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European Fund and Asset Management Association

EFAMA Response to the ESMA's Call for Evidence on asset segregation and custody services (ESMA/2016/1137)

EFAMA is the representative association for the European investment management industry. EFAMA represents, through its 28 member associations and 62 corporate members, EUR 21 trillion in assets under management, of which EUR 12.6 trillion is managed by 56,000 investment funds end 2015. Just over 30,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 25,900 funds composed of AIFs (Alternative Investment Funds).

Preliminary considerations

EFAMA welcomes ESMA's Call for Evidence on asset segregation and custody services as a precious occasion to confirm our previous key messages - as per our response to the previous consultation around *Guidelines on asset segregation under the AIFMD* of December 2014 – and to clarify our position on new aspects of ESMA's work. We refer in particular to the practicality of the initial two options envisaged by ESMA in its 2014 consultation in meeting the desired policy goals, as well as to the treatment of certain CSDs as third-party delegates subject to UCITS/AIFM Directive rules on liability.

With regard to the first point, we wish to reiterate the view held by a clear majority of our Members, whereby individual account segregation as per Options 1 and 2 of the ESMA 2014 consultation would be impractical to implement and where the policy goal of guaranteeing the protection of UCITS/AIF fund assets from the insolvency of a third-party delegate is sufficiently guaranteed via separate book-keeping in the accounts of the delegating depositary institution. Larger pools of securities in omnibus accounts would also facilitate the use of tri-party collateral management agreements, as well as broader market liquidity.

As to the second key aspect of our response, we believe that the relevant pieces of EU legislation (i.e. the UCITS/AIFM Directives and CSDR) would deserve to reflect the distinction between an "issuer" CSD and "investor" CSD in light of a clear "liability gap" between UCITS/AIF depositaries and certain CSDs, where the latter become interposed in the sub-custody chain while competing with depositaries through the offer of ancillary services.

We regret that the time allowed for stakeholders to respond to some of the very detailed questions in the Call for Evidence has been extremely short. Our response will therefore unfortunately not be able to address some of the questions to the extent their relevance would deserve.

Q1: Please describe the model of asset segregation (including through the use of 'omnibus accounts') in your custody chain/the custody chain of the funds that you manage. Please explain what motivates your choice of asset segregation at each level (e.g. investor demand, local requirements, tax reasons). In your description, please take into account the following:

a) please describe – with the use of a chart/diagram – at least three levels of account-keeping in your custody chain, as follows:

i) the first level should be the level of the AIF/UCITS-appointed depositary,

ii) the second level should be the level of a third party delegate of the depositary, and

iii) the third level should be the level of a sub-delegate of the third party delegate or the CSD, where applicable.

You may wish to add further levels of accounts, depending on your custody chain.

b) if you use 'omnibus accounts' (i.e. accounts, in which the assets of different end investors are commingled, rather than each individual investor's assets being held in a separate account) at any level of the custody chain, please provide, in as clear and detailed a manner as possible:

i) an explanation including at which level of the chain you use them;

ii) a description of the features of these accounts (e.g. whose assets are held in them, who holds title to those assets or is considered to be the end investor, etc. - e.g. AIF, UCITS, other clients, depositaries or their third party delegates);

iii) an explanation on how any restriction on reuse of the assets applying to the funds (AIF/UCITS) which you have in custody/manage (e.g. the restriction under Article 22(7) of the UCITS Directive) is respected, when they are held in an omnibus account at a given level; and

iv) the number or percentage of 'omnibus accounts' versus 'separate accounts' in your custody chain.

c) if you do not use 'omnibus accounts', please specify why and how far down the chain it is possible for you not to use them (i.e. whether this works in all situations or, if it is necessary to use 'omnibus accounts' at some level of the custody chain, at which level)?

d) in the chart/diagram to be provided under a), if applicable, please refer to the five options in the table under Q22 below and specify if your model matches or closely matches with any of the models described therein.

e) if your model makes any distinction between AIF and UCITS assets, please highlight the difference between the two in the chart/diagram to be provided under a).

f) According to a Briefing Note published by ECON in 2011, there are five basic models for holding securities with an intermediary: the trust model, the security entitlement model, the undivided property model, the pooled property model and the transparent model. ESMA is interested in gathering evidence on whether there may be any link between certain securities holding models and certain asset segregation models. Therefore, ESMA invites stakeholders to provide input to the following questions:

i) What securities holding model do you use?

ii) Is such model the market standard in your jurisdiction?

iii) Is the market standard model in your jurisdiction one of the five mentioned above, or a different one? If a different one, please provide details.

