law; and what shall be considered as the applicable law.
- a. ESMA is requested to advise the Commission on:
- the type of 'other assets' with respect to which the depository shall exercise its safekeeping duties pursuant to paragraph 8(b), namely all assets that cannot or are not to be kept in custody by the depository pursuant paragraph to Article 8(a);
 - the conditions applicable to the depository when exercising its safekeeping duties over such 'other assets', taking into account the specificities of the various types of asset, including but not limited to financial instruments issued in a 'nominative' form, financial instruments registered with an issuer or a registrar, other financial instruments and other types of assets.
- b. To that end, ESMA is requested to advise the Commission on:
- the conditions upon which the depository shall verify the ownership of the AIF or the AIFM on behalf of the AIF of such assets;
 - the information, documents and evidence upon which a depository may rely in order to be satisfied that the AIF or the AIFM on behalf of the AIF holds the ownership of such assets, and the means by which such information shall be made available to the [depositedepository](#);
 - the conditions upon which the depository shall maintain a record of these assets, including but not limited to the type of information to be recorded according to the various specificities of these assets; and the conditions upon which such records shall be kept updated.
- c. In its advice, ESMA should also consider the circumstances where assets belonging to the AIF, are subject to temporary lending or repurchase arrangements or any type of arrangements under which financial instruments may be re-used or provided as collateral by the AIF or AIFM on behalf of the AIF, whether or not such arrangements involve transfer of legal title to the financial instruments, and advise on the conditions applicable to the depository to perform its safekeeping duties accordingly.

2.1 Definition of the financial instruments that should be held in custody

Box 78

Definition of financial instruments to be held in custody – Article 21 (8) (a)

(Recommended Revisions as Marked)

Pursuant to Article 21 (8) (a), financial instruments belonging to the AIF should be included in the scope, of the depository's custody function when they meet all the criteria defined below:

1. they are transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC [and the depository or its sub](#)

custodian is the registered holder of the financial instruments or the depositary or its sub-custodian is the only registered holder of the assets (whether on a client by client basis or according to an omnibus scheme)

2. they are not provided as collateral in accordance with the provisions set out in Box 79 **(i.e. they have not been transferred out of the depositary's book and their ownership right has not been transferred to a third party) ; and**

Option 1

~~3. they are registered or held in an account directly or indirectly in the name of the depositary.~~

Option 2

3. they are financial instruments with respect to which the depositary may itself or through its sub-custodian instruct the transfer of title or an interest therein by means of a book-entry on a register **subject to regulated central reconciliation procedures and** maintained by a settlement system **which acts directly for the issuer or its agent. This settlement system can be either one of the European settlement systems** as designated by Directive 98/26/EC **or one of a list established and maintained by ESMA for** similar non-EU securities settlement system ~~which acts directly for the issuer or its agent.~~

Additionally, financial instruments which **are can-be** physically delivered to the depositary should be held in custody.

Financial instruments that are directly **(in the name of the AIF)** registered with the issuer itself or its agent (e.g. a registrar or a transfer agent) in the name of the AIF should not be held in custody unless they **are can-be** physically, delivered to the depositary. Further, financial instruments which comply with the definition set out above will remain in custody when the depositary is entitled to re-use them whether that right has been exercised or not. Where the financial instruments have been provided by the AIF or the AIFM acting on behalf of the AIF to a third party under a temporary lending agreement, they will no longer be held in custody by the depositary and fall under the definition of 'other assets' in accordance with Article 21 (8) (b).

~~**In the context of Option 1, where the financial instruments are registered directly with the issuer or its agent making the depositary the only registered owner on behalf of one or more unidentified clients, the financial instruments should be held in custody. However, such financial instruments should not be held in custody if the depositary is clearly identified in the register as acting on behalf of the AIF and thus the AIF is clearly identified as the owner of the financial instruments.**~~

All financial instruments that do not comply with the above definition should be considered as 'other assets' under the meaning of the AIFMD Article 21 (8) (b) and be subject to record keeping duties.

Q32: Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view.

ETDF comments: Option 1 is not acceptable as it could cause the scope of assets in custody to go far beyond the duties of the depositary. There is indeed no direct link between the registration and the qualification for assets in custody. This is explicitly acknowledged in ESMA advice (please refer to

explanatory text 10: “ESMA recommends clarifying that maintaining a record could mean registering the assets in its name in the first instance or...”).

Registration of assets with registers that are neither selected nor delegates of the depositary cannot do not cause the assets to qualify for assets in custody (e.g.: registrars commonly used for shares in other UCI's).

ETDF believes therefore that option 2 better reflects the reality and market practice and ultimately gives a good basis for distinguishing assets within the scope of Art 21.8 (a) vs assets within the scope of Art 21.8 (b).

Assets under Art 21.8 (a) are settling throughout recognized clearing systems (CSDs, ICSDs) and are held in "nominee name" by a depositary/custodian or a nominee company. Other financial instruments (e.g. target funds), real estate and private equity investments, that are not traded via CSDs or ICSDs should by default fall under Art 21.8 (b).

Q33: Under current market practice, which kinds of financial instrument are held in custody (according to current interpretations of this notion) in the various Member States?

ETDF comments: “Custody” is a broad concept whose meaning varies depending on the context. The directive defines “custody” in a way that is intended to create “*obligation de resultats*” so that even intangible assets are treated like physical property, subject to a particular legal regime creating an absolute obligation to return the property to its owner. This particular results-oriented approach is inconsistent in many respects with the laws of other states across the EU and throughout the world, which tend to consider the custodian’s role to encompass a test of conduct that varies depending on the facts and circumstances – such as the nature of the asset or financial instrument to be held - and the agreed understanding of the parties. The approach commonly understood in the U.K. and other common law countries is outlined above: common law fiduciary concepts apply in respect of assets that are held by the custodian as “bare trustee” on behalf of clients. The United States has generally adopted the Uniform Commercial Code concepts (at each state level), set out in Article 8, by which interests in “securities entitlements” – a bundle of rights deriving from but not the same as the security itself – are held “in custody” by securities intermediaries in the chain of custody. In this case, common law fiduciary concepts associated with responsibilities of “agents” or “bailees for hire” apply.

In civil law jurisdictions throughout the EU it is acknowledged that rights *in rem* in securities arise by virtue entering into a fiduciary contract such with a custodian so that segregation from the custodian (and insulation from creditors of the custodian) is assured¹. Legislation exists in certain civil law countries giving similar effect to positions reflected at CSDs. The net effect of all of this is recognition in civil law jurisdictions that rights to securities arise which are derived from records maintained at intermediaries in a chain of custody, which each link in the chain being dependent on the next. There is no direct “link” between a beneficial owner and the issuer: as a result, the approach being imposed under the directive will be difficult to make consistent with legal systems throughout the world.

Any *in rem* property interest in shares or interests which are not held via CSDs is more tenuous. In the case of interests in funds not traded on regulated markets or other financial instruments (such as private equity shares), there is no chain of custody at all as there is no arrangement to ensure the certainty of settlement that CSDs provide. It should be remembered that a hallmark of “custody” means holding a property interest on behalf of another. In the case of securities held via the Depositary Trust Company, New York, the rules of the CSD are incorporated into applicable law, giving legal effect to DVP/RVP settlement. This in turn means that legal title has deemed to have passed as and when the CSD determines. This has implications for what is deemed “held in custody”. Variations on this approach exist

¹ See, e.g., Luxembourg, Law of 27 July 2003, ratifying the Hague Convention of 1st July 1985.

throughout the world, including in the EU. No such assurance exists where the investment is in a security or other interest (such as a fund unit or private equity share) that is intangible and is reflected outside of this framework.

With this in mind, financial instruments commonly understood as “held in custody” are transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC (derivatives excluded). These financial instruments, in bearer form, are subject to mandatory registration in a regulated CSD.

There is therefore consistent with the proposal for the definition, as amended by ETDF, in BOX 78

Box 79**Treatment of collateral – Article 21 (8) (a)****(Recommended Revisions as Marked)**

Financial instruments provided as collateral should not be **regarded as** held in custody if they are provided:

Option 1

~~under a title transfer financial collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements~~

Option 2

under a title transfer financial collateral arrangement or under a security financial collateral arrangement by which the control over / possession of the financial instruments within the meaning of Article 2 (2) of Directive 2002/47/EC on financial collateral arrangements is transferred away from the AIF or the depositary to the collateral taker or a person acting on its behalf

Option 3

~~under a financial collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements~~

ETDF comments: The ETDF favors Option 2 as it provides the necessary level of flexibility to accommodate the different types of arrangement and model. In that context, financial instruments provided as collateral (taken and given by the AIF) are deemed as “not held in custody with the depositary” if they have been transferred out of the depositary’s book. By consequence, when the financial instruments are deposited with a third party (i.e. not the depositary itself or its sub-custodians), the depositary’s duty is limited to the recordkeeping function as per Art 21.8 (b).

To avoid any confusion, we also propose to amend the first sentence of box 79 as the original text as proposed by ESMA could lead to the interpretation that assets that are pledged as collateral should be taken out of custody.

Q34: How easy is it in practice to differentiate the types of collateral defined in the Collateral Directive (title transfer / security transfer)? Is there a need for further clarification of option 2 in Box 79?

ETDF comments: The differentiation between the different types of collateral defined in the Collateral Directive requires a detailed analysis of the collateral arrangement which, in practice, forms part of the custodians and prime brokers on-boarding procedures when negotiating collateral arrangements. On that basis, we do believe that further clarification is required

Indeed, financial Instruments that have been provided as collateral do not qualify for assets in custody except in the following cases:

- they have not been transferred out of the depositary's book, and,
- the ownership rights have not been transferred to a third party, and
- they cannot be re-hypothecated by a third party which is not the depositary

2.2 Conditions applicable to the depositary when performing its safekeeping duties on each category of assets

Box 80

Safekeeping duties related to financial instruments that can be held in custody

(Recommended Revisions as Marked)

1. To comply with its obligations pursuant to Article 21 (8) (a), the depositary should be required to at least:

(a) Ensure the financial instruments are properly registered in segregated accounts in order to be identified at all times as belonging to the AIF

(b) Exercise due care in relation to the financial instruments held in custody to ensure a high level of protection

(c) Assess and monitor all **relevant significant** custody risks. **It will inform the AIF or the AIFM acting on behalf of the AIF on the market practices in those markets where those assets are custodised. In particular, depositaries should be required to assess the custody risks related to settlement systems and inform the AIFM of any material risk identified.**

2. Where the depositary has delegated its custody functions, the depositary would remain subject to the requirements of §1 (c) and would further have to ensure the third party (hereafter referred to as the 'sub-custodian²⁾') complies with §1 (b) as well as with the segregation obligations set out in Box 16.

