

## THE ASSOCIATION OF GLOBAL CUSTODIANS

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31 January 2011

Dear Sir or Madam:

### **Re: Response to Consultation Paper on the UCITS Depository Function and on the UCITS Managers' Remuneration**

The Association of Global Custodians ("**AGC**") is an informal group of ten banks that conduct depository and custodian services throughout Europe, collectively holding more than EUR 55 trillion of assets on behalf of their clients globally, including a substantial stake in EU domiciled fund assets.

The AGC seeks to play a constructive role in ensuring the effectiveness of regulation, while avoiding unintended consequences. In that spirit we welcome the European Commission's consultation paper dated 14 December 2010 (MARKT/G4 D (2010) 950800) on the UCITS depository function (the "**Consultation**") and its request for feedback on the impact of its proposed changes on the UCITS industry and stakeholders. We also welcome the European Commission's intention to update the framework applicable to UCITS depositories, aiming to introduce targeted changes to the depository functions in Directive 2009/65/EC (the "**UCITS Directive**") in order to enhance transparency and harmonisation of duties and liabilities among EU countries and to ensure consistency between the rules and regulations applicable to UCITS depositories and to depositories of alternative investment funds. In this regard, while consistency between the legislation applicable to UCITS depositories and depositories of alternative investment funds is a welcome step, the AGC believes that it may not be appropriate to extend all mechanisms contained in the Alternative Investment Fund Managers Directive and its Level 2 rules, once finalised ("**AIFMD**"), to retail investors in the UCITS context. The interests of retail investors are currently safeguarded through other channels such as restrictions on the eligibility of assets in which UCITS can invest, investment and borrowing limits, prospectus publication, transparency and reporting requirements, which are appropriate to the retail context. In addition, AGC members see no objective reason to go beyond or restrict the possibilities introduced for depositories by AIFMD. From a technical point of view there is no difference in addressing safekeeping, custody and settlement issues for a professional investor as compared to a retail investor; all the arguments, difficulties and risks explained and highlighted during the AIFMD debate with respect to global investments and a complex

THE ASSOCIATION OF GLOBAL CUSTODIANS

UCITS Consultation Comments

31 January 2011

Page 2

chain of necessary intermediaries, fully apply to UCITS. Applying further restrictions would inevitably lead to higher costs or, potentially, restrictions on geographic or investment product scope for UCITS investors, which members do not believe is the Commission's intention.

The AGC has identified a number of areas in the Consultation's proposals, which members believe would benefit from clarification, so that the new legislative proposals can be effective in achieving their aim without creating unintended consequences. This submission focuses on issues which the AGC believes to be key to depositaries. Thus, the AGC does not comment on the questions contained in Part 2 of the Consultation relating to UCITS managers' remuneration policies. Should the Commission require further information in relation to any of the issues considered below, AGC members would be pleased to provide this upon request. For such information, please contact Maria Troullinou at [Maria.Troullinou@CliffordChance.com](mailto:Maria.Troullinou@CliffordChance.com) as an initial matter.

Sincerely yours on behalf of the Association,

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

## RESPONSES TO QUESTIONS ON UCITS DEPOSITARIES

### A. DEPOSITARY'S DUTIES

#### 1. Safekeeping

**Box 1** - *It is necessary to define what activities and responsibilities are related to the notion of "safekeeping" of assets.*

The meaning of "safekeeping" within the context of UCITS has long been of interest to the depositary industry, as the commonly understood meaning of the term in this context is not necessarily consistent with other European legislation. For example, the Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – common systems of value added tax: uniform basis of assessment (the "**Sixth VAT Directive**") treats the activities of "safekeeping" and settlement of transactions and related services differently, in that the former attracts VAT charges, while the latter does not.

"Safekeeping" is generally understood to refer to the holding of physical assets in safes or vaults, while "custody" extends the notion to book-entry recording of intermediated securities holdings (commonly referred to as "position records"). In order to give effect to the requirements that are applicable to UCITS, the meaning of "safekeeping" in the context of the relevant depositary obligations is thought to have both of these meanings, encompassing assets which are held in a physical safe, as well as intermediated securities held in book-entry accounts. Depositary services address one more additional duties, which – if exercised - qualify the custodian to become a depositary. Clarifying the activities and responsibilities that are related to the safekeeping of assets in the context of UCITS will not have an adverse effect on the terminology of the Sixth VAT Directive but will assist to ensure that there is certainty in each Member State about the basic requirements of the depositary's role.

Unlike "safekeeping", which relates to instruments that a depositary would usually hold itself on behalf of the UCITS, directly or through a chain of intermediaries, oversight duties are carried out in relation to instruments which cannot normally be safekept by the depositary, but which a depositary might well record for record-keeping purposes at the request of the UCITS manager (for example, private equity). In order to clarify the differences between the two terms and the respective duties and liabilities that they give rise to, the AGC encourages the Commission to clarify and further restrict the definition of safekeeping, so that it only applies to assets which can be physically held by a depositary or as book-entry custodian. This proposed amendment raises questions

about the type of assets that can be subject to safekeeping or oversight only, in respect of which please see the response to Box 2 below.

More broadly, the UCITS and AIFMD consultations have shown that the term “safekeeping” has not been used consistently across all member states: this has led to some confusion which the consultations are helpfully rectifying.

There is a need to harmonise use of terms so they are consistently applied across the EU. However, more important than use of terminology is ensuring a conceptual framework that protects investors, provides legal certainty, reduces cost sensibly and minimises systemic risk.

**For the sake of clarity, henceforth, “safekeeping” in this response will refer to the holding of financial instruments that a depositary would usually hold either itself directly or through a chain of intermediaries via CSDs or ICSDs (see response to Box 2 below).**

**Box 2 - It is envisaged to complete articles 22 and 32 of the UCITS Directive, in a way which is consistent with the approach in the AIFMD, in order to:**

- *Distinguish safekeeping duties between (1) custody duties relating to financial instruments (such as securities) that can be held in custody by the depositary; and (2) asset monitoring duties relating to the remaining types of assets. A reference to the custody of physical assets, such as real estate or commodities, is not necessary because such assets are currently not eligible for holding within a UCITS portfolio;*
- *Supplement the requirements on custody duties with a segregation requirement, so that any financial instruments on the depositary's book held for a UCITS can be distinguished from the depositary's own assets and at all times be identified as belonging to that UCITS; such a requirement would confer an additional layer of protection for investors should the depositary default;*
- *Equip the depositary with a view over all the assets of the UCITS, cash included. The directive should more explicitly make clear that no cash account associated with the funds' transactions can be opened outside of the depositary's acknowledgement, with a view to avoiding the possibility of fraudulent cash transfers;*
- *Introduce new implementing measures in the mentioned Articles defining detailed conditions for performing depositary monitoring and custody functions, including (i) the type of financial instruments that shall be included in the scope of the depositary's custody duties; (ii) the conditions under which the depositary may*

*exercise its custody duties over financial instruments registered with a central security depositary; and (iii) the conditions under which the depositary shall monitor financial instruments issued in a nominative form and registered with an issuer or a registrar.*

The AGC supports the Commission's recognition of the distinction between financial instruments that can normally be registered in a book-entry securities account and financial instruments that can only be monitored through position-recording.

The financial instruments which will fall within the scope of the depositary's safekeeping duties should not include all financial instruments listed in Annex I, Section C of Directive 2004/39/EC on Markets in Financial Instruments ("**MiFID**"). In particular, the depositary's safekeeping duties should not extend to instruments in the nature of contracts (such over-the-counter derivative contracts ("**OTC derivatives**") or contracts for difference) or other financial instruments that are not held via ICSDs or CSDs acting as final issuer CSDs (such as private equity investments and interests (shares or units) in any funds, including in funds not available for trading on regulated markets), as such instruments are not normally safekept by depositaries. Such financial instruments may only be recorded for record-keeping purposes.