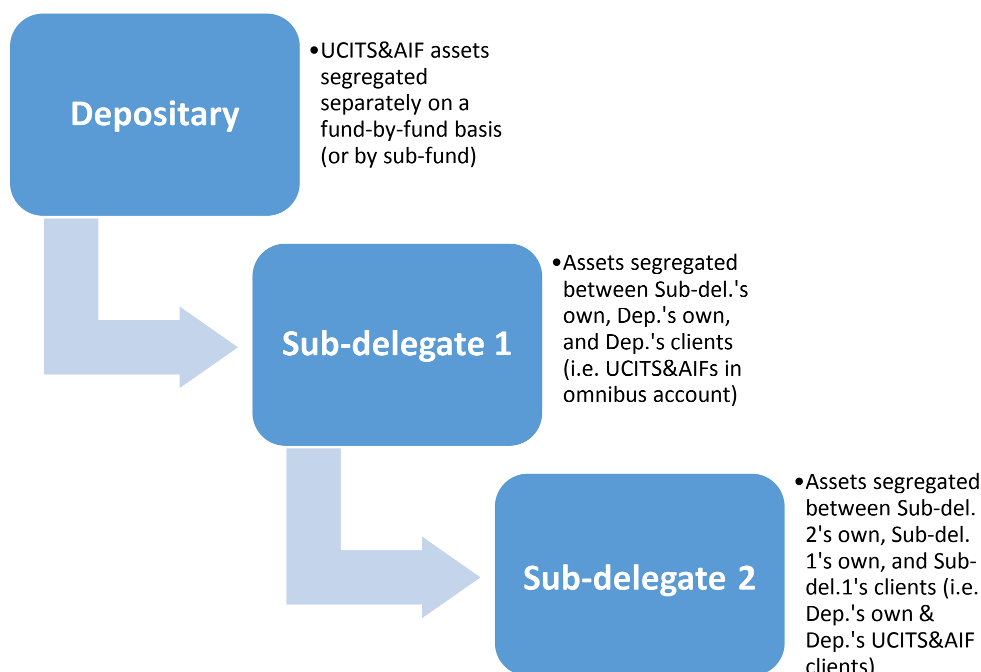
iv) Does the model you refer to under f) i) require a particular way of segregating assets or omnibus accounts at one of the levels referred to at letter a) above? If yes, please specify.

g) Please explain the naming conventions (i.e. in whose name is the account opened) applied to the accounts with the delegates/sub-delegates of the depositary in the model described under answers to questions a) to e) above. Please also specify if there are instances where the accounts with the immediate delegate of the depositary are opened in the name of the funds.

Given the very specific nature of the questions, we refer the ESMA to the replies of individual firms.

Q2: Please explain how, under the framework you have described in your response to Q1, the assets of the AIF/UCITS are protected against the insolvency of any of the parties involved in the custody chain (depositary, delegate, sub-delegate, – including prime broker – CSD) and – in case of use of 'omnibus accounts' – of their other clients whose assets are also held in this same account. In particular, what happens if a party, whose assets are held in another party's 'omnibus account', becomes insolvent? Does this place at any disadvantage the other parties using the omnibus account who are not in default?

In order to respond to the questions above, we refer to the following stylised table (conform to the "minimum" segregation requirements under Article 21(11) letter d) (iii) of the AIFM Directive) to illustrate our answer, assuming that there are two degrees of delegation below the appointed UCITS/AIF Depositary:



Should a party, whose assets are held in another party's omnibus account, become insolvent (e.g. the insolvency of the Depositary whose own assets are held in an omnibus account structure at the level

of Sub-delegate 2, together with the assets of the Depositary's UCITS/AIF clients), the other parties' assets (the UCITS/AIF clients as per our example) would not form part of the bankruptcy estate of the Depositary. Likewise, creditors of an AIF whose assets are held in an omnibus account with other UCITS/AIF assets at the level of Sub-delegate 1. In both cases, creditors could only claim against the Depositary and it is the latter's updated books and records (reconciled periodically with the records of the Sub-delegates) that guarantees the traceability of the assets' title independently from the degrees of delegation and type of segregation along the sub-custody chain.

The segregation model as set out in the stylised table above is also fully in line with the legislative objectives of the asset segregation requirements under the revised UCITS framework. In fact, according to Article 22a(3) letter d of "UCITS V", the custody functions may be delegated by the depositary to a third party only "(…) where that third party at all times during the performance of the tasks delegated to it takes all necessary steps to ensure that in the event of insolvency of the third party, assets of a UCITS held by the third party in custody are unavailable for distribution among, or realisation for the benefit of, creditors of the third party". The same prerequisite for the sub-delegation of custody functions is imposed by Article 99, in connection with Recital (122) of the AIFM delegated Regulation. It clearly follows from these provisions that the relevant asset segregation requirements aim to prevent that, in the event of a sub-delegates' insolvency, the safe-kept assets fall within the sub-delegate's insolvency estate. Hence, any specification of the asset segregation requirements must ensure the clear traceability - via book-keeping registration - of the assets' title throughout the custody chain.

Please note, however, that this description would only apply to securities. Regarding cash, in case of the insolvency of the depository or sub-delegate, cash would be amalgamated to the assets of the defaulted entity, giving rise to a credit against the defaulted entity and thus subject to a recovery rate). Please also refer to our answer to Q.3 below.

Q3: Please describe the differences (if any) between 'omnibus accounts' (i.e. books and records segregation) and separate accounts in terms of return of the assets from the account in a scenario of potential insolvency or insolvency. In particular, please indicate whether the assets may be transferred to the depositary or another delegate more easily and/or quickly under a particular insolvency regime from either of the two types of account and explain why. If possible and relevant, please (i) distinguish among the various jurisdictions of which you have knowledge and (ii) explain whether a specific type of account may have an impact on the timeline for the aforementioned transfer of assets or, more generally, on the order of events in a scenario of potential insolvency or insolvency.

