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Association of Global Custodians

26 June 2015

Tilman Lueder
Head of unit
European Commission
DG Internal Market and Services - Unit G4
Asset Management
rue de Spa 2 (02/020)
1000 BRUSSELS

Dear Mr. Lueder,

The signatories to this letter are writing to you regarding the segregation obligation arising pursuant to Article 21(11)(d)(iii) of Directive 2011/61/EU ("***AIFMD***") (as further specified in Article 99(1)(a) of Regulation 231/2013 ("***AIFMR***" and together with AIFMD, the "**Legislation**").

In order to assist you with any review of these matters, we have set forth below the following positions:

- Segregation between AIF and non-AIF assets and segregation between the assets of different depositaries at the sub custodian level and throughout the custody chain (referred to herein as "**Full Segregation**") has been rejected by a large number of market participants and organisations, including depositaries, prime brokers and investor;
- The Legislation does not require such segregation and current asset segregation practices (which are not restricted to Full segregation) are both permitted by the Legislation and are considered more beneficial to the market generally;
- Full segregation does not provide a higher level of protection to investors or their assets than current asset segregation upon insolvency of a sub custodian to whom custody has been entrusted;
- Full segregation does not have a positive impact on speed and efficiency with respect to the return of assets upon such insolvency;
- Full Segregation applied in all contexts would have negative and damaging operational impacts and result in higher operational risk with respect to depositaries, as well as with respect to the prime brokerage, collateral agency and securities lending industries; and
- Full Segregation would likely reduce market liquidity in securities with negative impact on investors.

I. Executive Summary

A. Segregation between AIF and non-AIF assets, or between assets of different depositaries, as proposed by Options 1 and 2 in ESMA's Consultation Paper on asset segregation under AIFMD (the "**Consultation**"), has been overwhelmingly rejected as neither required nor necessary by a broad range of regulatory authorities, industry participants and groups (including the UK Financial Conduct Authority (FCA), the Association of Global Custodians European Focus Committee, the Alternative Investment Management Association (AIMA) and the Irish Funds Industry Association (Irish Funds)).

B. The manner in which custodians, collateral agents and prime brokers currently hold and segregate client assets (i.e., in accordance with Option 4 in the Consultation) is consistent with and permitted by the Legislation. This is true with respect to general custody arrangements, and also with respect to sub-custodial accounts established to support other securities financing transactions such as repo and securities lending. The requirements under Article 21(11)(d)(iii) of AIFMD and Article 99(1)(a) of AIFMR are satisfied by maintaining records necessary to ensure proper segregation as necessary to return financial instruments held in custody of the depositary (on whom the restitution obligation falls). This, rather than Full Segregation, would likely be the most important driver for the speedy return of assets on insolvency.

C. We have received preliminary legal advice relating to around 100 jurisdictions confirming that, in the vast majority of those jurisdictions, asset segregation, as set forth in the Legislation would not be the dispositive or controlling factor in determining the recoverability of assets in the event of the sub-delegate's insolvency. Supplemental legal opinions have been obtained by depositaries and/or their relevant delegates that identify the additional or alternative factors that determine the recoverability of investor assets under relevant local laws in those and other jurisdictions in order to provide appropriate disclosure to investors and facilitate asset protection.

D. Full Segregation would not result in faster, easier and more efficient recovery of client assets in an insolvency. The key reason for the delay in return of client assets following in the Lehman insolvency arose due to the complexity of competing security and other proprietary assets by, among others, depositaries, prime brokers, sub-custodians and securities settlement systems, each of which may be based in different jurisdictions and subject to competing and legal regimes that apply on insolvency of the relevant intermediary. Holding assets in a separate omnibus account does nothing to address this key consideration and will not assist in the swift return of a client's assets on insolvency. In fact, Full Segregation would significantly increase the number of client accounts in each market, complicating the reconciliation/resolution process and causing major delays in returning client assets.