ETDF comments: ETDF believes that box 80 (c) somewhat imposes too strict standards on the depositary ignoring the fact that the AIF or AIFM should already be familiar with the custody risks associated to settlement systems as a result of their decision to invest into a particular given market.

On a separate note, ETDF would like to draw ESMA's attention on the explanatory note 35 stating that box 80 includes CSD's and registrars. Registrars are unlikely to be considered as "settlement systems" contrary to CSD's and therefore, the associated assets should fall under Art 21.8 (b) and not Art 21.8 (a).

Box 81

Safekeeping duties related to 'other assets' – Ownership verification and record keeping

(Recommended Revisions as Marked)

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (8) (b) including by third parties **under an ex-post verification regime**.

To comply with its obligations pursuant to Article 21 (8) (b), the depositary should be required to at least:

1. Ensure it has timely access to all relevant information it needs to perform its ownership verification and record keeping duties, including from third parties (e.g. prime brokers).
2. Ensure that it possesses sufficient and reliable information for it to be satisfied of the AIF's ownership right or of the ownership right of the AIFM acting on behalf of the AIF over the assets.
3. Maintain a record of those assets for which it is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership of those assets.

In order to comply with that obligation, the depositary should be required to:

- (a) register, on behalf of the AIF, assets in its name or in the name of its delegate; or
- (b) ensure, where assets are registered directly in the name of the AIF or the AIFM, or physically held by the AIF or the AIFM, it is able to provide at any time a comprehensive and up to date inventory of the AIF's assets.

To that end, the depositary should:

Option 1

- (i) ensure there are procedures in place so that assets so registered cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions; or

- (ii) have access to documentary evidence of each transaction **and position** from the relevant third party on a timely basis

or

- (iii) **receive and store electronic data from the relevant third party on a timely basis.**

Option 2

~~mirror all transactions in a position keeping record~~

~~In the context of § (b) the AIFM should be required to ensure that the relevant third party provides the depositary with certificates or other documentary **necessary to establish and verify the ownership. evidence** or the appropriate electronic data **every time there is a sale / acquisition or a corporate action and at least once a year.**~~

~~In any event, the depositary should ensure that the AIFM has and implements appropriate procedures to verify that the assets acquired by the AIF it manages are appropriately registered in the name of the AIF or in the name of the AIFM on behalf of the AIF, and to check consistency between the positions in its records and the assets for which the depositary is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership.~~

~~Additional requirement if Option 2 is retained in Box 78 with regard to the definition of financial instruments to be held in custody~~

~~In the context of § (a), the depositary should ensure the AIF, its investors or the AIFM acting on behalf of the AIF, are able to exercise their rights if a problem arises that affects assets for which the depositary or its delegate is the registered owner either by clearly identifying the AIF as the ultimate owner of the assets or, where the depositary or its delegate is the only registered owner of the assets on behalf of a group of one or more unidentified clients, by taking appropriate actions to ensure the AIF's ownership right is recognised by the relevant parties. Where a legal action is required, the costs related to such an action would have to be borne by the AIF, the AIFM or as the case may be the AIF investors. The depositary should set up and implement an escalation process for situations where an anomaly is detected (e.g. to notify the AIFM and if the situation cannot be clarified / corrected, alert the competent authority).~~

ETDF comments: the ETDF is in favor of option 1 which appears to be the most pragmatic approach comparing to option 2 that would lead to significant costs and workload with ultimately no real benefit for the investor. The depositary should be able to leverage the existing set of records and control environment in place at the AIF, AIFM or third party administrator to fulfill its duties. The proposed revised text is indeed aiming at keeping things simple and making a clear cut between the art 21.8 (a) and art 21.8 (b). The last 3 paragraphs of option 2 impose unjustified obligations in a context of a record keeper function

Q35: How do you see the delegation of safekeeping duties other than custody tasks operating in practice?

ETDF comments: In practice, we envisage few delegation scenarios for safekeeping duties other than custody tasks with the exception maybe of the Prime Broker. Also, alternatives strategies can, by nature, include non standard asset classes such as properties, wine and fine art, precious metals... that require the support of a variety of third parties including but not limited to notaries, lawyers, property managers, financing companies... They may be the ones at the top of the holding chain thus those who have the original documents related to title and detailed records of assets and as a consequence, should be responsible for providing the relevant information on the ownership. The responsibility for appointing

those third parties should remain with the AIF or the AIFM who should ensure that the depositary has appropriate and timely access to records and documentary evidence held or controlled by the third parties

Q36: Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

ETDF comments: when the assets are registered directly with an issuer or a registrar, the depositary must rely on its contract with the AIF to receive the necessary information about statements, corporate actions and transactions... as there is no direct relationship between the issuer and the depositary. In some cases, the registrar may refuse to recognise the standing of the depositary in requesting information directly on the status of the assets, requiring the depositary to make any such requests via the AIFM. The control from the depositary is in that case fully dependant on the external information provided by third party. This situation usually applies to real estate, private equity funds, and is efficient and common practice.

In some cases, typically in the case of a fund of funds investment, the asset may be registered in the name of the depositary or a group affiliated nominee company, on behalf of the AIF. This allows the depositary to control the execution of the investment and to specify the mailing address and bank accounts that must be used in relation to the assets. At the same time, the underlying registrar is notified that the depositary is acting on behalf of the AIF, and provide the relevant information to assist the depositary in segregating assets from the depositary's proprietary assets from the depositary's clients ones.

Finally, in other cases where larger volumes of transactions are made on behalf of a number of clients (e.g. liquidity management fund platforms), the depositary may operate an 'omnibus' registration with the registrar, which provides control and segregation from proprietary assets, while offering greater efficiency and automation, which can lower transaction costs for all investors.

It is important to mention that those different models are quite common and are considered as key from an operational perspective not only for the depositary but also the AIF or AIFM. Therefore, we strongly recommend ESMA to define an approach that would not disregard any of these options.

37: To what extent would it be possible / desirable to require prime brokers to provide daily reports as requested under the current FSA rules?

ETDF comments: ETDF believe it would be possible / desirable to require prime brokers to provide daily reports especially in the context of the monitoring of re-hypothecation, segregation and mark to market of the assets.

Q38: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 81? Please provide an estimate of the costs and benefits related to the requirement for the depositary to mirror all transactions in a position keeping record?

ETDF comments: ETDF does not support option 2 as it would lead to a complete change of operating model not only for the depositary but also for the AIFM and other third parties involved. Whilst it is extremely difficult to come up with an estimation of the costs imply by option 2 because of the broad diversity of products falling under the AIFM directive, one would expect those additional costs to be significant with actually no real added value.

Meeting the requirements of option 2 would lead the depositary, with the support of the other stakeholders, to:

- duplicate part of the clearer or of the prime broker activity
- modify the relationship with fund manager,
- implement a new system architecture and to increase the number of depositary staff,
- additional running costs widely up to more than 100% of the current costs for AIFs with large trading volume on derivatives or on assets provided as collateral.

The depositary should be in the position to comply with option 1 at a reasonable cost as a result of the new requirements set by the directive.

Therefore, it should be clarified that for asset types such as listed derivatives assets provided as collateral... the depositary can discharge its assets monitoring duties by receiving and storing the received by those third parties (Please refer to amendments in box 81).

Q39: To what extent does / should the depositary look at underlying assets to verify ownership over the assets?

ETDF comments: ETDF would be looking for more clarity from ESMA when referring to the “underlying asset”. This been said, investment strategies for alternative vehicles can utilize multilayered structures including but not limited to SPV's, master-feeder... to hold the final investment and the approach towards the depositary oversight within EU in relation to those structured vehicles can differ from one member to another. Unless ESMA come up with clearer and precise guidelines on how and when the look-through concept should be applied, we would recommend to limit the scope of responsibility of the depositary in relation to the verification of the ownership and oversight duties to the first level of investment.

3 Depositary functions pursuant to §9 – Oversight duties

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

[...] (c) the conditions for performing the depositary functions pursuant to paragraphs 7, 8 and 9

Extract from Level 1 Directive

9. In addition to the tasks referred to in paragraph 7 and 8, the depositary shall:

- (a) ensure that the sale, issue, re-purchase, redemption and cancellation of units or shares of the AIF are carried out in accordance with the applicable national law and the AIF rules or instruments of incorporation;*
- (b) ensure that the value of the shares or units of the AIF is calculated in accordance with the applicable national law, the AIF rules or instruments of incorporation and the procedures laid down in Article 19;*
- (c) carry out the instructions of the AIFM, unless they conflict with the applicable national law or the AIF rules or instruments of incorporation;*
- (d) ensure that in transactions involving the AIF's assets any consideration is remitted to the AIF within the usual time limits;*
- (e) ensure that an AIF's income is applied in accordance with the applicable national law and the AIF rules or instruments of incorporation.*

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions the depositary must comply with in order to fulfil its duties pursuant to Article 21(9). The advice shall include all necessary elements specifying the depositary control duties when inter alia verifying the compliance of instructions of the AIFM with the applicable national law or the AIF rules or instruments of incorporation, or when ensuring that the value of the shares or units of the AIF is calculated in accordance with the applicable national law and the AIF rules or instruments of incorporation and procedures laid down in Article 19.

Box 82

Oversight duties – general requirements

Recommended Revisions as marked)

At the time of its appointment, the depositary should assess the risks associated with the nature, scale and complexity of the AIF's ~~strategy and the AIFM's organisation~~ in order to define oversight procedures which are proportionate to the AIF and the assets in which it invests. Such procedures should be regularly updated.

To comply with its oversight duties, the depositary is expected to perform *ex post* controls and verifications of processes and procedures ~~in relation to its obligations pursuant to article 21(9)~~ that are under the responsibility of the AIFM, the AIF or an appointed third party. The depositary should in all circumstances ensure a procedure exists, is appropriate, implemented and frequently reviewed.