In line with our response to the ESMA consultation paper on *Guidelines on asset segregation under the AIFMD* of December 2014 (ESMA/2014/1326), we maintain that the account segregation requirements beyond those envisaged under Article 21(11) letter (d) (iii) – i.e. where the third-party segregates the assets of the depositary's clients from its own assets and from the assets of the depositary – would <u>not</u> essentially improve the degree of traceability of client securities' entitlements in the event of the third-party delegate's insolvency. The minimum degree of segregation contemplated by the above clause would already ensure that all assets, other than those of the defaulting third-party, remain "bankruptcy remote" from any eventual claim advanced by the latter's creditors. In this regard, we therefore wish to draw the ESMA's attention to the important distinction between record (or "book")

segregation and account segregation, where the former would suffice in ensuring that AIF assets are adequately protected in the context of bankruptcy proceedings involving a third-party delegate, or further sub-delegates thereof, in a third-country jurisdiction.

In this regard, EFAMA would again wish to draw the ESMA's attention to the specificity of the record-keeping obligation set forth under Article 16(1) of the Directive 2006/73/EC, related to the implementation measures of the MiFID. This clause requires the third-party to "distinguish" 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. On the other hand, the "segregation" between assets belonging to AIFs and assets belonging to non-AIFs at the level of the third-party delegate, as proposed under both Option 1 and Option 2 of the ESMA 2014 consultation paper, would in no way either strengthen the protection of AIF assets, or contribute to more transparency in the intermediated holding chain for the purpose of increasing investor protection, when compared to their mere "distinction" via record segregation. These views were more recently also largely echoed by the majority of industry participants invited to the ESMA roundtable on asset segregation and custody services which took place last 20 July at the ESMA premises in Paris.

Finally, from a non-EU, third country perspective, the maintenance of individual segregated positions throughout the custody chain – as per Option 1 – is generally recognised as not operationally feasible outside the EU. In other words, the imposition of a requirement to segregate beneficial ownership throughout the entire holding chain assumes a holding chain entirely subject to the jurisdictional control within the EU. In practice, such is not the case with regard to securities held via chains extending outside the EU, where detailed segregation requirements may not be compatible with prevailing insolvency laws, regulations or market practices.

Q4: Should you consider that asset segregation pursuant to options 1 and 2 of the CP does not provide any additional protection to the existing arrangements you described in your response to Q1 in case of insolvency, and that these arrangements provide adequate investor protection, please explain which aspects of the regime contribute to meeting the policy objective through measures including:

i) effective reconciliation,

ii) traceability (e.g. books and records), or

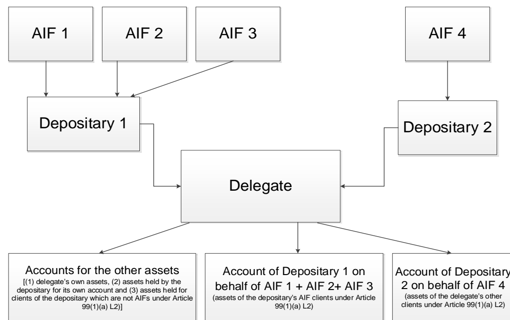
iii) any other means (e.g. legal mechanisms).

Please justify your response and provide details on what any of the means under i) to iii) consist of.

Given the very specific nature of the question, we refer the ESMA to the replies of individual firms.

Q5: In the chart below (option 1 of the CP), AIF 1 would only have recourse against Depositary 1 under the PRIMA concept.

a) In the event of, for instance, a default of Depositary 2, would separate accounts at the level of the Delegate make it easier for Depositary 1 to enforce the rights in respect of the assets held in the account on its behalf against the Delegate?



b) In the event of the default of the Delegate, would separate accounts at the level of the Delegate make it easier for Depositary 1 and Depositary 2 to enforce their rights in respect of the assets held in the account on their behalf against the Delegate or its liquidators?

a) Referring to the relevant chart, to our understanding, Depositary 1 would not be impacted by the default of Depositary 2, given that the delegate segregates the accounts of the two depositaries and of their respective clients separately. Hence, the default of Depositary 2 would affect the Depository 2' own assets and these only.

b) Yes, as on the basis of our understanding of Article 21(11) letter (d) (iii) of the AIFM Directive and of our interpretation of Article 22a(3) letter c. of the "UCITS V" Directive.
More generally, we note that the PRIMA (Place of the Relevant Intermediary Account) concept is in line with the degree of segregation provided for under Article 21(11) letter (d) (iii) of the AIFM Directive, reflecting the fact that direct contractual relationships existing only between immediate parties, i.e. the UCITS/AIF investor's claims (or rights *in rem*) are enforceable only *vis-à-vis* the more immediate institution, the fund depositary. As there is therefore no bilateral contractual link between the end-investor and a given sub-custodian, the former has no entitlement over the assets in turn sub-delegated to the latter by the depositary/custodian. On this basis, the implementation of Option 1 would necessarily call for additional authentication and independent adjudication of an individual's entitlements on the assets held in sub-custody before any return can be effective. Such course of action would inevitably need to be weighed against all its related operational costs, risks and inefficiencies.