A similar rationale applies to cash held by a depositary which is a credit institution, since cash is not safekept, but instead takes the form of a record on a bank's books as a liability to the relevant client. A depositary's obligations as regards cash held on its books as a deposit obligation should therefore not be within the scope of its "custody" duties. Cash that is not held as a deposit obligation on the depositary's books would be held as a deposit obligation at another deposit-taking credit institution. In such cases, the cash would not be within the scope of the depositary's "custody" obligation, (although the depositary might have "oversight/supervision" responsibilities).

The key legal distinction to determine which financial instruments are capable of being "held in custody" should depend on: (i) whether the depositary holds the financial instrument itself or via a sub-delegation or (in the case of CSDs or ICSDs) participation arrangement, and (ii) whether the financial instrument is a contract right or is reflected on books and records of a third party not appointed by the depositary directly or via one of its sub-delegates. Financial instruments falling within category (ii) would include OTC derivative instruments, private equity shares (with respect to which the registrar is solely the agent of the issuer) and fund units or shares not available for trading on regulated markets (in which case the transfer agent, who is the agent of the issuer and not of the depositary or any of its sub-delegates, reflects ownership interests).

With regard to the depositary's duties in relation to other assets the depositary's ability to validate ownership of assets is dependent on external factors that are effectively beyond its control (and far more within the control of the fund manager). In

these cases, depositaries are not in a position to be able to "verify" ownership unconditionally, since "ownership" of assets other than those capable of being held "in" custody is dependent on a number of external factors and risks which are not necessarily available to the depositary.

More fundamentally, an investment decision undertaken by the investment manager may take into consideration a variety of factors, some of which may include less certainty or clarity of the nature of the ownership interest in the asset being purchased. Depositaries might query whether these considerations have been considered as part of the investment decision. They may also undertake a review of the key infrastructure elements, including a review of "who" is in control of determining and recognising realisable value of the asset, but they are in no position to second-guess the validity of the manager's investment decision.

Different considerations may exist across "alternative" asset classes which may still be available for investment by a UCITS:

- In the case of OTC derivative instruments, any rights of the manager or the manager on behalf of the UCITS for which it invests are in the nature of contract rights. As a result, it cannot be said that "property" interests arise. The exposure is a function of counterparty risk, typically a core investment consideration.
- In the case of loan notes in which an UCITS may invest, these may or may not be evidenced by promissory notes, which may or may not evidence the indebtedness incurred by the borrower (depending on the applicable legal regime). Loan transactions may be subject to complex structures in which the loans are divided into participations in respect of which an agent lender acts for other lenders, one of which may include the UCITS. Such participations may be securitised, or they may not be. They may be traded on secondary markets, or they may not be.
- In the case of private equity investments, ownership of shares of target companies typically are recorded on registers maintained by registrars of the target companies who act solely as agent for those companies. They have no contractual link with the depositary or any of its sub-delegates. It is possible that depositaries or their sub-delegates might own the private equity shares in nominative form, but this is not standard practice and would likely not be accepted as a recognised form of ownership throughout the world.
- In the case of investment by the UCITS in other fund units or shares (i.e. so-called "fund of funds"), similar to private equity investments, ownership interests are recorded on registers maintained by agents of the issuers (often a transfer agent) who have no contractual privity with a depositary or any of its sub-

delegates. Whilst it is possible that some target funds may permit investments by the depositary or its sub-delegate in a nominative form, many or most will not.

- Assets, including those that might otherwise be considered Financial Instruments, which are delivered to third-party trading counterparties pursuant to valid collateral arrangements, will fall under the depositary's oversight/supervision duties in respect of "other assets".

## 2. Oversight functions

**Box 3** - *It is envisaged to achieve a higher degree of consistency in the oversight duties to be performed by UCITS depositaries: the oversight duties related to UCITS with a corporate form should be aligned with those to be performed in respect to UCITS with a common fund form (article 22).*

The AGC welcomes the proposal to ensure consistency between UCITS in corporate form and common fund form, provided that pre-trade checks will not be required for UCITS created under any corporate form.

**Box 4** - *It is envisaged to introduce implementing measures that will clarify further the scope of each listed supervisory duty, for example the methodology to be used for the calculation of the Net Asset Value of the UCITS.*

The proposal to introduce implementing measures that will clarify further the scope of each listed supervisory duty is welcomed. However, the AGC is of the view that the depositary's oversight duties should remain proportional in relation to the duties of the other involved parties. The depositary's duties should not require the depositary to conduct *ex ante* investment compliance monitoring or to re-execute tasks such as recalculating the Net Asset Value ("**NAV**"), but should at most require depositaries to check that procedures and systems are in place permitting the relevant third party to perform these functions adequately.

With reference to the above example, the depositary's duty under art 22(3)(b), to ensure that the value of units is calculated in accordance with the applicable national law and the fund rules, should be limited to a duty of oversight whereby the depositary's role is to ensure that the fund administrator or other valuer is in a position to carry out the calculation adequately. The depositary's duty should not extend to duplicating the work of the valuer by recalculating the NAV. Any such validation of the NAV should instead form part of the Management Company's (or the Investment Company's) responsibilities, as the fund administrator is a delegate of the Management Company (or the Investment Company).

3. **Delegation of depositary's tasks**

**Box 5** - *It is envisaged to restrict more explicitly the delegation of the depositary task to the safekeeping duties and that the conditions and requirements upon which a UCITS depositary may entrust its safekeeping duties to a third party should be aligned with those under the AIFMD.*

*It is also envisaged to require additional information for UCITS investors be published (for example in the prospectus) where a network of sub-custodians is to be used. Such information would specify the risk that such a sub-depositary network might fail or default, and how this risk can be dealt with.*

*Finally, implementing measures are envisaged in order to detail the depositary's initial and on-going due diligence duties, including those that apply to the selection and appointment of a sub-custodian.*

The AGC considers it vital to have clarity as to the functions that can be delegated by a depositary. We would suggest that delegation is not problematic if the depositary is legally responsible for the performance of the tasks and properly supervises the performance of sub-custodians it appointed.

The AGC would like to express its concern should the proposed additional requirements mandate disclosure of the details of the network of sub-custodians used, because networks of sub-custodians are under continuous risk assessment in accordance with the UCITS Directive and as such, they are constantly subject to change. It would therefore be impractical to present specific information on such networks in the form of a static document such as a prospectus. The AGC would like to reiterate that risks of failure and default within the sub-custodian network – which may only be under contractual control by the depositary - should form part of the relevant information considered by the entity acting on the fund's behalf, such as the fund's manager or board of directors, when taking an investment decision in relation to the relevant market. On this basis, the depositary's duty of disclosure should be to such entity, which in turn is responsible to the investors, rather than directly to the individual investors. Alternatively, if it is considered that the provision of the sub-custody arrangements' information is essential to informing an investor's decision about investing in a UCITS, a more practical solution than publication in a prospectus might be to refer investors to a website containing the relevant information. This would not only allow for such information to be updated on a regular basis, but would also remove the costs associated with updating hard copy prospectuses and the disadvantage of having a static form of disclosure. However, a sub-custodian network may involve multiple providers even in a given market, for instance in order to have alternative arrangements for risk mitigation, whereby the information provided may not equally apply across all investors and thus add confusion. We also foresee potential conflicts depending on the

outcome of the current MiFID consultation as it pertains question 122. As such, we do not believe that a general disclosure to the market on the details of the sub-custody network would be beneficial to investors with a view to assessing their risk and taking more informed decisions.

