esma European Securities and Markets Authority

Reply form for the Call for Evidence
Asset Segregation and Custody Services

15 July 2016

European Securities and Markets Authority

Date: 15 July 2016

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Call for Evidence Asset Segregation and Custody Services (ASCS), published on the ESMA website.

Instructions

Please note that, in order to facilitate the analysis of the responses, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

- use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
- do not remove the tags of type <ESMA_QUESTION_CE_ASCS_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- if you do not have a response to a question, do not delete it and leave the text "TYPE YOUR TEXT HERE" between the tags.

Responses are most helpful:

- if they respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives that ESMA should consider

Naming protocol

In order to facilitate the handling of stakeholders' responses, please save your document using the following format:

ESMA_CE_ASCS_NAMEOFCOMPANY_NAMEOFDOCUMENT.

E.g. if the respondent were XXXX, the name of the reply form would be:

ESMA_CE_ASCS_XXXX_REPLYFORM or

ESMA_CE_ASCS_XXXX_ANNEX1

Deadline

Responses must reach us by **23 September 2016.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input/Consultations'.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the headings 'Legal notice' and 'Data protection'.

Introduction

Please make your introductory comments below, if any:

<ESMA_COMMENT_CE_ASCS_1>
Further to the Madoff case and the Lehman Brothers bankruptcy one of the main objectives of AIFMD and UCITS V was to increase the protection of investor's assets in order to restore investors' confidence in the investment fund industry.

AIFMD and UCITSV have introduced a specific custody regime for collective investment funds with regards to the strict liability regime of the depositary for assets held in custody and the obligations to take necessary actions in case of custody risk, ideally before a delegate or a sub-delegate goes bankrupt.

To that end, AIFMD and UCITS V require transparency on the custody chain as mitigating custody risks is essential in the interest of asset managers and investors and financial markets, given the amounts at stake, the importance of reputational risks and the need to keep investor's confidence. Segregation is a cornerstone for investor protection and trust in the role of the depositary in the wider financial sector:

- Article 21 of AIFMD and Article 22a of UCITS V state that a delegate of a depositary "segregates the assets of the depositary's clients from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a particular depositary". Clarity from ESMA will enable depositaries to have a clear legal basis to require compliance with the segregation rules by their delegates.
- Segregation requirements in AIFMD Level 2 text -Article 99 / UCITSV level 2 text Article 16 to be implemented by delegates and sub-delegates of the depositary's custody function not only introduced protection in the case of bankruptcy of delegates/sub-delegates but also provide the depositary with a look-through view of assets whatever the level of delegation of custody to assist with the monitoring of custody risks (e.g. risks of fraud, misuse of assets) and the transfer of assets to back-up delegates when they are at risk of becoming bankrupt.

The new AIFM and UCIT legislations have been carefully and diligently prepared and implemented by ESMA, European Commission, European Parliament, and respective European governments to improve:

- investor protection,
- market protection,
- market efficiency,
- reduce significantly systemic troubles,
- transparency,

and also to promote and perpetuate a robust European Label.
One of the corner stones of these new legislations is the improvement of the custody certainties, including by requesting segregation as far as feasible.
We strongly believe that this should be also reflected in the other European texts and fields.

AFG wishes to remind ESMA that IOSCO has also reiterated strong way that the notion of segregation is a key concept and necessary for the protection of assets, including assets of the funds (OICV-IOSCO, *"Standards for the custody of Collective Investment Schemes 'Assets",* November 2015).
The accounting technique in the accounts segregation of financial instruments by financial intermediaries is thus seen as the only real tool to (i) ensure protection of the owner' rights of financial instruments by promoting their identification and thus their claim and (ii) ensure the good custody of financial instruments by promoting their identification to prevent unauthorized use.

Furthermore, in the work carried out by its "Legal Certainty Group" in 2008, the European Commission has established a direct link between accounts segregation and investor protection. This group, followed by the Commission, believes that assets segregation recorded in account is likely to improve investor protection by making their assets safe from (i) the creditors' rights of a financial intermediary subject of bankruptcy proceedings and (ii) any form of appropriation by the same intermediary [*«Second Advice of the Legal Certainty Group, Solutions to Legal Barriers related to Post-Trading within EU – August 2008»* Recommendation 9.4 (Segregation) p.72-73 and Recommendation 11.3 (Prohibition of attachments of segregated client accounts by creditors of the account provider) p.76-77.]. In other words, legal experts have considered that this technique should be favoured as investors' protection tool.