Q6: Many respondents to the CP argued that, in an insolvency scenario, imposing a model where investors have individual accounts throughout the custody chain would not necessarily provide any particular benefit over the use of IT book segregation in an omnibus account (i.e. books and records instead of separate accounts). Please explain how the level of protection indicated in the policy objective at the start of this paper can be achieved through the use of omnibus accounts. Please also:

a) describe how segregation in books and records would ensure the aforementioned investor protection;

b) provide an example of how such books and records are used in insolvency proceedings to trace and return client securities when omnibus accounts are used; and

c) explain how the above-mentioned segregation in books and records would address any of the risks of 'omnibus accounts' mentioned in recent IOSCO work.

Given the very specific nature of the question, we refer the ESMA to the replies of individual firms.

Q7: Please describe the impact of settlement process and account structures on the different levels through the custody chain in the case of

o Cross-border investments

- Through CSD Links

- In relation to cross-border investments through CSD links, what are the functions of an investor CSD?

- Through T2S

o Prime broker services

o Tri-party collateral management / securities lending.

Given the very specific nature of the question, we refer the ESMA to the replies of individual firms.

Q8: It has been argued that each time a new end investor or new AIF or UCITS is added as a customer, instead of one new account being created, many new accounts would need to be created at multiple levels in the chain of custody. If you agree with this statement, please provide further details of how this would work in practice.

We note that each time a new UCITS' or AIF's compartment is added as a customer, a new account is indeed created for that compartment. For the reasons illustrated in our response to Q.3 above, many national competent authorities consider this is sufficient only at the level of the depositary. EFAMA is aware of alternative business models, where individual accounts are opened also with the depositary's sub-delegates at lower levels of the custody chain. Although possible, the majority of our Members deem the latter practice as impractical, given the implied operational and legal burdens and increased costs, as well as in terms of foregone opportunities via the re-use of client securities (when available and within the boundaries of SFTR) for no real advantage in terms of investor protection.

Q9: If the number of accounts were increased, what effect would it have on the efficiency of settlement operations (e.g. the ability to net off transactions)?

From an efficiency standpoint, we would note that the multiplication of accounts at the different levels of the custody chain will inevitably imply greater operational risks, as participants would need to process a far greater amount of transactions/settlement instructions (reducing the efficiency of dealing block trades) and reconciliations (*inter alia*, also to support daily securities lending or EPM activities), thereby increasing the potential for false or erroneous account bookings and entries. Additional negative effects would be that higher costs, due to an increased requirement for personnel, would ultimately be borne by the investor and established business models would risk becoming unprofitable causing further market consolidation.

Q10: Many respondents to the CP argued that option 1 in the CP would prevent asset managers from:

a) executing block trades; and

b) benefiting from internalised settlements (settling across the account provider's own books rather than the books of the sub-delegate).

If you agree with the statements under a) or b), please explain the relevant issue.

Given the specific nature of the question, we refer the ESMA to the replies of individual firms

Q11: Many CP respondents indicated that the costs associated with option 1 are very significant. Please provide further data on quantifying the cost impact (including one-off and on-going) of option 1 on AIFs/UCITS (and their shareholders), depositaries, global custodians, prime brokers, delegates, their clients and the different markets?

As per our previous response to the ESMA, we note it is difficult to provide a ballpark figure relative to the costs associated with Option 1, as these very much depend on the volume of accounts and transactions involved, as well as on the level of automation in place at the level of the depositary and its eventual sub-delegates, and on the collateral management structures in place. The multiplication of individual accounts required to segregate AIF from UCITS assets throughout the sub-custody chain will inevitably imply additional costs. These would derive in terms of workload to set up additional accounts, reconciling these with internal records and ensuring related follow-ups when necessary; in terms of providing upgraded information management systems; as well as in terms of increased risks when processing corporate actions and guaranteeing settlement. It would therefore not only be a matter of multiplying tasks to be performed for each separate individual account, but it is also the monitoring of the ensuing operational risks that implies ongoing costs as participants would need to process a far greater amount of settlement instructions and reconciliations. In addition, applying a greater degree of segregation throughout the custody chain requires important infrastructure modifications, ranging from re-mapping of existing systems to the implementation of a brand new infrastructure.

For a more detailed cost estimate, where possible, we would refer the ESMA to the replies of individual firms.

Q12: Are there any advantages of using omnibus accounts not covered in your responses to other questions?

We do not think there are.

Q13: Please consider the case where a third-party delegate or sub-delegate in the custody chain also acts as a clearing member under EMIR. What would be the impact (if any) of the interaction between the approaches described under each of the options in the table under Q22 below and the choices provided for under Article 39(2) and (3) of EMIR (including if this may raise any operational difficulties)? Should you consider that there is any impact, please explain why.

EFAMA would refer the ESMA to the individual responses of depositary institutions and/or their respective representative associations.

Q14: Please describe the functioning of the following arrangements and clarify the operational reasons why, and the extent to which, the segregation requirements under option 1 would affect them:

a) tri-party collateral management arrangements;

b) prime brokerage arrangements.

Regarding tri-party collateral management arrangements under Question 14 letter a), the implementation of Option 1 would be highly impractical, given the constant and necessary exchanges of collateral throughout the trading day, to ensure that all exposures can be appropriately collateralised across a range of differing collateral eligibility profiles. The impact on the securities lending business is particularly relevant. Here, appointed lending agents offer clients a long-term, low-risk, given the over-collateralisation of the exposures to their trading counterparties. Key to the classification of the business as "low risk" is the ability to appoint triparty collateral custodians to facilitate the movement and settlement of non-cash collateral. These triparty collateral providers offer the scale and transparency that ensures that UCITS and AIF depositaries can comply with their enhanced liability and oversight requirements under their AIFM Directive and "UCITS V" obligations. Such model allows them to clearly identify, at the level of each UCITS or AIF fund, the allocated collateral.