Instead, in terms of the additional information that could be provided in a prospectus, the AGC agrees that there would be merit in setting out a series of standardised statements, so far as practicable, in order to assist investors to identify the meaning of the risks being described consistently between types of funds and jurisdictions, where the essence of the risk is the same and not subject to frequent changes.

The AGC considers that the types of procedures for the selection and appointment of third party delegates and the procedures for the periodic review and ongoing monitoring of that third party should reflect international standards for depositaries and global custodians as a minimum, harmonised baseline, to ensure consistency across all Member States. The AGC acknowledges that the due diligence activity of the depositary is an important part of its function and would therefore suggest setting a minimum baseline, which requires depositaries to take account of the following:

- Exercising reasonable care, prudence and diligence in selecting sub-custodians, after considering all factors relevant to the safekeeping of such assets in the local market;
- Incorporating in written contracts with sub-custodians provisions that afford fund assets appropriate levels of care and protection, including proper segregation of depositary assets from fund assets;
- Sustaining a system to monitor the ongoing appropriateness of maintaining assets with appointed sub-custodians;
- Reporting when assets are held with a sub-custodian and any material changes in such arrangements;
- Withdrawing assets from the sub-custodian as soon as reasonably practicable if the sub-custodian no longer meets the relevant requirements.

The AGC considers that recourse to best practices which are generally consistent with legal regimes outside of the EEA and which are currently undertaken by global custodians would provide an effective form of protection. Please see APPENDIX I for a summary of the main principles proposed.

## **B. UCITS DEPOSITARY LIABILITY REGIME**

### **1. Improper performance**

*Box 6 - It is envisaged that the depositary liability regime might be clarified in case of a UCITS suffering losses as a result of a depositary's negligence or intentional failure to perform its duties.*

The AGC welcomes the proposal to clarify the depositary liability regime in case of a UCITS suffering losses as a result of a depositary's negligence or intentional failure to perform its duties.

### **2. UCITS depositary specific liability in case of loss of assets**

*Box 7 - It is envisaged to clarify the UCITS depositary liability regime in case of loss of assets. Accordingly, the UCITS depositary shall be under the obligation to return the financial instruments of the identical type or of the corresponding amount to the UCITS. No further discharge of liability in case of loss of assets is envisaged, except in case of force majeure. Implementing measures should be introduced, as necessary, to clarify all necessary underlying technical aspects, for example to identify the circumstances under which assets may be lost.*

The AGC believes that the key issue in this respect is developing an understanding as to when assets can be said to have been "lost". Assuming that the ordinary meaning of the term is applied, the AGC considers that it would be appropriate to transpose the language of the AIFMD into the UCITS Directive. "Lost" is commonly understood to mean that the depositary or their agent has been dispossessed of the relevant financial instrument and cannot recover it by reasonable means. The AGC would welcome a clarification to the effect that financial instruments which have been detained temporarily because of the operation of national laws, markets or insolvency procedures are not to be regarded as "lost". Accordingly, the meaning of "lost securities" for the purposes of the safekeeping duty should be distinguished from the meaning of the term in relation to the scenario discussed in Box 8 below.

The UCITS Directive should, as far as possible, be consistent with AIFMD Level 2 rules (once finalised) and as such clarify the *force majeure* exemption from depositary liability.

Thus, the AGC believes that following the approach of the AIFMD, namely that the depositary is relieved of its restitution obligation where the cause of the loss is an "external event beyond the reasonable control of the depositary, despite having made all reasonable efforts to the contrary", is the best option in such case, especially as different jurisdictions understand the concept of "force majeure" differently. In some jurisdictions

the term has no specified meaning and the law relies upon the parties to be clearer about their intentions. Relying on the AIFMD approach would clearly provide that the depositary has to account for losses which occur due to factors which are within its control (having regard to what can reasonably be expected of a depositary in the given circumstances), reiterating the fact that from a depositary point of view there is no technical difference of any kind whether custody services are offered for an institutional or retail CIS.

The Case Studies previously provided by the AGC to the Commission in May 2010 in the context of the AIFMD set out several examples of the types of circumstances in which financial instruments may be considered either unavailable or "lost", but which are beyond the reasonable control of the depositary. We have provided the Case Studies by way of separate attachment in order to supplement this response; the Case Studies should not be considered an exhaustive list of the circumstances leading to loss or unavailability of financial instruments. The AGC would be happy to update or explain the Case Studies if this would be desirable.

The AGC would like to stress that the ability to delegate and use sub-custodians is of paramount importance and should be safeguarded in the context of UCITS. We acknowledge the Commissions' statement on the liabilities of the depositary in such a situation, but this should be clearly distinguished from the actual ability to delegate the safekeeping of the assets. In this respect, we disagree with the views enunciated in the Consultation on pages 13-14, which state that:

*"the Madoff fraud and the Lehman default have shown that the risks associated with the use of local sub-custody networks are not negligible....given the very large investors base and the retail nature of UCITS holders, introducing a regime with the same contractual possibility for the depositary to be discharged of its liability as it may be the case in the AIFMD, is not considered to be entirely appropriate, or proportionate".*

The AGC disagrees with the suggestion that retail funds should be distinguished from alternative investment funds, as UCITS fund managers should be free to offer their investors a diverse choice of funds. Hindering the ability to delegate in the context of UCITS would lead to the closing-off of certain markets for retail investors, which wholesale investors would still be able to access due to the different provisions contained in the AIFMD, which would be fundamentally in contradiction with the permissible investments under UCITS that have materially contributed to transform UCITS into one of the most visible success stories of European law making.

**Box 8** - *As already provided under articles 22 and art. 32 of the UCITS Directive, it is envisaged to maintain the rule according to which the depositary's liability is not affected if it has entrusted to a third party or some of its safekeeping tasks. As a result, the*

*depository faces the same level of liability, should the UCITS assets be lost by a sub-custodian. Moreover, it is envisaged that the legislative proposal should clarify the fact that if assets are lost, the UCITS depository liability regime has the general obligation to return the financial instruments of the identical type or of the corresponding amount to the UCITS with no delay.*

*As mentioned above, no further discharge of liability (either regulatory or contractual) in case of loss of assets by a sub custodian shall be envisaged, except in case of "force majeure".*

As noted in Box 7 above, the AGC would like to distinguish between the situation where the "loss" has been caused in a non-safekeeping context by virtue of negligence or intentional failure of the depository and where "loss" has occurred in the context of safekeeping. We note that the latter situation has been discussed in the context of our response in Box 7 above.

The AGC is of the view that the relevant provisions contained in the AIFMD are reasonable, where "loss" of the relevant financial instrument is the result of misappropriation or misdelivery by the depository, or some other inexplicable disappearance.

### 3. **Burden of proof**

**Box 9** - *It is envisaged to clarify that the depository should carry the burden of demonstrating that it has duly performed its duties.*

Members wish to point out that a reverse burden of proof is an unusual requirement, which is contrary to the legal principles applicable in most Member States. The AGC believes that the introduction of such a provision could promote opportunistic litigation, which would in turn increase costs. A reversal of the burden of proof in this context is not necessary, as the burden of proving that a depository has been at fault in causing a loss is not onerous. It is advisable to leave this issue to be addressed in the context of the civil liability regime.