E. The operational impact of Options 1 and 2 in the Consultation across the prime brokerage and collateral agency markets would, in particular, lead to a substantial increase in costs for clients, operational complexity and settlement failures. For example, assume a single prime broker or collateral agent acting for a single AIFMD client which holds assets in 50 jurisdictions with one sub-custodian per jurisdiction. Option 1 would require the prime broker or collateral agent and each sub-custodian to set up a new "omnibus depositary account" associated with each depositary and transfer all assets to such account: multiply this by 50 sub-custodians in 50 different jurisdictions and the impact would be highly disruptive. Many clients appoint multiple prime brokers and collateral agents: if the prior example is extended to account for all prime brokers, collateral agents, depositaries and sub-custodians in the market, the impact becomes correspondingly more disruptive. The buy-side has rejected Options 1 and 2, due to the increase in complexity and risk of operational failure, increasing the risk of loss of assets that regulators intend to prevent.

F. Full segregation would have an extremely damaging effect on collateral agency, which is an important element of the repo and securities lending markets. Such segregation would reduce liquidity and increase various risks (e.g., settlement risk, counterparty risk, operational risk). It would also be inconsistent with overall European policy objectives of encouraging economic growth and would increase the restrictions that are preventing capital markets from operating efficiently.

II. <u>Introduction</u>

The Legislation does not and should not mandate Full Segregation. Such segregation does not achieve any higher level of protection on the insolvency of the depositary or delegate, does not speed up the return of assets, and is not required on the face of the language of the Legislation. Market participants support the implementation of Option 4 in the Consultation and have rejected the sole implementation of either Option 1 or Option 2.

III. <u>Interpretation of the Segregation Obligation</u>

The Legislation does not mandate physical segregation

- The manner in which prime brokers and collateral agents currently hold and segregate client assets (i.e. Option 4 in the Consultation) is consistent with and permitted by the Legislation.

- Article 21(11)(d)(iii) of the AIFMD provides that a depositary is required to ensure that a third party delegate:

  > "*segregates the assets of the depositary's clients from its own assets and from the assets of the depositary" so as to ensure that the assets of a depositary's clients can at any time be* ***clearly identified*** *as belonging to the clients of a particular depositary*".

- As envisaged by Option 4 in the Consultation, the segregation obligation is satisfied provided that the third-party delegate (appointed as a "sub-custodian") segregates the assets of the depositary's clients from its own assets and from the assets of the depositary. All prime brokers and collateral agents in the market currently operate with this level of segregation, as specifically set out in AIFMD.

- The segregation obligation is further set out in Article 99(1)(a) of AIFMR so as to require the depositary to ensure that the third-party delegate:

> *"keeps such **records and accounts** as are necessary to enable it at any time and without delay to **distinguish assets** of the depositary's AIF clients from its own assets, assets of its other clients, assets held by the depositary for its own account and assets held for clients of the depositary which are not AIFs."*

- The segregation obligation under the Legislation requires the third-party delegate (appointed as "sub-custodian)" to keep ***records and accounts*** to be able to be to ***clearly identify*** and ***distinguish*** AIF assets. It does not mandate the segregation of such assets into separate, artificially-constructed omnibus accounts at the level of the third=party delegate. It is possible to make such a distinction or identification immediately and at all times by reference to the books and records of the depositary or prime broker/collateral agent.

- Options 1 and 2 in the Consultation, proposing Full Segregation, are therefore neither required nor necessary to satisfy the AIFMD segregation obligation.

- This interpretation of AIFMD is consistent with best practice as set out by the FCA CASS Rules. The FCA has confirmed that "the omnibus account…can include the assets of AIFs and other clients of the third party, as long as these assets are segregated from the third party's own assets". This interpretation of AIFMD has also been affirmed by the CSSF.

"Mutatis mutandis" obligation in Article 99(3) of AIFMR

- The "*mutatis mutandis*" obligation set out in Article 99(3) of AIFMR does not require Full Segregation at the sub custodian level.

- The segregation requirement in Article 21(11)(d)(iii) of AIFMD, as further specified in Article 99(1)(a) of AIFMR, in effect, requires a depositary to segregate the individual AIF assets on their own books and records, but it does not impose an additional obligation to ensure segregation of assets down-stream with its delegates and sub-delegates, other than as between proprietary and client assets.

- Article 99(1)(a) of AIFMR, states that a depositary must ensure that a third party keeps such ***records and accounts*** as are necessary to ***distinguish*** AIF assets. AIFMD specifically contemplates and envisages books and records segregation throughout the custodial chain. It is neither required nor necessary for a sub-custodian to maintain a duplicative set of books and records where AIF assets are segregated for the relevant depositary:

imposing such a requirement would be extremely damaging to the collateral agency, prime services and securities lending markets.