Typically, managers of UCITS or AIFs will entrust lendable assets to a lending agent (i.e. either a custodian, an asset manager or a third-party provider). Although these lendable assets may be held in custody within a local jurisdictions (e.g. Japanese equity in Japan), they are often (book) registered into a common omnibus pool, where assets from other beneficial owners (e.g. direct asset owners, such as insurance companies, pension funds, SWF, etc.) may also be recorded. Securities borrowers, on their part, may at a given moment contact the agent lender, expressing their interest for specific types of securities (e.g. a given quantity Japanese shares). The latter shares, when available on loan in the

omnibus pool, are exchanged in return for collateral of at least the same value (but typically more via over-collateralisation), as the ceded shares. The received collateral is typically delivered through the tri-party collateral agent and registered in the name of the UCITS, AIF, or its representative (i.e. the depositary).

In a scenario where Options 1 or 2 would require lending institutions, like managers of UCITS or AIFs, to segregate assets on an individual fund-by-fund basis, the Japanese shares (as per our earlier example) requested by a potential borrower, when available, may need to be pooled from several smaller individual accounts and where one is less likely to contain enough shares to wholly satisfy the request. Unlike the previous situation characterised by an omnibus pool, here the shares would need to be exchanged for collateral via multiple transactions, in theory, one for every separate individual account from where the requested shares are to be drawn. To a borrower, such circumstances are particularly less attractive, given the greater number of transactions to post collateral to the UCITS/AIF individually segregated accounts (obliging the tri-party agent in parallel to perform multiple separate book entries instead of one only as for one omnibus pool) and inevitable higher costs and operational (settlement) risk.

Consequently, borrowers are more likely to target larger omnibus pools, leaving fully segregated fund clients to also suffer a performance "drag" to the extent that securities from these accounts become less palatable and are less likely to be loaned out from their individual UCITS or AIF. In competitive terms, UCITS and AIFs would have lower penetration rates[1] (i.e. the % of their portfolio securities out on loan at any given time) compared to other available lenders (e.g. insurance companies, pension funds, SWF, etc.), rendering securities lending less profitable for borrowers and UCITS/AIF investor end-clients alike. From this perspective, the implementation of Option 1 will thus not only negatively impact market liquidity, but also reduce fund investors' long-term revenue streams[2].

From the collateral optimisation/substitution perspective, there are additional drawbacks to the proposed Options 1 or 2. For the securities lending transaction illustrated above, as for repo ones, the borrower (as the collateral provider) may seek to optimise or substitute all or some of the collateral provided to the tri-party agent under the terms of the securities lending agreement during the course of the day. This model is predicated upon books and records allocation of collateral at the AIF/UCITS level, with securities held in an omnibus account at the level of the sub-delegate or CSD. In the absence of this option to optimise their collateral throughout the day, borrowers would be required to post collateral to individually segregated accounts, thus making their inventory more difficult to manage especially when needing to source eligible collateral to satisfy EMIR clearing obligations. The likely outcome, as mentioned previously, would be a migration of borrowing away from UCITS and AIF's towards other beneficial owners such as SWFs or pension funds.

In sum, Option 1, from the perspective of the majority of EFAMA Members, carries no evident value added in meeting the dual policy objectives presented at the outset of the latest Call for Evidence. Rather, it bears a significant downside potential in harming the liquidity of European markets to the advantage of non-EU ones, while reducing available securities loan pools to the detriment of UCITS/AIF investors. Where full account segregation is implemented at all levels of the sub-custody holding chain,

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[1] For UCITS funds, we note this is limited to 20% of the individual NAV.

[2] According to estimates provided by a global asset manager using tri-party service providers, managed UCITS have delivered clients an average 4.5 bps over the past 3-4 years (amounting to some 10-15% off the TER), i.e. making it cheaper for clients to invest.

although short of the CSD (see *infra*), this would reflect both established corporate group structures, as well as the commercial choices, of a minority of our Members.

With regard to Question 14 letter b), we would refer the ESMA to the individual replies of prime brokerage service providers and/or of their trade representatives.

Q15: Are you able to source any data on quantifying the additional costs and market impact for prime brokers and/or collateral managers as a result of implementing option 1?

Q16: Many respondents to the CP argued that the requirements under option 1 would trigger 'legal certainty risk' and 'attendant operational risk' in relation to collateral management. Should you agree with these statements, please specify what precisely you understand by "legal certainty risk and "attendant operational risk". How could those risks be mitigated?

Please refer to our response to Q.14 above.

Q17: Could adaptations to IT systems help to face the challenges that option 1 represents in relation to collateral management? If so, please explain how, if possible indicating the costs and timescales of the work that would be needed.

Given the very specific nature of the question, we refer the ESMA to the replies of individual firms.

Q18: Have you identified any operational (or other) challenges in terms of the impact of the requirements under option 1 of the CP for the functioning and efficiency of T2S? If your answer is yes, please explain in detail.