The depositary is required to establish a clear and comprehensive escalation procedure to deal with situations where ~~potential~~ irregularities are detected in the course of its oversight duties, the details of which should be made available to the competent authorities upon request.

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (9) including ~~the outcome of the AIF, or AIFM monitoring on the actual and ongoing performance of the processes and procedures, including~~ by third parties and particularly:

- that the depositary ~~receives documentation such as the risk management procedures of the AIF, or the AIFM, the relevant information produced by independent assessment and services providers on the AIF, or AIFM, all reserves expressed by the AIF auditors on the annual financial statements and the outcome (findings and assessments) of the controls performed by the AIF, or AIFM, internal control and risk management functions...~~
- ~~that the depositary,~~ is able to perform on-site visits of its own premises and any service provider appointed by the AIF or the AIFM (e.g. Administrator, external valuer) to ensure the adequacy and relevance of the procedures in place.

ETDF comments: The wording in the box should make it clear that the specific oversight duties as set out in Article 21(9)(a)-(e). In our view, ESMA's recommendation goes well beyond the requirements of Article 21.

Paragraph 1 - AIFMD does not place any responsibility on the depositary to assess the risks associated with nature, scale and complexity of the AIF of the AIF's strategy and the AIFM's governance arrangements. Such responsibility rightly sits with the AIFM as required by Article 15 and Article 20. For that reason, we believe the broad reference to the AIFM's organisation should be deleted from this paragraph.

Paragraph 3 - The text refers to 'potential irregularities'. This is too vague and gives rise to much uncertainty. Will these be elaborated upon in the Level 3 measures or will it be left to each national

regulator to determine? We note that the implementing measures for UCITS IV (Commission Directive 2010/44/EC) contains a list of types of irregularity upon which we would encourage ESMA to give consideration to producing a similar list

Additional comments on “Explanatory Text” after box 82

Paragraph 48 – This paragraph is drawn too widely. It should be for the depositary to determine what factors it needs to take into account in relation to the matters for which it has an oversight responsibility under Article 21(9).

Paragraphs 49 and 51 could be taken to imply that a depositary needs to be satisfied that the AIFM has complied with Article 20 regarding delegation. This is not one of the depositary's oversight duties. Responsibility for ensuring that the requirements of Article 20 are met rests with the AIFM. The AIFM needs to be in a position to satisfy its competent authority regarding its delegation arrangements.

In addition, definitions of the third parties specified in paragraph 49 would be helpful.

Box 83

Clarifications of the depositary's oversight duties

Duties related to subscriptions / redemptions (a)

(Recommended Revisions as Marked)

To fulfil its duties pursuant to Article 21 (9) (a), the depositary should be required to:

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1. ensure that the AIF, the AIFM or the designated entity has and implements an appropriate procedure to:

(a) reconcile

- the subscription / redemption orders with the subscription proceeds / redemptions paid, and
- the number of units or shares issued / cancelled with the subscription proceeds received / redemptions paid by the AIF

(b) verify on a regular basis that the reconciliation procedure is appropriate. To that end, the depositary should in particular regularly check the consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register **The frequency of the depositary's checks should be proportionate to the frequency of subscription and redemptions**

2. ensure and regularly check the compliance of the procedures regarding the **primary market** sale, issue, repurchase, redemption and cancellation of shares or units of the AIF with the applicable national law and the AIF rules and / or instruments of incorporation and verify that these procedures are effectively implemented.

ETDF comments: ETDF believes that the depositary oversight in relation to Article 21 (9) (a) should be limited to the primary market only. Shares or Units negotiated on a secondary market should be excluded from the scope of this oversight

Box 84
Clarifications of the depositary's oversight duties
Duties related to the valuation of shares / units (b)
(Recommended Revisions as Marked)

1. ~~The depositary should verify on an on-going basis that appropriate and consistent procedures are established for the valuation of the assets of the AIF in compliance with the requirements of Article 19 and its implementing measures and the AIF rules and instruments of incorporation.~~
2. The depositary should ensure that the valuation policies and procedures for the calculation of the value of the units or shares of the AIF are effectively implemented and periodically reviewed.
3. The depositary's procedures should be proportionate to the nature, scale and complexity of the AIF and conducted at a frequency consistent with the frequency of the AIF's policy for the calculation of the value of the units or shares of the AIF as defined in Article 19 and its implementing measures.
4. Where the depositary considers the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable law or the AIF rules or the provisions of Article 19, it should notify the AIFM and ensure timely remedial action has been taken in the best interest of the AIF's investors.
5. ~~Where applicable, the depositary should be required to check that an external valuer has been appointed in accordance with the provisions of Article 19 of the AIFMD and its implementing measures.~~

ETDF comments: ETDF believes that some of the provisions as described in box 84 go beyond the requirements included in the level 1 text. Level 1 indeed does not require the depositary to directly oversee the valuation of assets. The decision over internal or external valuation is the responsibility of the AIFM, and the AIFM to ensure compliance with the requirements of Article 19 in this regard. We would recommend then to delete paragraph 1. As the depositary is not required to oversee the valuations of assets or the decision to appoint an external valuer, ETDF also believes that paragraph 5 should be deleted.

The oversight of the depositary should therefore be limited to the verification on a periodical basis that the valuations and procedures as defined by the AIF or the AIFM on behalf the AIF are effectively implemented and periodically reviewed.

Box 85
(Recommended Revisions as Marked)
Clarifications of the depositary's oversight duties
Duties related to the carrying out of the AIFM's instructions (c)

To fulfil its obligation pursuant to Article 21 (9) (c), the depositary should be required to:

1. Set up and implement appropriate procedures to verify the compliance of the AIF / AIFM with applicable **national laws** and **regulations** as well as with the AIF's rules and instruments of incorporation. In particular, the depositary should monitor compliance of the AIF with investment restrictions and leverage limits **defined in the AIF's offering documents**. Those procedures should be proportionate to the nature, scale and complexity of the AIF.

2. Set up and implement an escalation procedure where the AIF has breached one of the limits or restrictions referred to under §1.

ETDF comments: ETDF considers that the point 1 goes beyond the level 1 provisions. Level 1 text which refers to the incorporation document (not offering documents, i.e. the prospectus that may change without the depositary being informed). Furthermore in that regards, the reference to laws and regulations goes a little bit further than the Directive which refers to “national law”, the difference may be tiny, but legally speaking it may not be the same. As the intent of this EU legislation is to promote harmonisation at EU level, we would recommend ESMA to limit its scope to EU rules

Box 86

(Recommended Revisions as Marked)

Clarifications of the depositary’s oversight duties

Duties related to the timely settlement of transactions (d)

Option 1

No additional requirement

Option 2

~~To fulfil its obligation pursuant to Article 21(9)(d), the depositary should be required to set up a procedure to detect any situation where the consideration is not remitted to the AIF within the usual time limits, notify the AIFM and where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.~~

~~Where the transactions do not take place on a regulated market, the usual time limits should be assessed with regard to the conditions attached to the transactions (OTC derivative contracts, investments in real estate assets or in privately held companies).~~

ETDF comments: We believe that option 1 is the preferred one as it provides the appropriate level of flexibility in the light of the very broad categories of asset classes and strategies falling under the AIFM directive. The current arrangements, processes and market practices allow for a timely settlement of transactions and the identification of possible fails or anomalies. In the latter case, the depositary takes the necessary steps to inform the AIF/AIFM and request its instructions. We therefore do not think that Option 2 will bring any additional added value and safety to the current arrangements.

Box 87

Clarifications of the depositary’s oversight duties

(Recommended Revisions as Marked)

Duties related to the AIF’s income distribution (e)

To fulfil its obligation pursuant to Article 21(9)(e), the depositary should be required to:

1. Ensure the net income calculation, once declared by the AIFM, is applied in accordance with the AIF rules, instruments of incorporation and applicable national law

- ~~2. Ensure appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements~~
- ~~3. Check the completeness and accuracy of dividend payments and where relevant of the carried interest. Review ex post the effectiveness of procedures as implemented by the AIF and AIFM related to dividend payments and where relevant, of the carried interest, based on samples transactions on periodical basis~~

ETDF comments: ETDF is in the opinion that the depositary's oversight duties related to the AIF's income distribution can only be interpreted as an obligation to oversee the allocation of a distribution to investors according to the rules of the AIF, once a decision has been made by the AIFM to distribute.

Distributions take many forms and are usually declared after the AIFM has decided on their working capital requirements and other strategic issues. Reasons for distributions may include, for example, income, capital gains, and a return of capital or repayment of a shareholder loan.

Under Box 87 (1) calculation of the net income for fund operations would require the depositary to enquire into the portfolio management decision regarding available cash, and possibly to duplicate the entire accounting process for all fund debits and credits to ensure their correct calculation under AIF rules, instruments of incorporation and applicable national law. This would not be possible to meet in most cases, may interfere unreasonably with management discretion or in any event would only be possible by incurring significant duplication and thus higher costs.

Point 2 : The depositary cannot be requested to check all financial reports This requirement is acceptable under the sole condition that the AIF/AIFM is required to provide the depositary with all information on possible reserves expressed on the annual financial statements. Indeed, the contractual relationship is between the AIF/AIFM and the external auditor and the reserves are expressed to the benefit to the AIF/AIFM who has the primary to cure them. Not sure we need to add this as we indicated that it would be limited to the impact on dividends distribution

Q40: To what extent do you expect the advice on oversight will impact the depositary's relationship with funds, managers and their service providers? Is there a need for additional clarity in that regard?

ETDF comments: The ETDF supports the proposal to introduce principle-based implementing measures with regard to oversight duties, which will result in an adequate harmonization of duties across the European Member States. ETDF also welcomes the right level of depositary duties which remain proportional in relation to the duties of the other involved parties.

The proposed advice will create benefits for the reason that it enhances the orderly harmonized cooperation between the depositary and the AIFM or the AIF in relation to clearly establishing all the relevant information / communications flows, which is essential for an adequate investors' protection.

