

THE ASSOCIATION OF GLOBAL CUSTODIANS

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19 February 2010

By Electronic Delivery

Jean-Paul Gauzes
Member of the European Parliament/Rapporteur

Dolores Duran Bono
Office of the European Council President

Ugo Bassi
Head of Unit
European Commission

RE: Custodians' Continuing Concerns about Draft AIFMD Provisions

Dear Sirs and Madam:

We write on behalf of the Association of Global Custodians (the "Association") to express Association members' continuing concerns with draft AIFM Directive provisions that would apply new, undue and inappropriate legal standards on fund depositaries and depositary functions.¹ Members conveyed their views on these matters in detail last year to the EU Council Presidency and also to the European Commission in the context of its UCITS Depositary consultation, and the Association appreciates Jean-Paul Gauzes' ongoing efforts to achieve consensus on the AIFM proposal. At this time, however, in view of the potential for serious market disruption and aggravated systemic risk that would flow from the proposed new standards, we set out below a synopsis of members' core concerns. For greater information regarding members' views, please find attached a 17-point appendix.

I. Global custodians are fundamental to safe and efficient securities custody and settlement globally; in the development of sound regulatory policy

¹ Members of the Association are listed on the letterhead above.

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affecting custody functions and standards, custodians' views should be heard and their experience should be fully taken into account.

- Major custodians hold in excess of EURO 64 trillion in assets globally, including EURO 27 trillion in EMEA.
- Global custodians provide a globally-coordinated set of specialized services vital to ensuring that clearing and settlement flows run smoothly.
- Custodians are already required under banking regulations to maintain significant levels of risk capital to backstop credit/operational risk.
- Central Securities Depositories and other domestic market infrastructure entities provide essential utility services that global custodians, local market subcustodians, and other intermediaries must use; such infrastructure entities are necessary to enabling cross-border investment, and their operating terms reflect mandatory local laws.

II. Transferring risk to custodians which custodians cannot reasonably control in an intermediated environment will expose the EU markets to new and greater systemic risk and will create "moral hazard" for investment managers.

- A transfer of liability of unprecedented nature, as various AIFM drafts propose, will lead to the following:

(A) significant cost increases to custodians (and in turn to investors) – including in the form of higher custodian operating expenses to manage the new risks, specialized insurance protection (which may be unobtainable or very expensive), and/or a new form of investor-level collateralization that will require additional controls.

The magnitude of the cost increases cannot be known at this stage; particular new costs will depend on multiple variables at the individual custodian level. What is certain is that custodians' cost increases will be passed on to investors;

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(B) diluted geographic/market coverage for custody and settlement services – possibly, global custodians' exit from the EU business entirely.

These reductions in service coverage will concentrate default-related risks in fewer providers – potentially providers with inadequate track records, limited capital relative to the new risk levels, undeveloped network disciplines, and limited risk management experience. Increased concentration in less robust institutions would magnify global financial complications during market crises as defaults and process delays unfold.

- Investors will face these higher costs and the reductions in asset classes and investment strategy choices *without having significantly more protection* should a material default occur.

III. Risks assumed by investment managers on behalf of investors are not simply “market” risk; if the AIFMD is adopted with the proposed new depositary liability provisions, managers will have to assess and disclose the new set of risks.

- Those responsible for making investment decisions and enhancing value must be responsible for assessing the entire range of risks that result from their decisions to invest in particular products and markets.
- Risk disclosure to investors is the responsibility of the investment manager/fund promoter. It has always been the case that investment managers/promoters must disclose material risks to investors -- including market risk, infrastructure risk, settlement risk, currency risk, counterparty/insolvency risk, tax risk, and so on. If the AIFMD is adopted with the novel depositary liability provisions currently envisaged, risk disclosures in fund disclosure documents will need to be fundamentally changed to describe the new systemic and concentration risks inherent in the expanded liability of depositaries. These risks would supplement the risks historically assumed by – and disclosed to – investors.
- Any force majeure provisions and other exculpations from depositary liability set out in the directive (and included in recognition of the real-world limits on depositaries' ability to protect investors) will also need to be disclosed to

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investors. This will make documented risk disclosure – an essential feature of an effective funds regime – variously complicated or confusing for investors.

- Investment Managers must also take responsibility to confirm the existence of portfolio assets as well as all portfolio movements; the depositary merely validates – based on information received from the manager – that the manager has undertaken sufficient steps to evidence continued ownership of all assets.