The duties of a depository should – as envisaged by this Consultation – be harmonized and it should be avoided that (i) arbitrage opportunities arise, through selective use of national procedural law; and (ii) the requirements to produce evidence become unreasonable and/or require the depository to respond to "strike" claims intended to compel depositories to settle in order to avoid costly litigation when they have done nothing wrong. Such states of affairs create arbitrary and disproportionate regimes with the reduction of legal certainty and the inability to contain cost.

4. **Rights of UCITS holders' action against the UCITS depositary**

*Box 10 - It is suggested to align the rights of UCITS investors, so that both share and unit-holders are able to invoke claims relating to the liabilities of depositaries, either directly or indirectly (through the management company), depending on the legal nature of the relationship between the depositary, the management company and the unit-holders.*

*Finally, implementing measures should also be introduced in order to encourage a high degree of harmonisation, for example to detail the conditions and procedures under which shareholders may directly use their rights towards a UCITS depositary.*

The AGC agrees that there should be no distinction between the rights of share and unit-holders to invoke claims. The experience of post-Madoff litigation in Luxembourg supports specifying a mechanism for claims to be brought in the first instance by the management company or the fund itself, as the entity responsible for the appointment of the depositary. The AGC believes that any implementing measures in this area should be consistent with the approach followed in the Securities Law Directive. Investors should primarily have a right of recourse against their direct contractual partner, as a first port of call, before being able to invoke claims against the depositary. Any such right of recourse against the depositary should then be in line with the UCITS complaints policy. The AGC believes that any such provisions should be clear on the procedural aspects surrounding the claims in question. Where investors are able to invoke claims against the depositary, this should be done in the Member State of the fund and under the relevant national law, so as to minimise the risk of claims being brought in more than one Member State. The provisions should ensure that depositaries are not exposed to "double jeopardy" risks and that they will not become subject to concurrent liability from investors and regulators, by virtue of the latter being able to establish a course of action on the basis of a no-fault statutory right of recourse available to the former.

C. **ELIGIBILITY CRITERIA**

1. **Eligibility criteria**

*Box 11 - It is suggested to introduce an exhaustive list of entities that should be eligible to act as UCITS depositaries, aligned with the AIFMD list. Such a list should include: credit institutions, authorised MiFID firms which also provide the ancillary service of safe-keeping and administration of financial instruments, and existing UCITS depositary institutions (by means of a grandfathering clause).*

The AGC welcomes the suggestion to introduce a list of eligible entity types in line with the AIFMD, as it will address one of the areas where the lack of harmonisation is most pronounced.

2. **Location of the depositary (passport issues)**

**Box 12** - *It is envisaged that a provision is introduced into the UCITS Directive creating a commitment to assess and re-examine the need to address depositary passport issues, to be undertaken a few years after the new UCITS depositary framework has come into force.*

The question of a depositary passport relates to the application to be appointed as a depositary for UCITS in a Member State other than the Member State where the institution in question is located. The AGC has no objection to conducting a review of this issue, but would like to note that this should be a long term goal. Currently, the depositary has to be located in the same Member State as the fund, as the lack of harmonisation in this area translates into significant risks from a monitoring perspective in cases where the depositary is located outside of the jurisdiction, where the fund and the supervisory authority are located.

D. **SUPERVISION ISSUES**

1. **Supervision by national regulators**

**Box 13** - *Differences between national supervisors' scope of competencies lead to an uneven supervisory framework, suggesting that such competences might be better harmonised. In the Commission's view, this remains a key issue to be addressed in order to fully achieve due levels of harmonisation in practice for the depositary function at the Community level.*

The AGC has no comment on this issue. As there has been no harmonisation in this area yet, the AGC believes that there is a need to retain flexibility at national level.

2. **Supervision by auditors**

**Box 14** - *The introduction of a requirement for an annual certification of the assets held in custody by the depositary would clarify the true existence of such entrusted assets. This annual certification could be performed by the depositary's auditors. Details related to any such requirement might need to be further defined in implementing measures or technical standards as appropriate.*

The proposal to introduce a requirement for annual certification of the assets held in custody by the depositary appears to be duplicative of the function of the fund's

auditor. In the interests of efficiency, it would be helpful to clarify what is expected from the fund's auditor as against the auditor of the depository.

As with any audit, the ability of the auditor to certify the "true existence" of assets will depend upon the quality of the evidence available. The AGC believes that the imposition of such an auditing obligation on the depository would entail significant costs. It is important to clarify the relevant provisions that will inform the auditing duty, by setting minimum standards in relation to the level and scope of the audit that will be required. We would suggest that recognised certifications (such as SAS 70 or the new SSAE 16 standards) describing the procedures and control mechanism depositories use to verify their positions could validly be used to serve the Commission's purpose, while at the same time limiting additional work and costs. The AGC would also like some clarity as to the exculpation provisions that will apply.

## **E. OTHER ISSUES**

### **1. Derogation from the obligation of UCITS to appoint a depository**

**Box 15** - *It is suggested to delete articles 32 (4) and 32 (5) of the UCITS Directive n°2009/65/EC.*

The AGC does not have any comments or views on this issue.

### **2. Single depository rule**

**Box 16** - *It is suggested that the requirement for a single depository per UCITS should be clarified (without prejudice to Article 113(2) of the UCITS Directive n°2009/65/EC).*

The AGC believes that the requirement for a single depository under the UCITS Directive is already clear, subject to the comments provided in Box 2 and further alignment which could be foreseen with AFMID Level 2 rules.

### **3. Organisational requirements and rules of conduct**

**Box 17** - *It is suggested to:*

- *Introduce for UCITS depositories similar rules of conduct as in the AIFMD, in addition to the already existing rules stated in the article 22 and 32 of the UCITS Directive;*
- *Introduce implementing measures in order to encourage a higher degree of harmonisation and consistency between the organisational requirements*

*applicable to all functions of the UCITS depositary (safekeeping as well as oversight) and, where appropriate, the existing MiFID requirements.*

The AGC would like to stress that in the context of looking at rules of conduct (including management of conflicts of interest) and organisational measures, the choice of depositary, especially when such a depositary is an EU credit institution, is based on its ability to efficiently provide services essential to the settlement of securities transactions, such as for example extensions of credit or foreign exchange services. Any restrictions on the ability of depositaries to provide such services will create inefficiencies, which will translate into increased costs and delays in the settlement of transactions. This will ultimately lead to delays in paying redemption proceeds to investors and will result in the depositary having less oversight and control over the assets of the UCITS. The AGC therefore suggests that any proposed changes should allow for the continuation of the relevant services and be subject to the overall duty to act in the interests of the UCITS fund. The AGC believes that the MiFID provisions should only apply in this context where appropriate in relation to the type of services provided.

4. **Exchange of information with competent authorities**

**Box 18** - *It is suggested to amend existing requirements concerning the disclosure of information to the competent authorities, on their request, in such a way that any information, obtained by a depositary while carrying out its duties, should be made available to its competent authorities if such information may be necessary for these authorities.*

AGC members anticipate that depositaries will generally be happy to provide information to the competent authorities in the discharge of their functions. The AGC would like to stress that the infrastructure for depositaries to provide real-time views into the trading activity of UCITS at the depositary level is not generally available. This should therefore be addressed with fund managers. The AGC believes that the appropriate supervisory authorities for these purposes are those of the Member State where the depositary is located and it is important to avoid imposing a requirement on the depositary to make such information available in more than one Member State.