- This interpretation coincides with the understanding that records and accounts must be maintained to provide meaningful protection to investors: depositaries must ensure reconciliations are conducted sufficiently and that delegates and sub-delegates maintain accounts which facilitate and do not frustrate the performance of the depositary's own functions and responsibilities.

- Please see Annex A for more detail on the *mutatis mutandis* language in this context.

Consistency with MiFID

- The segregation obligation on the depositary is clearly framed by reference to the principles in MiFID, which permits omnibus accounts, requiring ***books and records*** client-specific segregation but downstream custody-account segregation between proprietary and client assets only.

- The meaning of the segregation obligation on the depositary at Article 21(8)(a)(ii) is clear – the depositary is required to hold custody assets on its books in accordance with the principles set out in MiFID, i.e. the ***records and accounts*** of the depositary must enable it at any time and without delay to ***distinguish*** assets held for one client from assets for any other client, and from their own assets[1], and the depositary must take reasonable steps to ensure that any client financial instruments deposited with a third party are ***identifiable*** separately from the financial instruments belonging to the depositary and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection[2].

- On the basis that the obligations on delegates of the depositary should not go further than the obligations on the depositary itself, the segregation obligations on delegates should also be framed by reference to MiFID.

IV. Protection of assets on an insolvency

Full Segregation does not provide a higher degree of protection of investors or their assets upon insolvency of a sub-delegate to whom custody has been entrusted than current asset segregation practices (which permit omnibus accounts that can include both AIF and non-AIF assets, as well as the assets of different depositaries).
As set out above, the declared objective of the segregation obligation as set out in AIFMD is clear identification of client assets, and so the interpretation of the segregation provisions should be viewed in this light. We are aware that there is a separate requirement within article 98(2)(a) of AIFMR regarding due diligence of delegates and notification of situations in which segregation is not sufficient to ensure protection from insolvency. However, the obligation in that provision is one

[1] art.16(1)(a) of MiFID
[2] art.16(1)(d) of MiFID

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of due diligence and disclosure, and should not impact the separate obligation of segregation.

The commingling of AIF and non-AIF assets, and assets of different depositaries, at the level of a delegate or sub-delegate would not preclude the maintenance of high standards of investor protection where the depositary and its delegates maintain robust processes, procedures and associated controls to:

- distinguish all records of an AIF's financial instruments;
- monitor the settlement cycle of the transactions relative to the financial instruments invested;
- oversee the assets' reconciliation process at the fund administrator level;
- reconcile on a periodic and ongoing basis the assets in an omnibus or collectively managed account with the depositary's books and records;
- minimise the risk of loss of financial instruments and assess the custody risks throughout the custody chain; and
- exercise due care in relation to the financial instruments to ensure a high standard of investor protection.

In the prime brokerage context, the United Kingdom and the United States are two of the most relevant jurisdictions. We therefore view those jurisdictions as illustrative examples of why the proposed segregation of assets at the sub custodian level would not provide any greater level of investor asset protection. Please see Annex B for a more detailed discussion of asset protection in these and other jurisdictions.

More broadly, please also note the following:

- The maintenance of segregated positions throughout the custody chain is generally recognised as providing no meaningful benefit from the standpoint of asset safety, including in the report of the Task Force on Adaptation to Cross-CSD Settlement in T2S. Even if mandatory segregation throughout the custody chain for a category of clients was operationally and safely feasible in the European Union, the imposition of a requirement to segregate beneficial ownership throughout the entire holding chain assumes a holding chain that is entirely subject to the jurisdictional control within the EU or which at least operates in a manner which is amenable to fulfilling such a requirement. This may not be the case in respect of securities held via chains extending outside the EU. In such cases, the imposition of segregation requirements may be frustrated by the operation of law or market practice outside the EU.