IV. Existing custody standards represent “best industry practices”.

- Depositories should be held to a standard of unjustifiable failure to perform. This standard is both well-understood and consistent with UCITS, although we recognize that the application of this standard might usefully be further defined and harmonized across the EU.
- Global custodians already exercise exacting due diligence over their sub-custodians, employing industry best practices that include recognized regulatory standards and requirements. In addition, sophisticated investors judge a global custodian in relation to the custodian’s peers, and those judgments reference industry best practices and recognized regulatory standards. Existing best practices set a very high performance benchmark.
- Liability standards in respect of a loss of assets must take into account the extraneous nature of market-wide events such as the operation of insolvency, administrative stays/delays and even fraud.

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The Association appreciates your consideration of members' views and your attention to the points conveyed. Members would be pleased to meet with you to discuss their concerns and suggestions. To arrange discussions, please contact the undersigned at 312.861.2620.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Dan W. Schneider". The signature is written in a cursive style with a large initial "D".

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

ATTACHMENT – Appendix

APPENDIX - Association of Global Custodians Comments

Supplemental Views Re AIFMD/UCITS Depositary Provisions

1. **Importance of Custodians**: The top ten custodian banks, whose subsidiaries act as depositaries for collective investment schemes in the EU/EEA, hold in custody the equivalent of over EURO 64 trillion in assets globally. Of this, EURO 27 trillion (42%) is in EMEA. Any undue liability that would be newly imposed on these custodians to compensate losses of even a portion of this amount would fundamentally change systemic risk to the affected banks, markets and investors, and would do so in ways that would have a highly undesirable impact on the established model of intermediated securities ownership.
2. **Reallocation of Responsibilities**: There is a moral hazard involved for investment managers if the depositary is assigned risks (as guarantor) for the consequences of investment decisions made by AIF/manager: this represents a fundamental shift in the investment process -- one that transfers risk to the depositary beyond what is reasonable or appropriate.
3. **Consequences of Reallocation of Risks**: The combined costs of depositary guarantor liability and additional duties would ultimately be passed on to investors through higher charges. The only alternatives for many depositaries will be to decline to provide the service for certain markets or exit the business entirely. This may lead to significant reduction in asset classes and strategies available to investors, with corresponding reduction in returns (see, pension scheme funding gaps) AND significant increase in service provider concentration. The concentration may well be focused in substantially less capitalized entities with less experience in global network control and risk management.
4. **Risk Disclosure**: Disclosure of risks is first and foremost a fund investment manager and fund promoter responsibility. Investors need to understand that the risks involved in undertaking investments in different markets are not limited to the rise or fall in the price of a security, but all other material risks of investments (e.g., sovereign risk, currency risk, tax risk, market infrastructure risk, settlement risk, insolvency risk, etc.). These risks must be disclosed in the funds' offering documents; they should be presumed to be known by investors and form part of the investment decision process.
5. **Investment Process**: Investment managers and institutional/sophisticated investors develop strategies that explicitly measure risks, as balanced against the potential for return. If Depositaries become guarantors for most elements of investment risk (e.g., market infrastructure risk, settlement risk, currency risk, insolvency risk, etc.), the risk-return analysis is effectively converted into an assessment solely of pricing risk and credit risk (to the depositary). This conversion changes the existing risk dynamics and distorts the normal investment risk assessment/decision-making processes for all parties.
6. **Proportionality**: Proportionality is necessary to tailor requirements (and liability) to the kinds of investment analyses that should be expected to be undertaken by investors and/or their advisors (investment managers). More sophisticated investors and their advisors are capable of understanding the various risks and should be held to have accepted the results of investment decisions made on their behalf. Less sophisticated investors may require more protections -- including conditions on access to funds which invest in assets classes or adopt strategies with higher risks that may be inappropriate for some investors.
7. **Need for More Detailed Requirements**: Custodian banks welcome efforts to recognize and define the role of depositaries, and we support a review of custody standards under current regulation with a view to consistency and predictability across Europe. However, it is necessary to work with a precise understanding of the way in which assets are held and risk is allocated today within the modern dematerialized securities holding framework. Also, careful identification

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is needed of the respective, and varying, roles and responsibilities of all the entities in the chain of custody, including issuers and CSDs. A set of minimum requirements should be dealt with at Level 2.