5. **The contract between the depositary and the UCITS manager**

**Box 19** – *It is suggested that the requirements set out in Article 23(5) and Article 33(5) of the UCITS Directive and their corresponding implementing measures should also apply to a situation where the management company home Member State is also a UCITS home Member State.*

THE ASSOCIATION OF GLOBAL CUSTODIANS

UCITS Consultation Comments

31 January 2011

Page 17

*It appears opportune to require the UCITS depositary to follow conduct of business rules which would oblige a depositary to act honestly, fairly, professionally, independently and in the interest of the UCITS and investors of the UCITS. Furthermore, the depositary should be required to establish appropriate policy for identification, management, monitoring and disclosure of the conflicts of interests which may arise when a depositary carries out activities with regards to the UCITS.*

The AGC supports this suggestion and is in favour of introducing such requirements and imposing such duties on the depositary where the services in question may entail potential conflicts of interest. The AGC understands the term "UCITS manager" to be referring to the UCITS management company, in line with the terminology used in the UCITS Directive.

## APPENDIX I

### PROPOSED APPROACH FOR SELECTION, SUPERVISION AND OVERSIGHT OF FOREIGN SUB-CUSTODIANS

#### 1. General Requirements

In general, the following requirements may be prescribed:

- 1.1 The records of the EEA account provider custodian should at all times delineate the name of the party for whose accounts the securities are so deposited, including when these securities are held through third parties outside the EEA.
- 1.2 If securities are to be placed onward with third parties, such as with sub-custodians, this possibility should be disclosed in the relevant agreement with the account holder together with sufficient disclosure of the conditions under which they are so held and which might limit their availability to be returned.
- 1.3 It should be disclosed that under various settlement systems records of securities considered "in transit" in connection with their settlement and records of registrars and other agents of issuers may not at any particular time match the EEA account provider's records, as it is not possible to ensure this.

#### 2. Appointment of "Foreign Sub-custodians"

In respect of securities held via non-EEA sub-custodians ("Foreign Sub-custodians") appointed by the account provider:

- 2.1 The EEA account provider should be required to determine that securities held via Foreign Sub-custodians will be subject to reasonable care, taking into account the standards applicable to custodians in the relevant market, after considering all factors relevant to the safekeeping of the securities in such market, including:
  - The Foreign Sub-custodian's practices, procedures, and internal controls, including the physical protections available for certificated securities (if applicable), the method of keeping custodial records, and the security and data protection practices;

## THE ASSOCIATION OF GLOBAL CUSTODIANS

UCITS Consultation Comments

31 January 2011

Page 19

- Whether the Foreign Sub-custodian has the requisite financial strength to provide reasonable care for the securities;
  - The Foreign Sub-custodian's general reputation and standing; and
  - Whether the account holder will have jurisdiction over and be able to enforce judgments against the Foreign Sub-custodian, such as by virtue of the existence of offices in a member state of the EEA or consent to service of process in member state of the EEA.
- 2.2 The EEA account provider should also be required to establish a system to monitor the appropriateness of maintaining the securities via a particular Foreign Sub-custodian and to monitor performance under the contract appointing the Foreign Sub-custodian.
- 2.3 Holdings with Foreign Sub-custodians should be verified on a periodic basis, either directly or by qualified, reputable, independent auditors.
- 2.4 Provision should be made that more sophisticated account holders (without an account provider having to "look through" immediate account holders to ultimate account holders) may consent to take risks identified contractually by the EEA account provider such that use of certain sub-custodians may be at the risk of the account holder (with the presumption that similar consent has been obtained by the ultimate account holder or its appointed representative). In such cases, some or all of the requirements need not apply where the EEA account provider identifies them as not capable of being performed with assured care. Such an approach would seem appropriate where account holders qualify as Professional Clients or Eligible Counterparties under MiFID.

## ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE:

### *Case Studies Illustrating the Inadequacy of Exculpation of Depositories from Liability for Loss of Financial Instruments*

#### EXECUTIVE SUMMARY

Under article 17.5 of the Alternative Investment Fund Managers ("AIFM") directive, Depositories are liable to the AIFM, the AIF and its investors for any loss of financial instruments, except where such loss is unforeseeable or could have been avoided by the expenditure of unlimited resources.<sup>1</sup> Such limited exculpations from liability fail to take account of a myriad of circumstances leading to loss of financial instruments that are not reasonably within the control of a Depository, but which may nonetheless be foreseeable.

Such circumstances include losses resulting from:

- |   |   |
|---|---|
| <b>1. Settlement System Rules</b>               | <ul style="list-style-type: none"> <li>• Settlement failures in non-DVP markets;</li> <li>• Non-exclusive control of accounts under client-specific account structures;</li> <li>• Compulsory liens and transaction reversals imposed by central securities depositories.</li> </ul>      |
| <b>2. Market Infrastructure Deficiencies</b>    | <ul style="list-style-type: none"> <li>• Market infrastructure outages;</li> <li>• Sub-standard market infrastructure and quasi market infrastructure (including sub-custodians).</li> <li>• Fraud by a sub-custodian, beyond the Depository's duty of supervision.</li> </ul>            |
| <b>3. Local Market Conditions</b>               | <ul style="list-style-type: none"> <li>• Market volatility</li> <li>• Widespread defaults</li> <li>• Market closures and currency devaluations.</li> </ul>  |
| <b>4. Appointment of Counterparties by AIFM</b> | <p>Failure of the AIFM's chosen counterparty in the context of:</p> <ul style="list-style-type: none"> <li>• Securities lending and repo arrangements;</li> <li>• Prime brokerage arrangements involving rehypothecation of AIF assets; or</li> <li>• Derivative transactions.</li> </ul> |
| <b>5. Investment Decisions of AIFM</b>          | <p>The decision to invest in:</p> <ul style="list-style-type: none"> <li>• Markets where infrastructure does not meet EU standards;</li> <li>• Highly volatile or unstable markets.</li> </ul>  |

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<sup>1</sup> To avoid confusion, depositories responsible for holding the assets of AIFs, as defined in the AIFM Directive, are referred to as "Depositories". Terms not defined herein have the meaning given to them in the AIFM Directive.

This list, and the more detailed case studies that follow, are by no means exhaustive. Attempts to enumerate specific exculpations based on these examples would therefore run the risk of excluding other circumstances, which are not covered herein, but which would (with the benefit of hindsight) have been thought "foreseeable". In order to avoid the legal uncertainty and systemic risk consequences that could result from the proposed liability regime, the directive should provide for a general exclusion of strict liability in cases where the Depositary is not at fault.

## INTRODUCTION

Article 17.5 (first paragraph), in the second sentence of the consolidated compromise text of 06/05/2010 provides:

“In case of any loss of financial instruments which the depositary safe-keeps, the depositary can only discharge itself of its liability if it can prove that the loss has been caused by an external event, that it was not foreseeable and that the depositary could not have avoided the loss which has occurred.”

The liability regime provided for in Art 17.5, when applied in practice, is likely to give rise to significant legal uncertainty as well as systemic risk. By excluding depositary liability only where an event is unforeseeable, or where the event could not have been avoided by the expenditure of unlimited resources, the text fails to take account of a myriad of events that are not reasonably within the control of a Depositary, but which may nonetheless be foreseeable.

The potential consequences of this liability framework are set out in the Systemic Risk Paper. The following case studies illustrate additional scenarios which the current wording fails to take into account, notwithstanding their foreseeability as the consequence of an AIFM's investment decision.