- Depositories and their delegates undertake rigorous procedures to assure asset safety, including by assessing the suitability of their sub-delegates and making arrangements for holding intermediated securities that properly respond to local legal requirements in the jurisdictions where they are held. Overwhelmingly, these assets are ultimately held as client assets accounts of the local sub custodian/sub-delegate in the local CSD. Whilst CSDs recognize client assets of CSD participants, it is not usually possible to sub-segregate amongst clients of the participant at the level of the CSD. This means that sub-segregation at the level of a delegate or sub delegate does nothing more than create another account at that sub-delegate. Given that the insolvency administrator of any given intermediary will look first to the books of the insolvent intermediary and then reconcile to positions held at such intermediary's delegate, there is no clear administrative advantage to sub-segregation at the level of the delegate. SSAE 16 and ISAE 3402 audit structures are in place to assure appropriate reconciliation of clients' assets accounts through chains of intermediation. Depositaries and/or their delegates have undertaken to engage local lawyers to provide information about local insolvency laws and the recognition of segregation arrangements. Segregation of omnibus accounts by client category has not been identified as a factor that would provide greater security in the case of the insolvency or other default of a sub-delegate/sub-custodian. We would commend CASS 6.3.4A-1 as an example of the approach to require a depository to take steps to achieve a defined result as opposed to an approach that attempts to determine specific steps that must then be implemented in many different legal and commercial contexts: "A firm must take the necessary steps to ensure that any client's safe custody assets deposited with a third party are identifiable separately from the applicable assets belonging to the firm and from the applicable assets belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection. "

V. <u>The Consequences of the various levels of segregation on speed of return of assets on an insolvency.</u>

Full Segregation would not result in faster, easier or more efficient recovery of client assets in an insolvency. In fact, such segregation would significantly increase the number of client accounts in each market, complicating the reconciliation/process process and causing major delays in returning client assets.
The reasons for this are set out below.

Rehypothecation and re-use

- Subject to the terms of the prime brokerage agreement, brokers may rehypothecate and re-use client assets. Where assets have been lent out into the market, equivalent assets would need to be sourced and re-delivered to the client's custody account.

- If the client has consented to rehypothecation of its assets and those assets have been rehypothecated, then the client would lose its proprietary interest in those assets and become an unsecured creditor. In the event of an insolvency of the relevant prime broker, an insolvency practitioner would need to return assets out of the insolvency estate to all higher ranking creditors prior to the re-payment of the client's unsecured claim. As highlighted following the Lehman insolvency, this process of repaying senior secured and preferential creditors can take considerable times (months or years) and the speed of return of assets would be entirely unchanged were they to have been held in fully segregated accounts.

Security interests

- All securities intermediaries throughout the custodial chain are likely to hold security interests over the client assets, whether they arise by contract or operation of law. The depositary may well have a custodial lien over the assets, the prime broker a custodial or banker's right of lien and similarly the sub-custodian would have an additional custodial lien over the same assets. Further, assets held through a securities settlement system will be subject to a mandatory lien imposed by the rules of the clearing house.

- Before the assets can be returned to the client the security interests in any relevant jurisdiction would need to be unravelled and resolved by an insolvency practitioner. This may take a considerable amount of time to resolve and, in some cases many years depending on the jurisdictions and complexity of competing claims. The insolvency practitioner will generally refuse to return the client's assets until the relevant insolvency process has been completed to its satisfaction in accordance with applicable law.

- The Lehman's collapse and other relevant problems encountered after the crisis have shown that delays in returning client assets were not caused by inadequate segregation, but rather by many of the assets being subject to security interests for which internal records relating to those assets were either inadequate, incomplete or inefficient, which made it extremely difficult to quickly unravel the chain of ownership or quickly return assets to the ultimate owner.

- Neither Option 1 nor Option 2 in the Consultation would have a positive effect on the speed of return of assets which are subject to multiple competing and overlapping security interests imposed throughout the custodial chain.

Record keeping and traceability

- Due to the complexity of establishing rights of rehypothecation and unravelling the competing security interests described above, the CASS rules under English law focus on the quality of the books and records, with regular reconciliations and reporting requirements, in order to improve the speed of return of assets on an insolvency.

- The physical segregation of client's assets into a segregated account makes absolutely no difference to the degree of traceability of a client's securities entitlement in the event of insolvency of a sub-custodian. The ownership rights of assets can be fully traced through books and records segregation but the speed of return of assets on an insolvency would remain subject to unravelling the chain of security interests.

- Neither Option 1 nor Option 2 address these issues or improve the speed of return of the client's assets.

VI. Interaction with other European Regulations

We are aware that segregation has been an area of interest in European regulations more broadly over recent years. In this context, please see Annex C for a brief discussion of the interaction of AIFMD with other European regulations.