EFAMA would note that the objective of individual account segregation according to the proposed Option 1 appears to be misaligned with the objectives of the Central Securities Depositaries Regulation (CSDR) and Target 2 Securities (T2S). Where the latter initiatives' main objectives are to increase the safety and efficiency of securities settlement and settlement infrastructures, Option 1 would stifle these by impeding settlement at an earlier moment as a result of the increased operational complexity associated with the proliferation of accounts and standard settlement instructions ("SSIs"), likely to provoke frequent settlement failures and delays. With the penalties for settlement failures envisaged under Article 7 of the CSDR, this is likely to result in additional costs for market participants to the detriment of their clients.

As global custodians, CSDs and their respective representative associations have also noted, the T2S platform was not designed to support potentially millions of additional accounts, opened in the name of investors or groups of investors, given that its development assumes the continued use of the omnibus account structures to facilitate cross-border settlement via CSD links, despite the fact that for

certain jurisdictions in Europe, local CSDs may provide individual client or end investor account segregation[3].

Q19: Many respondents to the CP argued that AIFs risk being shut out of key markets due to the following:

a) the mismatch that will arise between local jurisdiction securities ownership rules and the mandated level of segregation required under option 1 in the CP; and/or

b) the requirement in certain countries to hold omnibus accounts across multiple depositaries, as is the case for certain stock exchanges.

If you agree with the above statement, please explain your concern with reference to specific jurisdictions and/or stock exchanges and the relevant requirements.

Please refer to our answer provided under Q.3 above.

Q20: Should you/the funds that you manage comply with option 1 in the CP, please provide details on if and how you apply the requirements under this option when delegating safe-keeping duties to third parties outside the EU.

Given the very specific nature of the question, we refer the ESMA to the replies of individual firms.

Q21: Many respondents to the CP argued that, given that many delegated third parties are located outside of the EU, option 1 of the CP could lead to higher fees charged by the delegated parties. Are you able to source any data on the potential higher fees charged by the delegated parties outside the EU as a result of implementing option 1?

Given the very specific nature of the question, we refer the ESMA to the replies of individual firms.

Q22: How would you compare and contrast the five options in the cost-benefit analysis (CBA) of the CP in terms of achieving the policy objective described in the above introduction? In your opinion, does any one of the options offer a better solution for achieving this aim, and if so, how? In answering to these questions, please refer to the table below which is copied from the CBA of the CP and adds the sub-delegate level.

Please note that as the present call for evidence is intended to cover asset segregation requirements for both AIFs and UCITS, with regard to the latter any reference in the table below to 'AIF' should also be read as 'UCITS', i.e. when applied to UCITS, references to 'AIF' should be read as 'UCITS' and references to 'non-AIF' should be read as 'non-UCITS'.

[3] For a detailed mapping of the different regimes jurisdiction per jurisdiction, please refer to the ECSDA Report *Account segregation practices at European CSDs*, published on 13 October 2015; available at: http://ecsda.eu/wp-content/uploads/2015_10_13_ECSDA_Segregation_Report.pdf

	Option	Description
	Option 1	**AIF and non-AIF assets should not be mixed in the same account and there should be separate accounts for AIF assets of each depositary when a delegate is holding assets for multiple depositary clients.** **When the delegate appoints a sub-delegate, this should hold separate accounts for AIF assets of each depositary and should not mix in the same account non-AIF assets of that depositary or AIF assets coming from different depositaries.**
	Option 2	**The separation of AIF and non-AIF assets should be required, but it would be possible to combine AIF assets of multiple depositaries into a single account at delegate or sub-delegate level.**
	Option 3	**AIF and non-AIF assets could be commingled in the account on which the AIF's assets are to be kept at the level of the delegate. However, the delegate could not commingle in this account assets coming from different depositaries.** **When the delegate appoints a sub-delegate, this should hold separate accounts for assets coming from different depositaries. However, AIF and non-AIF assets could be commingled in the account of a given depositary in which the AIF's assets are to be kept at the level of the sub-delegate.**
	Option 4	**AIF and non-AIF assets could be commingled in the account on which the AIF's assets are to be kept at the level of the delegate. The delegate could commingle in this account assets coming from different depositary clients.** **When the delegate appoints a sub-delegate, this could commingle in the same account AIF and non-AIF assets and assets coming from different depositaries and the delegates' clients (but should not be mixed with the delegate's or depositaries' own assets).**
	Option 5	**AIF assets should be segregated on an AIF-by-AIF basis at the level of the delegate or sub- delegate.**

Based on the arguments developed above, as well as those of our previous submission to the ESMA on the topic of *Guidelines on asset segregation under the AIFMD*, EFAMA has a strong preference for Option 4.