### 1. SETTLEMENT SYSTEM RULES

- 1.1 *Settlement risk in non-DVP markets.* The greatest financial risk, to which Depositaries and their clients are exposed in the clearing and settlement process, is the risk that the seller of a security could deliver but not receive payment or that the buyer of a security could make payment but not receive delivery ("**settlement risk**"). In markets, particularly outside the EU, where no such mechanism (delivery versus payment or "**DVP**") exists, settlement risk may cause Depositaries and/or their clients to lose the full value of the securities transferred. Paragraphs 1.2 to 1.5 illustrate examples of markets in which settlement does not take place on a strictly DVP basis, and in which an AIF may therefore be exposed to the risk of loss of its financial instruments, or their value, for reasons wholly outside the control of the Depositary. In addition, transactions concluded off-exchange are also likely to give rise to increased settlement risk as they will often be settled on a non-DVP basis.
- 1.2 *Gross settlements of securities and net settlement of funds.* Although securities settlement systems involving “gross settlements of securities transfers followed by net settlement of funds transfers” ("**Model 2 DVP**") have been identified by the Committee on Payment and Settlement Systems of the Bank for International Settlements ("**BIS**") as one of three broad structural approaches to achieving DVP, such structure may still leave market participants exposed to significant settlement risk. Under Model 2 DVP, the system will settle securities transfer instructions on a trade-by-trade (gross) basis, with final transfer of securities from the seller to the buyer (delivery) occurring throughout the processing cycle, but settlement of funds transfer instructions will occur on a net basis, with final transfer of funds from the buyer to the seller (payment) occurring at the end of the processing cycle. Although corresponding funds transfers

are irrevocable (i.e. committed), until funds have actually been received into the AIF's account at the relevant Depository, an AIF selling securities in a Model 2 market, having already transferred the securities, will be exposed to the risk that its counterparty buyer and/or the counterparty's settlement agent may fail to transfer the funds, resulting in a loss of the value of the AIF's securities.

- 1.3 As a variation on Model 2 DVP, in certain markets (e.g., Jordan, the UAE), book-entry securities settled through the local depository ("**CSD**") are transferred to the buyer gross on trade date ("**T**") and cash is multilaterally netted on trade-date-plus-two (T+2), and electronically transferred between banks via the local CSD's settlement bank. Securities are reflected by the sub-custodian in "pending" status until settlement date. On T, when the CSD receives matched trade instructions, the stock exchange immediately transfers shares from the seller's broker trading account to the buyer's broker trading account, at which time title is considered to have passed and the shares may be sold or otherwise used via the local broker's trading account. Under this model, in addition to settlement risk, the AIF is also exposed to the risk that the relevant broker, in accordance with market practice, re-uses the securities credited to its account, notwithstanding that such securities are beneficially owned by the AIF. While steps may be taken to prevent such re-use of securities, such safeguards are dependent on the mechanisms employed by the relevant buyer's broker (acting on instruction from the buyer, who may be an AIFM acting for the AIF) and are not within the control of the Depository.
- 1.4 ***Client specific registration markets.*** In certain markets securities must be registered in the name of the beneficial owner in a client-specific account at the central securities depository, rather than being held in the Depository's nominee account at the CSD. Theoretically these accounts belong to the client, however, operationally such client-specific accounts are linked to the Depository, who should be the only authorised operator of the account. Under such arrangements, clients should only be able to instruct such accounts through the Depository, however, in practice there may be instances where the client can instruct the movement of such securities independent of the Depository, and outside the Depository's control. This may occur in certain Middle Eastern markets where trades executed by a client through a broker are binding and settlement on behalf of the broker occurs automatically, without instructions from the Depository (see above). In such markets therefore, an AIFM could execute a trade away from the Depository, and the movement of such securities would be outside the Depository's control. Under the directive, the Depository would be liable for restitution of the securities and for ensuring that the AIFM does not carry out disposals of the AIF's securities in this manner.
- 1.5 ***Non-linked securities and cash movements.*** In some markets (again, Jordan and the UAE being examples) securities and cash movements are not linked for broker-custodian transactions, such that cash settlement for trades on particular exchanges settle between brokers on a net basis, without any direct involvement of the sub-custodian. In respect of securities purchases, the sub-custodian must transfer funds to the broker's cash account at the central bank, while in respect of sales, the proceeds

are settled into the broker's cash account at the central bank, following which the broker must transfer the funds to the sub-custodian in order to credit the client's account. In the event that securities were re-used as described in example 1.3 above, the corresponding proceeds would be credited to the broker's cash account and not the sub-custodian's cash account.

- 1.6 ***Liens imposed by settlement systems.*** Conditions of participation in a central securities depository ("CSD") or international central securities depository ("ICSD") require compliance by Depositories or their sub-custodians with rules that are not negotiable. In many cases (but not all), these rules are incorporated into local law, one example being the rules of the Depository Trust Company, which are incorporated into New York law. These rules are intended to ensure certainty of settlement and reduce systemic risk that may arise in relation to pending transactions. To this end, these rules usually require participants, such as Depositories, to satisfy their obligations absolutely. To ensure compliance with the rules, CSDs and ICSDs enjoy broad enforcement rights and remedies, including the ability to impose liens over the accounts, as well as other powers intended to eliminate the CSD or ICSDs exposure to settlement risk in respect of the transactions of the participants and their clients. As a consequence, a CSD or ICSD may withhold client assets held in the participant Depository's account until the relevant trade is settled. CSDs will often have no visibility of individual client positions, such that an AIF may be deprived of access to its assets due to a CSD exercising its rights under a compulsory lien, notwithstanding that the relevant pending settlement obligations do not relate to the AIF's own trading positions.
- 1.7 ***Reversals of payments of principal and income at ICSDs.*** Whereas settlement risk covers the risk of a transaction not being finally settled, under the rules of certain ICSDs, there is also a risk that transactions once effected, will be reversed. Under their rules, ICSDs may reverse credits related to interest payments or principal redemptions to participants in order to correct payment/credit errors at the ICSD or to correct errors or adjustments initiated by issuers through their paying agents or common depositories. These reversals are made without prior authorisation from the affected participants, and may be carried out several weeks or more after the original credit.
- 1.8 As a consequence, Depositories who are ICSD participants are required to make adjustments to their clients' accounts, which are disruptive of settled investment/income expectations and often affect fund valuations reported in prior months. Although ICSDs customarily pre-advise their participants about imminent reversals of principal, there is effectively no way for Depositories to control or limit the financial risk attributable to payment reversals. The risk posed by these reversal practices should be borne by issuers and their investors, not by Depositories who have no control over such reversals.

## 2. MARKET INFRASTRUCTURE DEFICIENCIES

- 2.1 The sophistication, stability and reliability of market infrastructure vary significantly across financial markets. Even in highly developed markets, there may be instances where market infrastructure will fail, albeit temporarily, causing settlement delays and resultant losses to its participants and their clients.
- 2.2 In less sophisticated financial markets, a lack of developed financial infrastructure together with inadequate regulation will significantly impair the functioning of the settlement system and the integrity of title to securities. While Depositaries may agree to provide services in such markets, the decision to invest in these markets must be assumed by the AIFM, insofar as risks involved are outside the control of the Depositary.
- 2.3 The following examples provide some illustrations of the risks posed by a failure in, or inadequate, market infrastructure, which are beyond the control of Depositaries.
- 2.4 ***SWIFT messaging system.*** Depositaries rely on the global messaging network, SWIFT, in order to receive and send instructions and other information from and to their clients, other financial institutions and market infrastructures. If SWIFT becomes unavailable, this may delay or prevent settlement or the processing of corporate actions taking place, or delay the making of payments or instructing the disposition of securities, and could lead to losses, either of financial instruments, or consequential loss of their value as a result of market movement and volatility. The current liability framework of the AIFM Directive appears to hold the Depositary liable to investors for the financial consequences of a failure in the functioning of SWIFT. Depositaries should not be held liable for such losses which, although foreseeable, are beyond their reasonable control.