According to the general requirements as described in Box 82, the ETDF understands that the oversight function as performed by the depositary should take into consideration the risks associated with the nature, scale and complexity of the AIF's strategy and the AIFM's organisation and essentially consist in assessing the control procedures and environment at the AIFM, the AIF or appointed third party. The ETDF broadly supports this approach but would like to make the following observations and comments:

- a) Assessment of the risks associated to the product and AIFM's organisation: the AIF, or the AIFM on behalf of the AIF, is required to provide details on its risk management procedures to the

Regulator as part of the incorporation documents. So far, the risk management papers were essentially focused on the risks associated to the management of the portfolio and did not really cover the aspects pursuant to article 21 (9) of the Directive. The ETDF reminds ESMA that the depositary is not directly involved in the risk management procedures from the AIFM and may therefore at best be in a position to check if the AIFM has –reasonable- procedures. Risk analysis and decisions shall remain the responsibility of the Board of the AIF (or AIFM on behalf of the AIF). As a consequence, the ETDF would recommend that the risk management procedures as filed by the AIF (or the AIFM on behalf of the AIF) should include specific provisions aiming at describing how the Board will exercise its supervision duties in that regards and the information (SAS70, KPI/KRI's) that will be made available to the depositary to fulfil its oversight duties. The timing for providing all the necessary information to the depositary is also critical. In some cases, at the time of the appointment of the depositary, a lot of variables affecting the product can still be unclear and as a consequence, it is very difficult for the depositary to perform an adequate risk assessment. The AIF or the AIFM on behalf of the AIF should give the depositary sufficient lead-time in order to allow him to conduct a proper risk assessment. On a related note, in order to ensure a level playing field and consistency amongst the services providers (administration companies, custodian, risk managers...), ESMA might consider imposing on the stakeholders playing a key function (fund administration, transfer agent, risk manager...) an independent assessment of their control environment (e.g. SAS 70 or equivalent). Those independent assessments have become with time quite common in the depositary community and it would make sense to extend those standards to the other service providers. This would also constitute an alternative to the issue resulting from the situation where competing firms would have to share detailed information on procedures and processes in the context of the due diligence. Finally, the ETDF wishes to point out that the general oversight procedures, referred in paragraph 1 of Box 82, should be reviewed on a regular basis and updated when necessary, rather than regularly updated

b) Ex post verifications of the procedures: according to the Note 49 of the explanatory text, the ETDF understands that, in order for the depositary to discharge its responsibilities, the “ex post verifications” should be mainly based the review of the adequacy of the procedures and escalate any gaps or issues as highlighted by its review. By consequence, the depositary is not required to monitor the actual and ongoing performance of the service providers (review of KPI/KRI's) as it should remain the responsibility of the AIF or AIFM on behalf of the AIF

c) Escalation process: as the AIF or AIFM on behalf of the AIF remains ultimately responsible for ensuring that an effective and sound control environment has been implemented at the level of the AIF, any issues identified by the depositary in the course of its oversight duties should be reported to the Board of the AIF or the AIFM if acting on behalf of the AIF

d) The written agreement between the AIFM or the AIF shall contain an obligation for the AIFM or AIF to provide or ensure any third party appointed by the AIFM or AIF provides all necessary information that permit the depositary the performance of its oversight duties, in compliance with Article 21 (9) of the AIFMD.

e) No prevailing means of controls (sample, assessment of procedures , on site visits, ...) should be designated in the implementing measures

The ETDF foresees additional costs associated with the extension of the five oversight duties to local depositaries of AIFMs or AIFs. However, the proposed advice on the depositary control duties seems to ensure the right balance between flexibility, the harmonization's objective and the costs associated to the implementation and on-going monitoring of such duties.

The principal based approach properly clarifies the scope of each listed oversight duty and provides the necessary flexibility for depositaries so that they are in a position to undertake verifications and checks of management functions in the context of alternative investment funds. Therefore, the ETDF does not believe that there is a need for additional clarity in that regard.

(Please also refer to proposed amendments in box 82)

Q41: Could potential conflicts of interest arise when the depositary is designated to issue shares of the AIF?

ETDF comments: Under the AIFMD requirements, the entity involved in the issuance of the units of the AIF will have to maintain and operate under effective organizational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors.

As a consequence, the same legal entity should be authorized to act as depositary and transfer agent for AIFs. The interests of the investors are primarily protected by an adequate structure which proposes a clear segregation between the depositary and the transfer agent functions (introduction of “Chinese walls”).

Q42: As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF is compliant with the applicable national law and the AIF rules and / or instruments of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

ETDF comments: On a periodic basis, the depositary ensures that the AIF, the AIFM or the designated entity (transfer agent and administrative agent) have appropriate procedures to reconcile the subscription orders with the subscriptions proceeds. It also ensures that the procedure is reviewed on a regular basis and updated if necessary. The review of the effectiveness of these procedures could be performed ex-post based on samples.

The depositary, where deemed appropriate, might decide to complement his review by conducting additional ex-post verifications based on information provided by the designated entity such as exceptions reports, key performance indicators, key risks indicators, etc. It is important to keep in mind that all these reviews are performed based on aggregated numbers as provided by the transfer agent and not based on individual shareholder / unitholder transaction.

ETDF wishes to point out that the verification of procedures implemented by the AIFM, the AIF or any third party should not necessarily be correlated to the frequency of subscription and redemptions. The ETDF suggests that the depositary verifies the procedures on a periodic basis.

Last but not least, some alternative products can introduce a further layer of complexity as they can operate on commitment and drawn-down basis at the discretion of the fund manager, use equalisation methods, commissions and retrocession's... Those features are typically not included in the records of the fund as they relates to individual shareholders transactions and positions. On that basis, we believe that in the context of the AIFM directive, those transactions should be excluded from the scope of the depositary bank oversight.

Q43: Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

ETDF comments: The scope of the review, as currently performed by the depositary, already includes not only subscriptions but also other types of shareholders related transactions, such as redemptions, switches etc...

As indicated in box 83, the depositary oversight in relation to Article 21 (9) (a) should be limited to the primary market only. Shares or Units negotiated on a secondary market should be excluded from the scope of this oversight

Q44: With regards to the depositary's duties related to the carrying out of the AIFM's instructions, do you consider the scope of the duties set out in paragraph 1 of Box 85 to be appropriate? Please provide reasons for your view.

ETDF comments: It is important to keep in mind that the responsibility for implementing an effective and sound risk management process remains the responsibility of the Board of the AIF (or AIFM on behalf of the AIF), the depositary is in an execution mode vis-à-vis the AIFM/AIF. According to the general requirements as described in Box 82, ETDF understands that the oversight function as performed by the depositary should mainly consist in assessing the control procedures and environment at the AIFM, the AIF or appointed third party. On that basis, the depositary could also rely on controls performed by the investment manager or any third party in charge of the compliance/risk monitoring. Combined with an initial due diligence over the investment management, including site visits if deemed necessary, the depositary will be in a position to discharge its oversight duty.

As indicated in the ETDF comments relative to box 85, we consider that the point 1 goes beyond the level 1 provisions. Level 1 text which refers to the incorporation document (not offering documents, i.e. the prospectus that may change without the depositary being informed). Furthermore in that regards, the reference to laws and regulations goes a little bit further than the Directive which refers to "national law", the difference may be tiny, but legally speaking it may not be the same.

Q45: Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

ETDF comments: ETDF believes that no clarification is needed for this oversight duty and decides to select option 1.

From a practical perspective, as far as financial instruments are concerned i.e. assets held within a sub-custody network, and as long as third party custodians involved in the safekeeping chain do provide the appropriate reporting, the ETDF believes that there is no fundamental difference between the current market practice for monitoring timely settlement of transactions and the suggested measures in paragraph 1 of the second option. The ETDF is also in the opinion that any request for the restitution of the financial instruments from the counterparty should, in the first place, be initiated by the board of the AIF (or AIFM on behalf of the AIF). The depositary should be acting, where possible, as a facilitator in the process (in some circumstances, the depositary might not be able to access the assets e.g. financial instruments held by a third party custodian or prime broker appointed by the AIF or the AIFM on behalf of the AIF).

In regards to assets not held throughout the traditional custody network (derivatives, real estate, private equity...), and due to the non-standard nature of those transactions, ETDF is in the opinion that the responsibility of assessing the usual time limits should not be transferred over to the depositary and should remain with the contracting parties of the transaction. The documents supporting the individual transaction signed by the parties should clearly indicate a settlement date to be used as a reference for defining if the assets have been remitted within the usual time limits.

Notwithstanding the above, and similar to other oversight duties, the depositary should be able to rely on his assessment of the existing control environment at the AIF, AIFM and/or a third party provider to discharge its responsibilities. Those control procedures should include assets and cash reconciliations, past due receivables and payables etc...

Section 2 Due diligence duties

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying: [...] (d) the due diligence duties of depositaries pursuant to paragraph 11 (c);

Extract from Level 1 Directive

11. The depositary shall not delegate to third parties its functions as described in this Article, save for those referred to in paragraph 8. The depositary may delegate to third party the functions referred to in paragraph 8, subject to the following conditions: [...]

(c) the depositary has exercised all due skill, care and diligence in the selection and the appointment of any third party to whom it wants to delegate parts of its tasks, and keeps exercising all due skill, care and diligence in the periodic review and ongoing monitoring of any third party to whom it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it;

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the duties the depositary has to carry out in exercising its due diligence duties pursuant to Article 21(11), namely:
 - procedures for the selection and the appointment of any third party to whom it wants to delegate parts of its tasks; and
 - procedures for the periodic review and ongoing monitoring of that third party and of the arrangements of that third party in respect of the matters delegated to it.
2. ESMA is encouraged to develop a comprehensive template of evaluation, selection, review and monitoring criteria to be considered

Box 88

Due Diligence Requirements

(Recommended Revisions as Marked)

1. When the depositary delegates any of its safekeeping functions, it should implement an appropriate, documented and regularly reviewed due diligence process in the selection and ongoing monitoring of the delegate.