Q23: Articles 38(3) and (4) of the CSDR state that a CSD shall offer its participants the choice between:

> **i) 'omnibus client segregation' at the CSD level (holding in one securities account the securities that belong to different clients of that participant);**
>
> **ii) 'individual client segregation' at the CSD level (segregating the securities of any of the participant's clients, if and as required by the participant).**

In addition, under Article 38(5) of CSDR, a participant shall offer its clients at least the choice between omnibus client segregation and individual client segregation and inform them of the costs and risks associated with each option.

a) Do you consider that a regime similar to the one under Article 38 of the CSDR but applied throughout the custody chain (according to which the manager of AIFs/UCITS, on behalf of their investors, informs the depositary of the level of asset segregation it wishes to apply throughout the custody chain to each individual AIF/UCITS, after having duly assessed the risks and costs associated with the different options) would achieve the policy objective described in the above introduction? Please explain why and, if the answer is yes, how.

b) Applying a regime similar to the one under Article 38 of the CSDR to the AIF/UCITS framework would mean that the fund investors would have the choice to invest in a given fund or not, after having been made aware – through appropriate disclosures – of the level of asset segregation that the managers of AIFs/UCITS had chosen and the related costs. However, investors would not have the opportunity to participate in the choice of the level of asset segregation as such a choice would have to be made by the manager for each individual fund as a whole (i.e. it would not be possible to have different levels of segregation for the investors in the same fund). Do you consider that this could raise any concern in terms of investor protection or could any concern be alleviated through appropriate disclosures? Please explain the reasons for your answer.

c) Please comment on any implications of such a regime for the account related provisions under Article 39 of EMIR.

a) In line with our reply to Q.3 above, we firstly support the minimum segregation requirement laid out under Article 21(11) letter (d) (iii) at the level of the sub-delegate, knowing that book-entry registration of the assets is per se sufficient to guarantee the attainment of the dual policy objectives outlined in the introduction of the present Call for Evidence. Although UCITS/AIF managers are not prevented from pursuing individual account segregation throughout the custody chain - bearing in mind our considerations around the appropriate use of omnibus account structures to define CSD links – we remain of the opinion that individual account segregation is not necessary to deliver on the policy objectives, especially when there are evident efficiency trade-offs to be achieved both in terms of greater market liquidity and improved fund performance. We are in principle therefore favourable to the choice between omnibus vs. individual account segregation, allowing providers to choose the model they consider more efficient in light of their corporate group structures and commercial imperatives.

b) We believe that the choice between omnibus vs. individual account segregation and their related trade-offs could be explained to investors in simple terms, taking all relevant factors

into account (e.g. choice of a tri-party vs. a bilateral collateral manager, insolvency protection in non-EU jurisdictions, a summary description of the sub-custody network, related risks, etc.). As for any investment, these elements should be presented to the investor for the latter to make an informed choice.

c) Please refer to our answer to Q.13 above.

Q24: Please describe any alternative regime which, in your view, would achieve the policy objective described in the above introduction.

Since its 2014 consultation around its proposed *Guidelines on asset segregation under the AIFMD*, the ESMA has gathered ample evidence and views to design a comprehensive regime around UCITS/AIF asset protection for these funds' end-investors. Necessarily, the proposed regime will need to strike a balance between what is proportionate and necessary for investor protection and segregation models that are commercially viable from an economic efficiency standpoint in light of market realities (i.e. market liquidity, intra-day settlement needs and growing need to secure financial transactions with quality collateral) and the interests of the other actors involved (i.e. depositaries, global custodians, CSDs, prime brokers, etc.).

Q25: Do you see a need for detailing and further clarifying the concept of "custody" for the purposes of the AIFMD and UCITS Directive?

EFAMA believes that the notion of "custody" is sufficiently well defined in the AIFM and UCITS Directives, respectively under Article 21(8) and Article 22(5).

Q26: If your answer to Q25 is yes, should the concept of "custody" of financial instruments include the provision of any of the following services for the purpose of the AIFMD and UCITS Directive:

a) initial recording of securities in a book-entry system ('notary service');

b) providing and maintaining securities accounts at the top tier level ('central maintenance service');

c) maintaining or operating securities accounts in relation to the settlement service;

d) having any kind of access to the assets of the AIF/UCITS; or

e) having any access to the accounts where the assets of the AIF/UCITS are booked with the right to pledge and transfer those assets from those accounts to any other party?

Q27: If your answer to Q25 is yes, would you include any other services in the concept of "custody" of financial instruments for the purpose of the AIFMD and UCITS Directive? If your answer is yes, please list and describe precisely the services that should be included.

Q28: Please explain how, in your views, "custody" services interact with "safe-keeping" services, in particular those referred to under Article 21(8) of the AIFMD (as well as Article 89 of the AIFMD Level 2) and Article 22(5) of the UCITS Directive (as well as Article 13 of the UCITS V Level 2).

Please refer to our answer to Q.25 above.

Q29: If you consider that the provision by a CSD of any of the core services (i.e. services mentioned under Section A of the Annex to the CSDR) or ancillary services (i.e. services provided in accordance with Section B or Section C of the Annex to the CSDR) should not result in the CSD being considered as a delegate within the meaning of Article 21(11) of the AIFMD and Article 22a of the UCITS Directive, please list the specific services and explain the reasons why.

With regard to the potential treatment of CSDs as "delegates" under the UCITS/AIFM Directive regimes, EFAMA is of the opinion that a long-term, comprehensive and clear-cut solution would only be possible via a revision of the relevant directives. Such revision should strive to obtain a clear recognition in the relevant articles, i.e. not in the recitals, of the dual role CSDs can play as either "issuer" or "investor" CSDs[4]. However, EFAMA also notes that relying solely on the "issuer" CSD / "investor" CSD distinction can be problematic and concerns have arisen that the "investor" CSD category may capture some CSDs which should not be treated as delegates. More specifically, CSDs that provide access to other CSDs using links that are intermediated by entities that are not Securities Settlement Systems (SSS) should be classified as falling within the scope of depositary delegation arrangements under the UCITS/AIFM Directives. However, CSDs that are providing exclusive access to other CSDs using direct links between SSS entities should be classified as market infrastructure and not as delegates[5]. Therefore, while "issuer" CSDs should not be treated as delegates, in respect of "investor" CSDs, EFAMA is of the view that not all of these should be treated as delegates.