Also of significance is that many investment management firms may not have full SWIFT functionality, which in itself heightens the risk of instruction error due to the need to find manual work-arounds or other solutions to provide an instruction functionality.

- 2.5 ***Securities registration systems.*** In certain less sophisticated markets, there is no central securities depositary and securities registration systems are poorly regulated by comparison with the EU. By way of example, Russian securities registers are maintained by the issuers themselves or by licensed registrars located across Russia. Due to inadequate supervision of registrars and inadequate enforcement of licensing regulations, transfers of securities may be inaccurately recorded leading to a loss of securities or distributions related thereto through fraud, negligence or oversight by registrars, who are often poorly capitalised, do not generally have adequate insurance cover, and are therefore unable to compensate the affected shareholders. These risks are beyond the control of Depositaries providing custody services within these markets and should not therefore be borne by such Depositaries. The risks should instead be borne by the AIFM who has chosen to invest in the relevant market.

- 2.6 ***Sub-standard sub-custodian.*** In many markets, Depositaries may be obliged to use a sub-custodian in order to gain access to the local CSD or central bank. In some markets, particularly in certain emerging markets, although all available sub-custodians may fail to meet EU standards, the AIFM may nonetheless wish to invest there. In such cases, Depositaries will habitually only provide services where the relevant client assumes the responsibility for its choice of sub-custodian, and the Depositary will agree with the client to limit its liability contractually. Under the directive, a Depositary's liability is unaffected by the appointment of such sub-custodians such that a Depositary would be liable to the AIFM to replace any financial instruments lost as a result of such sub-custodian's failure, notwithstanding that it was the AIFM's informed choice to use such sub-custodian. The directive should make clear that Depositaries are not liable when appointing sub-custodians in markets where, although no sub-custodian meets the required standards, the AIFM has nonetheless chosen to invest there.
- 2.7 ***Fraud by a sub-custodian beyond the Depositary's duty of supervision.*** It is appropriate that Depositaries comply with certain duties of supervision in respect of sub-custodians or other delegates which they choose to appoint, which may include certain periodic reviews and reconciliations of accounts designed to prevent fraud. However, it would be inappropriate to impose liability on Depositaries beyond such duties, where loss of financial instruments is caused by a delegate or sub-custodian acting fraudulently, as in the Madoff example, but which could not have been discovered by the Depositary acting reasonably and in compliance with such standard of care. The details of such supervisory duties could be appropriately addressed in Level 2 legislation, rather than in the Level 1 directive.
- 2.8 ***Subscription/Redemption Accounts Held with sub-custodians.*** From time to time a Depositary is appointed by an AIF to receive all payments made by, or redemption proceeds to be paid to, investors in a particular market subscribing in units or shares of the AIF, but the Depositary does not have access to the local central bank so must use a local sub-custodian bank to hold such cash. In the event of the collapse of the local banking system, as was the case in Iceland, the local bank may become insolvent, following which its operations cease to function normally. As a result, the local bank's records do not show that the funds invested reached its account at the central bank.
- 2.9 In such circumstances, under article 17(1)(a) of the Spanish Presidency Compromise text of 11 March 2010, the Depositary would be obliged to "ensure" that payments made by or on behalf of investors have been correctly booked in a segregated account in the name of the AIF, however, it is unclear whether the Depositary's own books are a sufficient record. If they are not, the Depositary will be liable to the AIF and its investors for failure to ensure correct booking, in response to which there is no defence. If the Depositary's books are sufficient, the Depositary, as deposit taker or agent, will be liable to the investors for the receipts, unless it is permitted to adjust its books to reflect the loss at the local bank level. Whether such action is permitted under the directive is unclear.

### 3. LOCAL MARKET CONDITIONS

- 3.1 **Market volatility.** The liability provisions in the directive effectively expose Depositories to market risk over which they have no control and which could lead to significant systemic risk. By way of example, an AIF may have a large exposure to Greek government bonds, the price of which has in recent months been volatile. At a particular moment, the Depository and the Valuator disagree on the value of the AIF's holdings, the Depository considering that the immediate sale of the bonds would be the only sensible way to protect itself against the liability risk associated with the increasing divergence of views between the independent professionals. Obviously, given that the Depository is only the custodian, not the owner of the assets, it cannot order their sale, yet due to the strict liability regime imposed by the directive, the Depository is nonetheless effectively exposed to the assets and therefore needs to hedge this risk by taking a short position in the bonds. Assuming shorting is permitted, this would drive down the price of the bonds further contributing to increased market turmoil. In the event that shorting is not permitted, this would leave the Depository exposed to the investment risk.
- 3.2 The situation above may further deteriorate where a particular market is affected by severe economic difficulties, such as Greece in recent months. This may have a consequential effect on the stability of local financial institutions and market infrastructure, particularly where such entities are government-owned. Instability of Greek financial institutions and market infrastructure would threaten access to securities held in local depositories and settlement systems, thereby exposing Depositories to liability if they were called on to replace any securities lost as a consequence. This is likely to prompt such Depositories to withdraw from the Greek market to avoid liability, which could provoke a generalised exit from the market leading to the further vulnerability of the Greek economy.
- 3.3 **Securities Market Closure.** The imposition of emergency measures by governments in times of economic crisis has in the past led to the loss of financial instruments in cases of expropriation, or to loss of access to, or the ability to trade such assets, effectively equating to the loss of the asset itself. Examples include the economic policies adopted by a number of Southeast Asian governments during the Asian Financial Crisis of 1997-99, effectively closing their markets.
- 3.4 In Malaysia, for example, in 1998 the Government adopted capital controls prohibiting licensed offshore banks from trading in *ringgit* assets, suspending all domestic credit facilities for overseas banks and stockbrokers and requiring the retention of the proceeds of the sale of Malaysian securities in the country for a year. Similar market closures which have had the effect of preventing client access to their assets for extended periods have occurred in Latin American countries, North Korea, Russia and China. Should similar circumstances arise in the future, under the current liability provisions of the directive, without provision for exculpation, the Depository would be liable to AIFs, AIFMs and investors who have invested in such markets and suffered loss due to these foreseeable, but unpreventable, cases of asset non-availability.

- 3.5 ***Asymmetric currency re-denomination.*** Short of closing securities markets, governments have in the past drastically affected the value of assets held in such markets through currency devaluation. For example, in Argentina the peso was convertible 1:1 to the USD for several years prior to January 2002. Due to USD capital flight, the Argentinian Government devalued the peso in January 2002, and redenominated locally held USD bank accounts into peso. This action caused huge losses for foreign banks as their USD holdings at the central bank of Argentina, and at Argentinian banks, were devalued, whilst they still had to meet their obligations to foreign USD account holders.
- 3.6 In the custody context, an AIFM could have claimed that it had deposited USD assets with the Depository, expecting restitution of those USD, not peso, assets. A similar situation could arise in the European context where an AIFM invests in a eurozone country which later seeks to return to its old currency at a lower exchange rate. It would be unreasonable to expect the Depository to assume liability for such loss of assets, as the Depository would be powerless to prevent such loss.
4. **APPOINTMENT OF COUNTERPARTIES BY THE AIFM**
- 4.1 ***Over-arching concern.*** It is not appropriate to hold a Depository liable for loss of financial instruments or other assets of the AIF where those assets are legitimately delivered out of the control of the Depository in order to facilitate trading arrangements established by the AIFM. When assets are legitimately delivered out of the Depository's control, whilst the selection, appointment, periodic review and ongoing supervision of a counterparty receiving the assets should be subject to the Depository's duty of supervision, the counterparty, having been appointed by the AIFM, should not be seen as a delegate of the Depository.
- 4.2 ***Securities lending and repo.*** AIFMs frequently "lend" securities held in long positions in order to enhance return to the AIF to "borrowers" such as broker-dealers who require those securities for various purposes, such as in order to cover shortages due to a settlement failure or to cover short sales for speculative or hedging purposes. Conversely, AIFMs might also "borrow" securities for the same purpose. Although referred to as "lending", securities loans – like sale and repurchase ("repo") transactions – will under some legal systems involve the transfer of legal title in the securities from the lender to the borrower in exchange for the borrower providing the lender with acceptable assets as collateral in the form of cash or other securities (in such cases, the services of third-party "lending agents" are often used in order to facilitate robust and controlled "lending programmes").
- 4.3 However, it is not always the case that legal title is transferred. By way of example, in transactions using the ISDA Credit Support Annex, under English law-governed transactions, which generally include most transactions involving non-US securities, title to the securities is transferred to the borrower. By contrast, under New York law, title to the securities remains with the lender. Consequently the legal position in terms of ownership may differ according to the domicile of the securities and the counterparty to the transaction. Nevertheless the securities provided by way of loan