(a) When appointing a sub-custodian, the depositary should roll out a due diligence process which aims to ensure that entrusting financial instruments to a sub-custodian provides an adequate level of protection. Such a process should include at least the following steps:

- ~~(i) assess the regulatory and legal framework (including country risk, custody risk, enforceability of contractual agreements). This assessment should particularly enable the depositary to determine the potential implication of the insolvency of the sub-custodian~~
 - (ii) assess whether the sub-custodian's practice, procedures and internal controls are adequate to ensure the financial instruments will be subject to reasonable care
 - (iii) assess whether the sub-custodian's financial strength and renown are consistent with the delegated tasks. This assessment shall be based on information provided by the potential sub custodian as well as third party data and information where available
 - (iv) ensure the sub-custodian has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security
- (b) The depositary should perform ongoing monitoring to ensure the sub-custodian continues to comply with the criteria defined under §1 and the conditions laid out in Article 21 (11) (d), and at least:
- (i) monitor the sub-custodian's performance and its compliance with the depositary's standards
 - (ii) ensure it exercises reasonable care, prudence and diligence in the performance of its custody tasks and particularly that it effectively segregates the financial instruments assets ~~in line with the requirements set out in Box 16 between 1) its assets and the assets of its clients 2) the assets held by the depositary for its account and the assets of the depositary's clients.~~
 - (iii) review the custody risks associated with the decision to entrust the assets to that entity ~~and promptly notify the AIF or AIFM of any change in these risks.~~ This assessment should be based on information provided by the sub-custodian as well as third party data and information where available. During market turmoil or where a risk has been identified, the frequency and the scope of the review should be increased
2. The depositary should design contingency plans for each market in which it appoints a delegate to perform safekeeping duties. Such a contingency plan may include the identification of an alternative

provider, if any.

3. The depositary shall ~~terminate the contract in the best interest of the AIF and its investors where the delegate no longer complies with the requirements.~~ take measures, including terminating the contract, if the depositary assesses that sub custodian no longer complies with the requirements and this situation cannot be cured within reasonable timeframes.

ETDF comments: ETDF regrets that ESMA did not choose the option to develop a comprehensive template of evaluation, selection, review and monitoring criterias. Such a template would definitely help clarifying the duties of the depositary, provide for documented evidences and be instrumental to achieve an European harmonisation.

Nevertheless, the proposals made by ESMA for formulating the due diligence duties of depositories when they appoint a sub-custodian appear generally appropriate. The envisaged requirements for the selection and ongoing monitoring process are largely in line with current market practice. Categorisation of depositories' due diligence duties into "selection" and "ongoing monitoring" also appears generally appropriate.

With regard to selection, a distinction should be made between general risk (e.g. country risk) and specific risk associated with the individual sub-custodian. Whilst general risk involves basic risk associated with the country of deposit, specific risk that may arise from the sub-custodian's business activity is individual risk that can be contained by selecting a different sub-custodian. Where risk arising from the business activity of a specific sub-custodian is concerned, a check on how the entity is organised professionally (e.g. qualification and experience of employees, reporting lines, complaint-handling procedure and market reputation) is usually conducted.

As regards the review during the business relationship, the ETDF welcomes the risk-based approach proposed by ESMA. In normal market situations and where the conduct of the sub-custodian gives no cause for concern, periodic reviews in the form of spot checks should be sufficient.

The contingency plans referred to in Box 88 (paragraph 2) are standard practice. The requirements for such a contingency plan should however be proportionate in regard to its degree of detail and differentiation.

In case the risk is not based on the sub-custodian itself but on general risks (e.g. political risks), which means that a change of custodian will not help solving the problem, the relevant authority and the AIFM should be informed, so as the AIFM can take the appropriate steps to adapt its investment strategy

accordingly. In case the AIFM does not react adequately, the depositary should be discharged from its liability.

We would also like to add the following comments in relation to Box 88:

- Paragraph 1(a) (i): the requirement on the assessment of the regulatory and legal framework including custody risk seems not advisable as it is not the role of the depositary to assess the legal framework of the effects of the segregation (see our comments in Box 89)
- Paragraph 1(b) (ii): the reference to Box 16 should not apply in this context as financial instruments are not registered in the account of the AIFs at the subcustodian's level. Such a requirement would cause a major additional costs and operational burden and will not bring any further protection (please refer to Box 89 on "Segregation" and section "Delegation")
- Paragraph 1 (b) (iii): the depositary's obligation under paragraph (b)(iii) should essentially be to revisit the assessments carried out under (a)(i) and (a)(iii). Conversely, the requirement to notify any change of the custody risk to the AIF/AIFM appears to be not advisable and possibly unlawful. Any changes identified by the depositary should be assessed and may lead to decisions followed by actions that could impact its relation with the sub-custodian. The AIF/AIFM may be informed of these decisions but this information should in no case be mandatory since the dissemination of information or decision to third parties with regards to custody risk of a given market/given entity may qualify as a breach of a confidentiality obligation and market abuse regulation. and may stark systemic consequences.
- Paragraph 2: should be deleted as paragraph 1 (as amended according to the ETDF comments) appears to be sufficient. Indeed, the on-going due diligences and procedures enable to identify alternatives wherever available in a timely manner.
- Paragraph 3: The termination of sub-custody agreement should not be mandatory. Indeed this may not in every case, when practicable, be in the AIF/AIFM's best interests. As an alternative, we would suggest that the depositary be required to "take such measures, including terminating the contract, as are in the best interest of the AIF and its investors provided that:
 - the depositary has assessed in good faith, the pro's and con's of the measures to be taken, and
 - the sub-custodian no longer complies with the requirements and
 - this situation cannot be cured in a reasonable period of time".

Section 3 Segregation

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying: (e) the segregation obligation set forth in paragraph 11 (d) (iii)

Extract from Level 1 Directive

11. The depositary may not delegate to third parties any of its functions as described in this Article, other than those referred to in paragraph 8.

The depositary may only delegate to third parties the functions referred to in paragraph 8, provided that:

(d) the depositary ensures that the third party meets the following conditions at all times during the performance of the tasks delegated to it:

[...]

(iii) the third party segregates the assets of the depositary's clients from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a particular depositary;

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on criteria to be satisfied to comply with the segregation obligation whereby the depositary shall ensure on an ongoing basis that the third party fulfills the conditions referred to in Article 21(11)(d)(iii).

Box 89

Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC implementing the MiFID Directive)

(Recommended Revisions as Marked)

1. Where **safekeeping custody** functions have been delegated partly or totally to a third party, the depositary must ensure that the third party acts in accordance with the segregation obligation pursuant to Article 21 (11) (d) (iii) by verifying that the third party has put in place arrangements that are compliant with the following requirements:
 - (a)** to keep such records and accounts as are necessary to enable it at any time and without delay to distinguish assets safekept for the depositary on behalf of its clients from **(1) its own assets and the assets of its clients (2) the assets held by the depositary for its own account and the assets held for the depositary's clients and from assets held for any other client (including assets belonging to the depositary itself)**
 - (b) to maintain records and accounts in a way that ensures their accuracy, and in particular their correspondence to the assets safe kept for the depositary's clients;
 - (c) to conduct, on a regular basis, reconciliations between its internal accounts and records and those of any sub-delegate by whom those assets are safekept;
 - (d) to take the necessary steps to ensure that any financial instruments belonging to the depositary's clients entrusted to a sub-delegate are identifiable separately from **(1) the financial instruments belonging to the sub-delegate and the assets of its clients (2) the assets held**

by the depositary for its own account and the assets held for the depositary's clients, by means of differently titled accounts on the books of the sub-delegate or other equivalent measures that achieve the same level of protection;

~~(e) to take the necessary steps to ensure that cash belonging to the depositary's clients deposited in a central bank, a credit institution or a bank authorised in a third country is held in an account or accounts identified separately from any accounts used to hold cash belonging to the third party or where relevant the sub-delegate.~~

~~2. Where the depositary has delegated its custody functions, monitoring the sub-custodian's compliance with its segregation obligations should ensure the financial instruments belonging to its clients are protected from the event of insolvency of that sub-custodian. If, for reasons of the applicable law, including in particular the law relating to property or insolvency, the requirements described in §1 are not sufficient to reach that objective, the depositary should assess what additional arrangements could be made in order to minimise the risk of loss and maintain an adequate level of protection.~~

3. The requirements in §1 and §2 should apply mutatis mutandis when the third party has decided to delegate part or all of its tasks to a sub-delegate as foreseen in Article 21 (11).

ETDF comments: Overall, the ETDF finds that the segregation criteria proposed in Box 89 seems to be adequate and reasonable. It would however make the following comments:

- It is favourably noted that there is no requirement to segregate assets on a fund by fund basis, and that the proposed wording allows the use of omnibus accounts for depositary clients' assets by sub-custodians as per current prevailing market practice in most jurisdictions
- Similarly, and corresponding to overall market practice, segregation of cash is limited to segregation from cash of third parties or the sub-delegate of the depositary. With respect to cash, it is important to note that further segregation requirements at sub-delegate level would not add protection to cash holdings in case of an insolvency of the sub-delegate, and would thus offer no further investor protection (neither in the EU neither outside of the EU).
- The extension of segregation requirements from financial instruments to *other assets* needs further analysis, with a view to determine to what extent such segregation is practical given the various types of other assets. If such an extension were to be retained, it would be preferable to add it to the rules rather than in an explanatory note (note 5), for legal certainty purposes.
- The duty to ensure segregation of other assets should at any rate be limited to cases where the depositary has appointed the delegate. In order to have a harmonized set of investor protection measures, the AIF/AIFM should have identical duties when it appoints another delegate directly for such assets.
- With respect to paragraph a) we suggest amending the proposed wording in order to clarify the conditions for segregation: in this respect "to distinguish assets between 1) its own assets and the assets of its clients and between 2) the assets held by their clients for their own account and for their own clients".
- With respect to paragraph d) a common wording should be used for a) and d) as what matters is that at all levels of the custody chain there is a segregation between 1) its own assets and the assets of its clients and between 2) the assets held by their clients for their own account and for their own clients".