Whereas under the AIFM Directive, CSDs, as operators of SSS, are outside the scope of the relevant provisions applying to third-party delegates, Recital (21) of the UCITS Directive contemplates circumstances where "entrusting the custody of securities of the UCITS to any CSD, or to any third-country CSD should be considered to be a delegation of custody functions". Such circumstances would coincide with a CSD offering "ancillary" services, as per Sections B and C of the Annex to the Central Securities Depositaries Regulation 909/2014 (CSDR), while not discharging the initial recording of securities, i.e. the "notary service" as referred to under point 1 of Section A of the Annex to the CSDR, possibly also in combination with the maintenance of accounts at the "top-tier level" (as per under point 2 of the same section).

[4] As per the definitions provided in ESMA's Draft technical standards the Central Securities Depositaries Regulation 909/2014 (CSDR), published on 28 September, 2015 (ESMA/2015/1457).

[5] Examples of the second case would include the Target2Securities (T2S) arrangements for greater cross-border settlement efficiency in Europe, as introduced by the ECB, and the Shanghai-Hong Kong Stock Connect programme, as operated jointly by the Hong Kong Securities Clearing Company Limited (HKSCC) and China Clear. Article 7 of the China Securities Regulatory Commission (CSRC) Stock Connect Rules mandates both China Clear and HKSCC to perform their functions effectively as joint CSDs, together acting as a "top tier level" CSD function as described under Recital (21) of the "UCITS V" Directive. The latter example makes a case for the exclusive access to the Chinese mainland A-shares market possible only via the HKSCC with exclusive direct links to its Chinese counterpart China Clear.

Only after the finalisation of the AIFM Directive, did it become apparent that certain CSDs (namely those offering ancillary services under a banking license) are competing with UCITS/AIF depositaries and their third party delegates by offering identical services, albeit on unequal terms. Such inequality stems from the fact that such CSDs are apparently exempted under EU regulation from the strict liability requirements UCITS/AIF depositaries are intended to comply with under their respective Directives[6]. In fact, there are currently no provisions in the CSDR that introduce a comparable and harmonised liability regime for CSDs, and where presently, only national laws and regulations apply to a large degree[7].

Such "liability gap" becomes more clear when considering that certain CSDs become interposed as third-party agents in the custody holding chain by providing custody in relation to securities that are initially issued in another CSD, while offering a range of ancillary services in direct competition with those offered by UCITS/AIF funds' depositaries. Such "investor CSDs" are domiciled in local jurisdictions where they operate an SSS, but only for a limited number of securities (either local securities or Eurobonds) and for which they also provide notary and/or central maintenance services (respectively points 1 and/or 2 of Section A of the Annex to the CSDR). In this capacity, they qualify as an "issuer" CSD, but for these few securities only.

Were UCITS/AIF fund securities to be "lost" at the level of an appointed CSD agent and where the latter is not clearly recognised as a "delegate" under the current UCITS/AIFM framework given that it is also considered as an "issuer" CSDs for other securities than those belonging to the UCITS/AIF fund, the fund depositary may avail itself of the opportunity to prove that such loss has resulted from "an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary"[8]. Where such test is convincingly proven and absent any eventual guarantees (in the form of privately negotiated general terms and conditions), a regulatory loophole would exist, implying fund end-investors would potentially not be able to claim any liability against the depositary. Such outcome would contravene the spirit and the EU Legislators' original rationale behind the depositary requirements under both UCITS and AIFM frameworks.

Important to consider is also the fact that, under certain circumstances, depositaries may have no choice but to rely on such agent, including entities within the agent's CSD network to which functions are in turn sub-delegated and which are entirely removed from the control of a UCITS/AIF depositary. As CSD participants, depositaries would have no insight into CSD governance structures and procedures, greatly limiting the quality of the former's required due diligence. This would translate in an impediment for the depositary to exercise its key oversight functions under the relevant Directive, where separate bilateral terms and conditions (T&Cs) typically prove impossible for depositaries or other delegates to negotiate on equal terms.

In light of these considerations, EFAMA would observe that certain CSDs are able to act in a dual capacity, i.e. as (i) an "issuer" CSD for a limited number of issues, while (ii) discharging competing services (i.e. as an "investor" CSD) in commercial competition with depositaries and their delegates (i.e. global custodians). In the absence of a comparable and harmonised liability regime for CSDs, the latter CSD types ought therefore to be treated as "delegates" under UCITS/AIFM rules in a number of

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[6] Particularly, with regard to the restitution of assets "without undue delay" in the event of a loss.

[7] Article 38 of the CSDR only introduces general provisions on the protection of securities belonging to CSD participants and their clients.

[8] As per Article 24 of "UCITS V" and Article 21(12) of the AIFM Directives

very clear and prescribed circumstances. We would recommend a comprehensive impact assessment prior to the Commission proposing amendments to the relevant Directives in due course.

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Brussels, 23 September 2016

[16-4058]