will remain on the balance sheet of the lender (e.g., the AIF), even though legal title to such securities may have been transferred to the borrower (e.g., the AIF's counterparty) such that the securities are no longer registered in the name of the AIF, and are no longer in the control of the AIF's Depositary.

- 4.4 In the event that the borrower becomes insolvent, a securities loan will be terminated. Unless the securities can be “recalled” outside the insolvency of the borrower, lent securities may be “lost” in the sense that they cannot be returned to the lender. A prudently structured securities loan will provide for collateral to be given to the lender (often maintained by the lending agent), but there is no guarantee that the collateral will be sufficient to cover the loss.
- 4.5 ***Derivatives transactions.*** Another instance in which the AIF's assets may be transferred away from the Depositary at the instructions of the AIFM is in the context of derivatives transactions. In order to mitigate counterparty risk, parties to a derivative transaction will habitually enter into a Credit Support Annex (“CSA”) which provides for collateral to be transferred from one party to another, according to each party's fluctuating credit exposure to the other party during the life of the derivative contract. As in the securities lending and repo example in 4.1 above, title to the collateral may be transferred to the collateral taker (under an English law CSA), or title to the securities may remain with the collateral provider (under a New York law CSA). Where AIFs enter into such arrangements, assets may be transferred away from the AIF's Depositary to the AIF's counterparty, or to a third party custodian by way of collateral. As in the securities lending and repo example above, although the securities provided by way of collateral will remain on-balance sheet for the AIF, legal title to such securities may have been transferred to the AIF's counterparty such that the securities are no longer registered in the name of the AIF, and are no longer in the control of the AIF's Depositary.
- 4.6 ***Rehypothecation of assets by AIFM's prime broker.*** The collapse of Lehman Brothers International (Europe) provides a real life example of the losses that may be suffered by an AIF as a result of the AIFM appointing a counterparty to whom the Depositary is instructed to transfer certain assets. Where an AIF instructs the Depositary to transfer assets to its chosen prime broker, here, LBIE, frequently, in accordance with the agreed terms of the contract between the AIF and its prime broker, such assets will be rehypothecated either in full or in part. In the event that the prime broker's records are inadequate, as was the case for LBIE, this could result in the AIF being deprived of such assets for an extended period, until it is determined whether such assets had been rehypothecated and whether they will be returned.
- 4.7 Insofar as a prime broker such as LBIE is holding an AIF's assets, the AIFM directive is unclear as to whether the prime broker is acting as a “delegate” of the Depositary or as a trading counterparty. If the prime broker is a delegate of the Depositary, the AIFM directive as proposed would appear to impose liability on the Depositary for strict (and possibly immediate) “restitution” of assets that are determined not to be “validly” rehypothecated. This in turn suggests that the depositary will be liable for

failure to "ensure" that the prime broker has segregated assets that could be lawfully rehypothecated from client assets that could not (i.e., outside the limits of the AIFM's consent). These claims, to which Depositaries have no defence under the current wording of the AIFM directive, represent a shift in the allocation of risk away from the AIF investors to Depositaries, even though such risk should more obviously be borne by the AIF investors themselves.

- 4.8 It is more sensible to consider the use of prime brokers as one of many forms of counterparty trading arrangements in which assets of the fund may be delivered as collateral to the counterparty. To do otherwise risks creating confusion around when a depositary must or must not consider a counterparty to be a "delegate": there is no universally agreed dividing line establishing when a counterparty is a "prime broker" and when it is some other form of OTC counterparty.
- 4.9 All counterparty trading collateral arrangements, therefore, should be treated in the same way. In this context, therefore, it makes more sense to exclude from the depositary's liability for restitution counterparty trading arrangements pursuant to which assets of the fund have been delivered as collateral (including where such collateral is subject to re-use / rehypothecation), subject to a duty of the depositary to "oversee" the adequacy of arrangements put in place by the AIFM in respect of assets of the fund that are delivered as collateral to such counterparties. This oversight duty might involve reviewing the selection, appointment and on-going use of the counterparty by the AIFM.

## 5. INVESTMENT DECISIONS OF AIFM

- 5.1 AIFMs may choose to invest in a wide variety of asset classes and markets. Although Depositaries play a role in verifying that asset purchase and sale transactions are carried out correctly, they cannot be held responsible for flaws in asset title or the assets themselves, beyond what is reasonable. Such risks flow from the AIFM's investment decisions and must therefore be borne by the AIFM and/or the investors in the AIF. Various examples cited above are of investment decisions: the choice of assets in countries with infrastructure or regulatory standards which fall short of the EU norms, or the choice of counterparties in transactions which may lead to loss of assets. These are not cases of failure of the Depositary's function but of the investment profile. It would not be right, as a policy matter, to shift responsibility for risk to Depositaries.
- 5.2 Depositary banks are quasi-market infrastructure, and as such should be risk averse. By transferring the investment risk to Depositaries, the liability provisions of the directive cause a misalignment of incentives, which could result in Depositaries turning away the business of AIFs in order to avoid shouldering the investment risk that would more appropriately be borne by the AIF's investors. In turn, this could lead to the decline of AIF activity - a legitimate business activity when duly regulated - which, as a matter of policy, is not the outcome which the directive purports to achieve.

6. **HOLDINGS RECORDED BY AN AGENT OF THE ISSUER, A REGISTRAR OR A TRANSFER AGENT**

- 6.1 Article 17(1)(b)(i) of the consolidated compromise text of 06/05/2010 provides that a Depositary appointed by the AIFM shall hold in custody all financial instruments that can be held in a Central Securities Depository, that can be credited into securities accounts or that are physically delivered to the Depositary. Although holdings recorded solely by an agent of the issuer, a registrar or a transfer agent cannot be held by the Depositary as such, the AIFM may request that a Depositary keep records of such assets for valuation and general record keeping purposes. For the avoidance of doubt, the directive should make clear that such position records do not amount to the holding of assets in custody nor do they evidence the integrity of those holdings, and as such there can be no liability on the part of the Depositary for loss of such assets.

**CONCLUSION**

The preceding list of exculpation scenarios demonstrates the complexity of circumstances in which Depositaries may be held liable under the current wording of the directive, notwithstanding the Depositary's diligence. Although already long, the above list is not exhaustive, and there will be other examples which we have not included, which would (with the benefit of hindsight) have been thought "foreseeable". It would therefore be more appropriate to provide for a general exclusion of strict liability in cases where the Depositary is not at fault, so that the Depositary is only deemed to be in breach of its custody duty in cases where its own processes or books are deficient, and this is the source of the fund's loss.