- With regards to the level of protection, please refer to Q.46.
- With respect to paragraph 1 e) we are of the opinion that e) should be deleted. Indeed, cash is recognised as a fungible asset and should not be subject to segregation. Such a requirement would cause a major additional costs and operational burden, whilst the cash assets represent the slightest portion of the assets of the AIF. Indeed, cash assets are a residual part of the assets since alternative financial instruments into the obligation of segregation are available and widely used.
- Paragraph 2 should be deleted. Protection of the financial instruments from the event of insolvency of the sub-custodian is subject to the local law recognising the full effects of the segregation. The depositary could not be requested to review and analyse national legislations with regard to insolvency procedure and go beyond the duties referred to in para 1 (amended as per ETDF's comments). Indeed, Segregation procedures should be viewed as a presumption of protection of the assets held in custody and deemed to be sufficient in this context. In addition ,it should be recognized that not all national legislations provide for segregation obligations and any segregation at the third party level (as provided for in Level 1) may not have any legal effects with regard of the protection of assets. Please refer to our comments to Q 46
- With respect to explanatory text paragraph 5 on page 176 of the consultation document, the ETDF is of the opinion that segregation obligations should not apply to assets subject to recordkeeping. By definition assets held in recordkeeping are either assets held with a third party custodian that is not a sub-contractor of the depositary, or assets held directly with the issuer or its agent, none of which would have been selected by the depositary.
- Consequently, no due diligence duty should be imposed on the depositary as per the internal organisation and quality of such third parties. The ETDF strongly rejects the concept of any duty to monitor the eligibility, whatever the circumstances, of such party. Nevertheless, the ETDF recognizes that the depositary has an obligation to ensure that the AIF/AIFM has put in place the necessary due diligences procedures with respect to such third parties.
- In addition, it is recognised that in some circumstances, these third parties (e.g. prime brokers) may not be in the position to comply with the segregation obligations, the AIF/AIFM has an obligation to report and disclose this situation in the documentation available to the investors.

Q46: What alternative or additional measures to segregation could be put in place to ensure the assets are 'insolvency-proof' when the effects of segregation requirements which would be imposed pursuant to this advice are not recognised in a specific market? What specific safeguards do depositaries currently put in place when holding assets in jurisdictions that do not recognise effects of segregation? In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

ETDF comments: there are unfortunately no statistics available on the countries where the concept of segregation does not apply. At most, all that can be reasonably expected is for the depositary to seek clarification or confirmation as to the conditions under which assets are held, but sub-custodians will not be placed to provide certainty as to legal effect in this regard.

At the end of the day, whatever the circumstances, since local legislation and local court decisions prevail in all disputes, no third party such as the depositary can be requested to ensure that the effect of the segregation or any other measures (although we do not see what could be these measures) is such that the assets held by a sub-custodian for the benefits of its customers are fully protected from an insolvency of the sub-custodian.

Indeed, the present ESMA advice acknowledges this circumstance (please refer to explanatory paragraph 32): in this case, the event of insolvency would qualify as an external event.

With this above qualification, the ETDF supports the principle of segregation, wherever recognised by the local legislation

V.IV. The depositary's liability regime

1 Loss of financial instruments

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

[...]

(a) the conditions and circumstances subject to which financial instruments held in custody are to be considered as lost;

Extract from Level 1 Directive

12. The depositary shall be liable to the AIF, or to the investors of the AIF, for the loss by the depositary or a third party to whom the custody of financial instruments held in custody according to point (a) of paragraph 8 has been delegated.

In the case of such a loss of a financial instrument held in custody, the depositary shall return a financial instrument of the identical type or the corresponding amount to the AIF or the AIFM acting on behalf of the AIF without undue delay. 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.

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions and circumstances under which financial instruments held in custody pursuant paragraph 8(a) shall be considered as 'lost' according to Article 21(12). In its advice, ESMA should take into account the various legal rights attached to the financial instruments depending, for example, on the legal concepts ('ius ad rem' vs. 'ius in personam') used in the jurisdiction where they have been issued and any legal restrictions applicable to the place where they are kept in (sub-) custody.
2. In its advice, ESMA should specify circumstances when such financial instrument should be considered permanently 'lost', to be distinguished from circumstances when such financial instruments should be considered temporarily 'unavailable' (held up or frozen).

To that end, ESMA shall consider inter alia the following circumstances:

- Insolvency of, and other administrative proceedings against, a sub-custodian;
- Legal or political changes in the country where financial instruments are held in sub custody;
- Actions of authorities imposing restrictions on securities markets;
- Risks involved through the use of settlement systems; and
- Any other circumstances which may prevent the AIF from using or disposing of its assets that are kept in custody by a depositary or a sub custodian.

Box 90

Definition of loss

(No Recommended Revisions)

1. Financial instruments held in custody by the depositary or, as the case may be, by a sub-custodian should be considered 'lost' within the meaning of Article 21 (12) if one of the following conditions is met:
 - (a) a stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed;
 - (b) the AIF has been permanently deprived of its right of ownership over the financial instruments;
 - (c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments.
2. The assessment of the loss of financial instruments must follow a documented process readily available to competent authorities and lead to the notification of investors in a durable medium taking into account the materiality of the loss.

Where an AIF is permanently deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments, for example in situations where shares are cancelled and replaced by the issue of new shares in a company reorganisation, this is not considered to be an example of the loss of financial instruments held in custody.

In case of insolvency of a sub-custodian, financial instruments should be considered 'lost' as soon as one of the conditions set out in §1 is met with certainty and at the latest, at the end of the insolvency proceedings.

To that end, the AIFM should monitor closely the proceedings to determine whether all or part of the financial instruments entrusted to the sub-custodian is effectively lost.

In case of a fraud whereby the financial instruments have never existed or have never been attributed to the AIF (e.g., as a result of a falsified evidence of title, accounting fraud, etc.), all conditions described in §1 should be deemed to be met.

ETDF comments:

ETDF overall agrees with the ESMA's definition of loss of a financial instrument provided that the definition of the financial instruments held in custody (box 78) is amended as suggested by ETDF. Should a different wording be retained for box 78, the assets should not be deemed to be lost, unless the loss is caused by the depositary's failure or negligence.

This been said, and whilst we agree that the board of directors of the AIF or AIFM has to play a key role in the determination of whether an asset is lost or not, we believe that the decision remains ultimately the competence of the local jurisdictions where the assets are held. There is indeed a myriad of circumstances that could lead to the permanent loss of the assets (e.g. settlement system rules, market infrastructure deficiencies, local market conditions, appointment of counterparties by the AIFM, investment decision of the AIF...) and the interpretations, especially when driven by the civil law, could potentially diverge from one country to another. On that basis, Explanatory note 19 seems problematic.

2 External events beyond reasonable control

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

[...]

(g) what is to be understood by external events beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary pursuant to paragraph 12;

Extract from Level 1 Directive

12. The depositary shall be liable to the AIF or to the investors of the AIF, for the loss by the depositary, or a third party to whom the custody of financial instruments held in custody according to point (a) of paragraph 8 has been delegated.

In the case of such a loss of a financial instrument held in custody, the depositary shall return a financial instrument of the identical type or the corresponding amount to the AIF or the AIFM acting on behalf of the AIF without undue delay. 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.

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions and circumstances for events to be considered as:
 - (i) external;
 - (ii) going beyond reasonable control, and;
 - (iii) having consequences which would have been unavoidable despite all reasonable efforts to the contrary.
2. If possible, ESMA is requested to advise the Commission on a non-exhaustive list of events where the loss of assets can be considered to be 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. ESMA is encouraged to consider the appropriate form (e.g. guidelines) of such a list.

Box 91

Definition of ‘external event beyond the depositary’s reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary’

(Recommended Revisions as Marked)

The depositary will not be liable for the loss of financial instruments held in custody by itself or by a sub custodian if it can demonstrate that all the following conditions are met:

1. The event which led to the loss did not occur as a result of an **improper act or failure act-or omission** of the depositary or one of its sub-custodians to meet its obligations
2. The event which led to the loss was beyond its reasonable control, i.e. it could not have prevented its occurrence by reasonable efforts

3. Despite **its reasonable efforts rigorous and comprehensive due diligences (in accordance with the national regulations and contractual arrangements with its sub-custodians)**, it could not have prevented the loss.

Subject to requirements of §1 and §2 being fulfilled, the depositary or the sub-custodian could be regarded as having made reasonable efforts to avoid a loss of a financial instrument held in custody if it can prove that it has taken all of the following actions:

- (a) it has ensured that it has the structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF, to identify in a timely manner and monitor on an ongoing basis any external events which it considers may result in a loss of a financial instrument held in custody
- (b) it has reviewed on an ongoing basis whether any of the events it has identified under point (a) present a significant risk of loss of a financial instrument held in custody
- (c) where it has identified actual **or potential** external events which it believes present a significant risk of loss of a financial instrument held in custody, it has taken appropriate actions, if any, to prevent or mitigate the loss of financial instruments held in custody

The above described conditions will apply to the delegate when the depositary has contractually transferred its liability to a sub-custodian.

The three above conditions are deemed to be met in case of insolvency of a sub-custodian.

ETDF comments: We understand that ESMA’s goal in providing its advice on the depositary provisions of AIFMD is to “strike *the right balance between the directive’s objective to set strict rules to ensure a high level of investor protection while at the same time not putting the entire responsibility on the depositaries as this would counterproductively create the incentive for regulatory arbitrage and in some cases may lead to increased systemic risk.*”

We support this objective. It is also important that the advice recognise and adequately reflect the key decision making role of the AIFM and provides access to AIFs that meet investors’ needs. These factors

are particularly important in considering the advice relating to 'External events beyond the reasonable control' of the depositary.

Notwithstanding the above, we would recommend the following changes to box 91:

- Point 1: We consider this proposed qualification necessary as it would be inequitable to hold the depositary liable in circumstances where it has not acted improperly.
- Point 3: Given that the Commission requested advice on what might constitute 'reasonable efforts' to avoid the consequences of an external event, we believe that the commencement of paragraph 3 should be amended accordingly. This would better reflect the wording of the Directive and the request for advice. The Directive does not refer to 'rigorous and comprehensive due diligences' and, in any event, paragraph 3 is intended to spell out what might be considered 'reasonable efforts'.

We also recommend further changes to the Box based on our interpretations of the current texts and review of the related explanatory text paragraphs:

Interpretations of the current texts

a) Definition of External event

ETDF is of the opinion that ESMA's draft advice on the definition of "external event" goes beyond Level 1 text. The interpretation that appears to have been taken of Article 21(12) of the Level 1 text is that the acts and omissions of any appointed sub-custodian are automatically deemed not to be "external events". The effect of that is that the depositary is strictly liable for all acts and omissions of any sub-custodian. There is nothing in Article 21(12) that requires or, in ETDF's view, even supports such an interpretation of the word "external". This issue is of such fundamental importance that such an interpretation could be considered to be a *de facto* amendment of the Level 1 text, which would go beyond ESMA's mandate to provide the Commission with technical guidance.