VII. Operational Impact

Proliferation of Accounts

Full Segregation would result in a huge proliferation of the number of omnibus account to hold assets. We believe that an expansion in the number of omnibus accounts used to hold AIF assets would significantly increase risks, operational complexity and cost, many of which would ultimately be passed on to clients. These increased costs would include both one-time upfront costs related to opening and migrating such accounts, as well as ongoing costs related to account maintenance and monitoring, reconciliations, reporting and costs related to required additional changes to sub-custody accounts.

The requirement for prime brokers to open AIF specific accounts with sub-delegates would not eliminate the risk of shortfalls. AIF assets are not more or less susceptible than other assets to losses. Indeed, a proliferation of accounts would increase operational risk and, as a result, the risk of permanent shortfalls. Furthermore, a larger number of additional omnibus accounts (either for AIFs or per depositary) would neither (a) speed up the return of assets in the case of an insolvency of a prime broker nor (b) reduce shortfall potential for AIFs. The operational complexities of running multiple client omnibus accounts would have no preventative effect on prime broker or depositary insolvency, and would likely increase the risk of both entity insolvency and segregated depositary shortfall.

Collateral Management

Full Segregation would have a damaging effect on collateral management.

Collateral management in particular is an environment where beneficial ownership of collateral changes frequently (including intra-day) as part of a dynamic process, whereas custody tends to involve beneficial ownership of securities changing less frequently (i.e., held for longer periods). This market difference is fundamental in understanding the negative impact of requiring segregation throughout the custody chain in the context of collateral management.

Requiring extensive segregation along the chain of custody, would not work effectively in a business model where there are frequent changes of beneficial ownership at the investor level. Among other problems described in this paper, such a requirement would force the tri-party collateral market to operate on a bilateral basis, which would increase various risks (e.g., settlement risk, counterparty risk, operational risk), reduce liquidity, and reduce the opportunity for funds to generate additional income in relation to their securities.

A key advantage of the omnibus account structure is the principle of data uniqueness. In any situation where segregated accounts are used, it is necessary for the relevant data to be stored and maintained in multiple locations (i.e., at each intermediary level). In a tri-party collateral management model, in which data at the end investor level is changing frequently, it would be impossible for market infrastructure (with settlement cycles and other obligations) to keep up with frequent changes of collateral at the end investor level if a fully segregated account structure is required. We strongly recommend that (rather than requiring segregated accounts to be used at various levels in the chain of custody) the Commission and ESMA takes a permissive approach, whereby it is possible for such segregated accounts to be used, but without requiring their use.

More broadly, such restriction is inconsistent with overall European policy objectives of encouraging economic growth and instituting a functioning capital markets union. A key aspect of encouraging economic growth is to ensure that markets are liquid, capital is able to move to where it is most needed, and collateral is used to reduce risk in the financial system. As stated by the Commission in connection with its proposed Capital Markets Union "Collateral is a vital part of the financial system as it underpins a large number of transactions in the market and provides a safety net in case there are problems. The fluidity of collateral throughout the EU is currently restricted, preventing markets from operating efficiently"[3]. Requiring Full Segregation throughout the custody chain would go against this stated aim and increase the restrictions that are preventing capital markets from operating efficiently.

VII. Conclusion

The concept that additional protection is afforded by segregation at the sub-custodian is broadly unaccepted by established securities market lawyers, investors and practitioners, as is the belief that assets can be more speedily returned in an insolvency if they are held in segregated accounts at the lowest level in the custody chain.

Further, the damage that such segregation will do to investors, AIFs, as well as to UCITS and ultimately all European funds, and the investment funds landscape generally in Europe will be irreparable. Mandating segregation at the sub-custodian is inconsistent with the European Commission's proposed Capital Markets Union, the FCA CASS Rules, MiFID II and EMIR and is also unsupportable under the principles of T2S (which allow for both omnibus and individual segregation). In addition, such segregation would have made no difference whatsoever in either of the Madoff or Lehman cases which, although they are often cited as a rationale for

[3] See e.g., p.23 of the Commission's Green paper on the Capital Markets Union.

segregation, were not in any way caused by inadequate segregation of client assets, but rather by inadequate or incorrect record keeping and/or fraud.

Yours faithfully,

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