8. **Inverted Burden of Proof:** Reversing the burden of proof is inappropriate and will result in problems under the rules of evidence in different Member States. "Obligation of Results", a civil law concept, is required in the case of tangible property being held by one party for another; however, extension of this concept, with an inverted burden of proof, to book-entry securities strains this obligation well beyond the circumstances it was intended to address. When book-entry securities or other financial instruments are "lost" without an explanation from the depositary, rules of evidence in all Member States already provide for just resolution; and claimants should still make their case in accordance with national laws. In any event, the burden of proof in such proceedings must remain with the party alleging fault.
9. **Utilisation of Sub-custodians:** Depositaries necessarily employ local, typically unaffiliated subcustodians not as a function of outsourcing but rather as a by-product of securing expert local market services globally. Furthermore, investment managers may choose to have the AIF invest in jurisdictions in which the political environment, market infrastructure and/or choice of available sub-custodians does not meet commonly accepted standards. These risks, if disclosed appropriately, should be considered part of the investment risk. The responsibility of the depositary should be limited to minimizing the risk through adequate due diligence and monitoring.

Minimum standards should be set out for the selection, appointment and monitoring of subcustodians, and those standards should reflect current industry best practices. These could be modelled on well-established standards that have long been employed by leading custodians worldwide, including those set out under U.S. Securities and Exchange Commission Rule 17f-5 under the Investment Company Act of 1940. Subcustodians, in turn, should be expressly permitted to use central securities depositories or their equivalent where local market practice so requires. Moreover, there should be recognition that use of central securities depositories and other market infrastructure entities is not equivalent to the selection and appointment of a subcustodian, and in most cases is entirely beyond the control of the depositary.
10. **Ensuring Ownership:** The task of verifying ownership of assets other than financial instruments should be allocated to the person who is in the best position to discharge it. The depositary's role is to validate that the manager has undertaken sufficient steps and to maintain records evidencing ownership on the basis of information received; however, this role is not tantamount to "verifying ownership" in the sense of providing in effect a legal opinion that title has unconditionally vested under the property laws of the relevant jurisdiction. As is widely recognized, significant work regarding the holding of cross-border investments remains to be done in the EU (and indeed outside the EU) and to that end is the subject of the EU consultation of 16 April 2009.
11. **Conflicts of Interest:** It must be made clear that the depositary's duties and liability are solely to one party: the AIF (which represents the collective interests of all investors), rather than investors individually or the AIFM. This focus avoids conflicts of interests and averts the risk of advantaging certain investors at the expense of other investors.
12. **UCITS Supervision Duties:** The extension of UCITS-supervision obligations (e.g., monitoring of unit deals, NAV calculation and investment compliance) should be clarified as ex

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post only (and this should apply equally to UCITS). Member States should also be able to derogate from applying these requirements -- originally designed to protect retail investors -- in respect of funds that are not open to retail investors (such as many hedge funds and private equity funds).

13. **Independent Valuation:** Valuation must be required to be independent of the AIFM in the sense that the Depositary should "oversee" that valuations are conducted appropriately on an ex post basis. Such oversight should not require the depositary to perform any material duplication of the accounting work that is undertaken by the AIFM or its administrative agents. Duplication would be inefficient, would double the costs of accounting paid for by funds, and would inappropriately extend the oversight function beyond the testing of controls.
14. **Eligibility Criteria:** The depositary role should be open to all of the institutions that currently perform it in the European Union, including trust companies established in Ireland and the United Kingdom which are not MiFID investment firms or EU credit institutions.
15. **Single Depositary:** A single depositary should be appointed for each AIF in the same way as required per UCITS.
16. **Prime Brokers:** Prime brokers typically play different roles than normal subcustodians, because they are providers of liquidity to funds and have collateral requirements. Any legislative provisions should allow prime brokers to continue to perform their particular functions, with depositary oversight responsibilities being proportional to the risk profile and business requirements of the specific fund.
17. **Consistency with UCITS:** There should be a consistent approach in respect of fundamental duties and liability of the depositary across UCITS and non-UCITS funds that are open to retail investors -- thus the need to align the AIFMD with the Depositary Consultation and ensure harmonisation across member states. There is no need for equivalence between hedge funds and UCITS retail funds; the principle of proportionality should always apply.