If ESMA's proposed interpretation of the word "external" is taken forward and accepted by the Commission, not only would this in ETDF's view be contrary to the Level 1 text, but the practical result is likely to be highly counter-productive. Capital costs to depositaries would increase significantly. Those costs, which will probably be uninsurable and would inevitably be ultimately borne by the AIF and investors in the AIF, in order for any depositary's business model to be sustainable.

ETDF also suggests to clarify that due diligences should be limited to aspects and circumstances pertaining to the custodial functions (and NOT to all possible other events such as political and natural events and disasters that should remain within the remit of the responsibilities of the AIF (or AIFM)).

'External' should be interpreted in a strict way, as everything that is not related to the depositary or any of its affiliates.

Following this rationale, the insolvency of a sub-custodian is an external event by nature which may prevent a depositary getting back the assets entrusted to a sub-custodian, despite rigorous due diligences performed by the depositary in relation to the segregation of the AIF's assets.

Indeed experience has shown that client's assets may have been used before insolvency in a desperate attempt to avoid the bankruptcy and inaccurate securities statements(fakes) may have been provided to the depositary. .

Assuming in all cases that an event should be deemed 'internal' if it did occur as the result of an act or an omission of the sub-custodians of the depositary:

- would not be neither in the interest of the fund industry nor in the depositary's other clients interest ,
- would lead to a concentration of the activity and of the systemic risk within a small number of global custodians that are direct members of CSD/ICSD .

The ETDF is of the opinion that, as long as it has fulfilled its duties, a depositary should never have to assume, directly or indirectly, the financial consequences of an investment decision taken by an AIFM. Qualifying events related to a sub-custodian as internal would go against such assumption.

As an example, we could think of a situation where a sub-custodian becomes insolvent following a fraud. In such a situation the depositary would have to face financial consequences since it would have to return the financial instruments which have been lost, but may not have any recourse to the sub-custodian since the latter is insolvent.

Finally, ETDF is concerned that AIFMs may choose to invest in countries with less secure internal infrastructure, safe in the knowledge that the depositary will be liable for any losses. ETDF does not believe that the burden of such risks should be placed on depositaries

b) Definition of the due diligences to be performed by the depositary

-ETDF is of the opinion that the wording used in Box 91 lacks clarity. As such it opens the way for diverging implementations in the EU Members States that would prevent full harmonization (see comments below in relation to explanatory notes 38 & 39)

The proposed advice should not include circumstances whereby the depositary would have to make act or decision that fall into the AIF/AIFM scope of duties/liability. In addition the advice should recognize that sub-custodians are regulated entities in their jurisdictions. In this respect a third party such as the depositary cannot be requested to, and made liable for, supplement supervisory duties.

It is our opinion that imposing a requirement of "rigorous and comprehensive due diligence" does not reflect the Level 1 text and could be read as requesting the depositary to go far beyond "reasonable efforts". The word "comprehensive", in particular, could be understood as imposing to the depositary to do all-encompassing due diligence, covering as wide a range of theoretical possibilities as may be conceived, regardless of how reasonable it might be to do so.

Review of the explanatory notes

- Paragraph 26: This paragraph currently states "although some events appear by nature 'external' to the depositary (e.g., nationalisation, war, legal or political changes, etc)..." (Our emphasis). We think this should be made a more definitive statement by replacing "appear" with "are" and removing the "etc".
- Paragraph 29 – With regard to fraud taking place within a sub custodian, the final sentence implies that such fraud would be deemed internal and so the depositary would be liable. We strongly disagree with this statement. Provided that a Depositary has met the due diligence duties in Box 88 then fraud within the sub custodian should not mean the consequential loss is to be borne by the Depositary.

- Paragraph 30: We welcome ESMA's clarification that market closures or a technical failure at the level of the Central Securities Depository or any other settlement system should be considered 'external'.
- Paragraph 34: We consider that the last sentence is not necessary as the subject matter belongs to the next section (i.e. paragraph 35 onwards regarding the meaning of 'reasonable efforts').
- Paragraph 37: The last sentence makes this paragraph unclear. The first sentence rightly recognises the fact that there may not be any appropriate action to take except informing the AIFM and gives the example of a nationalisation where there is no 'appropriate action' to be taken by the depository within reasonable efforts. The last sentence then contradicts all that has gone before that by stating that informing the AIFM is not sufficient to discharge the depository of its liability. We believe that the last sentence should be deleted.
- Paragraphs 38 and 39: We have serious reservations about the workability of the proposals regarding 'appropriate action' as outlined in these paragraphs. We also believe that it does not meet ESMA's goal of striking the right balance as mentioned at the beginning of this section. In addition, it does not recognise the key decision making role of the AIFM nor will it necessarily meet investors' needs.

In a situation where a depository believes that the only appropriate action is to dispose of the financial instruments and it informs the AIFM, if the AIFM disregards this advice, the only remaining appropriate action is that of notifying the AIFM's competent authority. Such notification to the AIFM's competent authority should be sufficient to discharge the depository of its liability as it will have made all reasonable efforts. It should not be unreasonable to expect the competent authority to have a responsibility to ensure that the AIFM is acting in a manner that is not going to cause investor detriment or potentially create greater systemic risk. The AIFM should also be under a direct duty to demonstrate that it is not acting negligently. The above approach also recognises the fact that it is the AIFM who has responsibility for portfolio management and who ultimately makes the decision whether or not to act upon the alert from the depository.

The process outlined in these paragraphs would not work in practice and would leave a depository with open-ended liability until such time as it is able to terminate the contract in respect of something it has made all reasonable efforts to address. The paragraphs indicate too that the AIF is to be given a period of time to find another depository. If a depository is terminating an agreement because the AIFM chooses not to act upon its advice, how likely is it that the AIFM will find another depository willing to take on the AIF? We question also whether it would be in the interests of AIF investors to effectively force their depository into terminating its contract as a means of discharging its liability.

We recommend that the Advice sets out the following:

- In a situation where a depository believes that the only appropriate action is to dispose of the financial instruments and it informs the AIFM, if the AIFM disregards this advice, the only remaining appropriate action is that of notifying the AIFM's competent authority. Such notification to AIFM's competent authority discharges the depository of its liability.
- In the above situation, the AIFM has a duty to consider the depository's view. If it decides to retain the investments, that is an investment decision and, unless the AIFM has acted negligently, liability in the event of a loss rests with the AIF.

- A requirement for the depositary to periodically review the situation such that as and when the depositary is of the view that the issue which led to the transfer of liability is no longer a concern, the depositary informs the AIFM and liability is transferred back to the depositary. As an alternative this suggestion, the discharge could be the subject of a “sunset clause” – it would be time limited and the depositary would have to re-notify.

ESMA could also consider requiring AIFMs to cover this possibility in their pre investment disclosures to investors under Article 23(d). This would allow investors to make an informed decision. If the situation then arises, ESMA could require that an AIFM to inform investors of its decision following the notification received from the depositary and remind investors of the potential consequences of its decision for the AIF. Investors could then make an informed decision as to whether or not to retain their holding in the AIF.

The above proposal would “strike the right balance between the directive’s objective to set strict rules to ensure a high level of investor protection while at the same time not putting the entire responsibility on the depositaries”.

3 Objective reason to contract a discharge

Scope of the Commission’s implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

[...]

(h) the conditions and circumstances under which there is an objective reason to contract a discharge pursuant to paragraph 13.

Extract from Level 1 Directive

The depositary’s liability shall not be affected by any delegation referred to in paragraph 11.

Notwithstanding the first subparagraph of this paragraph, in case of a loss of financial instruments held in custody by a third party pursuant to paragraph 11, the depositary may discharge itself of liability if it can prove that:

- (a) all requirements for the delegation of its custody tasks set out in the second subparagraph of paragraph 11 are met;*
- (b) a written contract between the depositary and the third party expressly transfers the liability of the depositary to that third party and makes it possible for the AIF or the AIFM acting on behalf of the AIF to make a claim against the third party in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf;*
- (c) a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, expressly allows a discharge of the depositary’s liability and establishes the objective reason to contract such a discharge.*

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions and circumstances under which there is an objective reason for the depositary to contract a discharge pursuant to Article 21(13).
2. In its advice, ESMA is encouraged to provide an indicative list of scenarios that are to be considered as being objective reasons for the contractual discharge referred to in Article 21 (13).

Box 92

Objective reasons for the depositary to contract a discharge

(Recommended Revisions as Marked)

The depositary will be deemed to have an objective reason to contractually discharge itself of its liability in accordance with the requirements set forth in Article 21 (13) if it can demonstrate that:

Option 1

~~1. it had no other option but to delegate its custody duties to a third party (e.g. as a result of legal constraints); or~~

~~2. it has agreed with the AIF or as the case may be the AIFM through a written agreement that it is in the best interest of the AIF and its investors to delegate such duties (e.g. if the delegate is in a country where the depositary does not operate).~~

Option 2

Where the AIF or, as the case may be, the AIFM and the depositary have explicitly agreed through a written contract that the depositary can discharge its responsibility, it should be considered that the requirement to have an objective reason is fulfilled.

ETDF Comments: The ETDF has a clear preference for option 2 as it remains the most pragmatic option. Option 1 refers to "best interest of the AIF and its investors". This notion remains very broad and in some situations challenging to establish. In addition, option 1 does not take into consideration scenarios where the depositary could actually perform its custody duties but the AIF or AIFM decided to use a third party instead (established relationship, bundled service offering...). Finally, option 1 does not as such provide required legal certainty. Indeed the fact that it would be up to the depositary to demonstrate that it had "no other option" or that it has "agreed ... it is in the best interest" is likely to give rise to subsequent legal challenges with all the ensuing complications and this can ultimately not be in the interest of the purported aims of the AIFMD to foster clear and transparent rules.

Q47: What are the estimated costs and consequences related to the liability regime as set out in the proposed advice? What could be the implications of the depositary's liability regime with regard to prudential regulation, in particular capital charges?

ETDF Comments: Providing estimated costs and elaborating on the impact on the business strategy as a result of the introduction of a completely new liability regime constitute at this stage a major challenge for the depositary community for the following main reasons:

- We have to keep in mind that the proposed new legislation has only been issued recently and the market players are still engaged in the first phase of the analysis i.e. "decryption" of

the text and high level impact assessment of levels 1 and 2. Whilst some participants have initiated more detailed analysis on the costs element (e.g. impact assessment in terms of capital requirements including pillar III), it is fair to say that organizations are still in an early stage to come up with costs estimates and impact on their business strategy and business model. Organisations would therefore need more time come up with some estimates,

- Information on costs and business strategy are very sensitive information because of the competitive implications. This type of information is and cannot be disclosed even to the forums or associations.

This been said, there are already some trends that could be anticipated should this liability regime remains as currently presented:

- The liability regime imposed on depositaries as currently suggested in the proposed text could somehow be assimilated to an insurance scheme for AIF's. Depositaries might in that context consider insuring part or all (if possible) of their risks associated to this new regime. Depositaries will not have other choice than recharging the costs associated to this insurance scheme back to the AIF and therefore the investors
- The proposed advise could create barrier entries to the depositary market. Some players on the market will most likely seriously reconsider whether they still want to offer depositary bank services. This situation could as a consequence, trigger a further consolidation on the depositary market

Ultimately, whilst one of the main objectives of the Directive was to reduce systemic risks, imposing such a liability regime on the depositary will unfortunately contribute to significantly increase those risks and additional costs to be recharged to the investors.

Q48: Please provide a typology of events which could be qualified as a loss in accordance with the suggested definition in Box 90.

ETDF Comments: As highlighted previously, the notion of loss is quite complex and every case must be reviewed and analysed in isolation. We would like also to stress the point that qualification as a loss remains ultimately the decision of the local jurisdiction.

The ETDF agrees with the principle and rules based approach laid down in Box 90. However, a typology can only be a non-exhaustive list. Below are suggested events (non exhaustive) that follow the current draft definition of "loss" proposed by ESMA in Box 90:

- a) A stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed:
 - Fraud resulting in the permanent loss of the financial instrument

- b) the AIF has been permanently deprived of its right of ownership over the financial instruments:
 - Nationalisation of the issuer – the financial instruments of the issuer are nationalised, expropriated or are otherwise required to be transferred to any governmental agency, authority or entity.
- c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments:
 - Change in relevant law e.g. due to the adoption of or change in any applicable law or regulation (including tax laws) it becomes illegal to hold, acquire or dispose of the financial instruments.
 - In some cases, government action may result in "loss" e.g. where a government (or governmental institution or agency) has taken action which had the effect of permanently and irretrievably preventing the transfer, sale or other disposition of the financial instruments.
 - In some cases, national or international embargoes i.e., a government (or government institution or agency) or an international organisation has announced a trade embargo affecting the ability to transfer, sell or dispose of the financial instruments) may be sufficiently permanent that the financial instruments can be considered "lost".
 - Liquidation, dissolution or winding up of issuer (ESMA rightly recognises, only where it becomes certain during (or at the end of) the insolvency process that the financial instruments are permanently and irretrievably lost).

In addition, the ETDF would like to make the following comments:

- Depositaries cannot be made liable for events outside their sphere of control and influence. it should be clarified that in case of loss resulting from a fraud whereby the financial instruments have never existed or have never been attributed to the AIF as a result of a falsified evidence of title it is not the responsibility of the depositary to return the assets. Indeed it is a part of investment process of the AIFM and it comes under its responsibility to ensure satisfactory title to financial instruments when the AIFM decides to invest in financial instruments in order to prevent fraudulent behaviour of the issuer or from the seller. The depositary has to ensure the AIFM has set up an appropriate procedure to monitor this risk but requiring the depositary to ensure satisfactory title to financial instruments would be beyond the current requirement to keep safe the assets, would require additional processes in all markets and lead to significant additional costs.
- The AIFMD Level 1 itself is clear on this as reference is made to "the loss by the depositary or a third party to whom the custody of financial instruments ... has been delegated". Box 90 seems to go beyond what Level 1 permits. This is certainly not the intention and hence Box 90 should be clarified appropriately by adding at the end of paragraph 1. "due to a wrongful action or omission of the depositary as prescribed by the AIFMD"
- There is need for further clarification of the requirement of the "notification of investors". What will the rule be in case of a dispute concerning if there has been a loss and/or whether such loss is covered by the liability exemption of an "external event"?
- We do not see how the depositary can "determine" in case of a sub-depositary's insolvency whether all or parts of the assets are "lost". This is ultimately a matter for the competent courts to decide and not for the depositary. At best the depositary can provide a non-binding preliminary assessment

Q49: Do you see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD?

ETDF Comments: the ETDF does not see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD provided that the notion of “effects of the segregation” is defined clearly. Due diligences in relation to segregation requirements should be set as an obligation of means and not as an obligation of results. This applies not only with respect to the assessment of foreign laws and regulations but as well as with respect to the assessment of effective implementation of segregation at sub-custody level.

Where the condition outlined above is assured, the ETDF strongly supports this proposal, and considers that matters relating to local legislation are inherently “external”. Local law and local courts decisions are, by definition, entirely outside the control or influence of the depositary. Further, changes in local legislation are also inherently unpredictable. The ETDF cannot see any justification for any matter pertaining to local law/court decisions being treated as an “internal” event.

Q50: Are there other events which should specifically be defined/presumed as ‘external’?

ETDF Comments: subject to the same observations as the ones provided in our response to question 48, the table below provides a non exhaustive list of circumstances that should be considered when assessing the “external” nature of an event triggering the loss of an asset of the AIF.

- | | |
|---|--|
| 1. Settlement system rules, market practices or other market infrastructure-imposed constraints | <ul style="list-style-type: none"> • Rules which apply in the event of settlement failures in non-DVP markets; • Compulsory liens and transaction reversal requirements imposed by central securities depositaries (including liens imposed by sub-custodians as a result of CSD requirements); • Non-exclusive control of accounts under client-specific account structures. |
| 2. Local Market Problems | <ul style="list-style-type: none"> • Market infrastructure outages or failures; • Sub-standard market infrastructure (such as systems of registration); • Fraud by or insolvency of sub-custodian. |
| 3. Local Market Conditions | <ul style="list-style-type: none"> • Widespread issuer defaults; • Market closures and currency devaluations; • Acts of state (sovereign events). |
| 4. Appointment of Counterparties by AIFM | <p>Failure of the AIFM's chosen counterparty in the context of:</p> <ul style="list-style-type: none"> • Securities lending and repo arrangements; • Prime brokerage arrangements involving rehypothecation of AIF assets; or • Derivatives transactions. |

5. Other External Events
- Acts of God;
 - Acts of third parties (such as an issuer or its agent)
 - *Acts of war, terrorism, insurrection or revolution.*

While our preference is for a rules and principle based approach, the ETDF may mention that all types of operational failures outside the sphere of influence of the depositary and its network are typically “external” events and the same goes for claims of third parties to be the true legal owner of a financial instrument

The ETDF would invite ESMA to consider if the box 65 “objective reasons” should not be extended to depositaries, this would probably clarify circumstances of discharge.

Q51: What type of event would be difficult to qualify as either ‘internal’ or ‘external’ with regard to the proposed advice? How could the ‘external event beyond reasonable control’ be further clarified to address those concerns?

ETDF Comments: We make reference to our comments in response to Q 48 regarding the sphere of influence and the need to clarify that the relevant due diligence and similar obligations are obligations of means.

In particular, most of the players active in the security servicing business do operate on platforms or use tools qualified as market standard that are owned or operated by third parties under service contract and/or software license (e.g. SWIFT messaging system, infrastructure used by clearing houses...). It is commercially impossible for the end-users of these tools to transfer their liability onto those service / IT infrastructure providers. Whereas the fact that depositaries do monitor the performance of those systems, we still believe that the depositary should not be held responsible in case of error or failure of those systems.

Q52: To what extent do you believe the transfer of liability will / could be implemented in practice? Why? Do you intend to make use of that provision? What are the main difficulties that you foresee? Would it make a difference when the sub-custodian is inside the depositary’s group or outside its group?

ETDF Comments: Arrangements whereby the depositary will transfer its liability could be envisaged in situations where the AIF wants to use Prime Brokers and sub-custodians which, by essence, do not meet the eligibility criteria’s for Depositary Bank but still perform safekeeping function throughout their own sub-custodian network, or when the AIF or AIFM impose on the depositary a particular sub-custodian as a result of market or commercial reasons.

This been said, the “transfer of liability” might be difficult to implement in practice as a result of the lack of legal harmonization across the globe regarding the definition and requirements to achieve an effective transfer of that liability.

As a consequence, ESMA's position considering sub-custodians outside the depositary's group as "internal" is a major concern for the depositary community in the absence of a harmonized framework and effective mechanisms allowing the depositary to discharge its liability. The end result means a strict liability regime imposed on the depositary which will contribute to increase significantly the systemic risk.

The transfer could eventually be organized provided that the depositary and the sub-custodians (as well as their local jurisdictions) accept that the AIF/AIFM may directly place a claim with regard to assets in custody with the third party. This might be instrumentalised by a provision in the written contract between the depositary and the third party (as referred to in condition b) in level 1 Directive extract) authorizing the depositary to act as an intermediary on behalf of the AIF /AIFM, without being itself party to the claim.

Q53: Is the framework set out in the draft advice considered workable for non-bank depositaries which would be appointed for funds investing mainly in private equity or physical real estate assets in line with the exemption provided for in Article 21? Why? What amendments should be made?

ETDF Comments: Whilst the proposed option can be envisaged for funds investing in private equity and real estate funds, ETDF questions whether non-bank depositaries are well placed and well equipped to act as custodians for financial instruments in the first place. Indeed it may be sensible to ensure that the exemption in Art. 21 does not come into play in cases where the assets comprise financial instruments that are held in custody.

Q54: Is there a need for further tailoring of the requirements set out in the draft advice to take into account the different types of AIF? What amendments should be made?

ETDF Comments: the diversity of funds captured by the Directive is intrinsically linked to the broad range of asset classes held by those funds. As a consequence, ESMA might want to further tailor the advice dealing with the distinction between assets under 21.8 (a) and those under 21.8 (b). Finally, ETDF is in favor, whenever possible of an alignment between AIFM and UCITS regulations for depositaries.