When first reading the call for evidence which came after a previous consultation on asset segregation under AIFMD, we had the following mixed feelings:

- a real interest in answering the call for evidence since we do think that, behind the UCITS AIFMD questions, it takes a transversal view on several legislations that have been developed independently like EMIR and CSD for example;
- a disappointment when we realised that what was expected is impossible to deliver in such a brief time: from July to September when summer holiday makes it impossible to convene experts of different fields; we strongly suggest that ESMA keep the file open.

The general tone in our response is that complaints do not amount to demonstrations. We stick to the view that there is no proposal to better reach the clear objective of investors' protection than through segregation of assets as it is foreseen. Yes, it does not ensure full protection in all circumstances due to insolvency or securities law in different countries, but it gives investors the best level of protection in many instances, even if other solutions can in some cases provide the same. We should see it as an option with no negative side. The technical impediments are not conclusive in our view from anything else but the absence of willingness to innovate and adapt the existing habits of transacting on collateral or securities lending. Eventually, we warn ESMA to be prudent in carefully analysing evidence that it will receive before deciding in the best interest of end client investors.
<ESMA_COMMENT_CE_ASCS_1>

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

In your description, please take into account the following:

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

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

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

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

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

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

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

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

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

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

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

c) **if you do not use 'omnibus accounts', please specify why and how far down the chain it is possible for you not to use them (i.e. whether this works in all situa-**

tions or, if it is necessary to use 'omnibus accounts' at some level of the custody chain, at which level)?

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

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

f) **According to a Briefing Note[1] published by ECON in 2011, there are five basic models for holding securities with an intermediary: the trust model[2], the security entitlement model[3], the undivided property model[4], the pooled property model[5] and the transparent model[6]. ESMA is interested in gathering evidence on whether there may be any link between certain securities holding models and certain asset segregation models. Therefore, ESMA invites stakeholders to provide input to the following questions:**

i) **What securities holding model do you use?**

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

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

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

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

<ESMA_QUESTION_CE_ASCS_1>
a) The answer to this question will be based on what we consider to be a standard for our French funds. For us level 1 texts of both AIFM and UCITS directives have put a clear requirement that assets of funds should be segregated all the way down on the chain of custody. In that context, the setup is as follows:

[1] http://www.europarl.europa.eu/document/activities/cont/201106/20110606ATT20781/20110606ATT20781EN.pdf
[2] See pages 14-15 of the Briefing Note.
[3] See page 16 of the Briefing Note.
[4] See page 17 of the Briefing Note.
[5] See page 18 of the Briefing Note.
[6] See page 19 of the Briefing Note.

- Level 1: depositary level
At the level of the depositary each fund has a set of specific accounts that are totally dedicated; thus there is no confusion with own account of the depository nor any other client of the depository.
- Level 2: delegate level
At the level of the delegate, the depository complies with the regulation and opens 5 different types of accounts in order to segregate its own assets, the own assets of the depositary, the assets of delegate's other clients, the assets of UCITS or AIF clients and the assets of depositary's other clients. Currently, these 2 last types of accounts are omnibus in the name of the depositary that group UCITS for example managed by different asset managers, except if we specifically require to be individualized at the level of the delegate (what is unusual)
- Level 3: sub-delegate level
At the level of the sub-delegate, there is a further segregation that stems from the regulation, which foresees that the sub-delegate must separate (i) its own account, (ii) the own assets of the delegate, (iii) the assets of UCITS or AIF in the name of the delegate per depositary, (iv) the assets of sub-delegate's other clients, (v) the asset of delegate's other clients (vi) the own assets of depository in the name of delegate (vii) the assets of depository's other clients in the name of delegate. It is an option, that we consider as meaningful, to get a more detailed review and ask for the sub-delegate to keep the structure that exist at the preceding level and segregate UCITS in several omnibus accounts, one for each of the clients of the delegate.

b) there are omnibus accounts that are used in this scheme, but among clients that are homogenous in their regulation and their risk control procedures. The possibility to track down to the individual fund who owns what is a prerequisite for the depositary to be able to confirm the reality of assets. In the same manner the segregation by type of funds is a powerful instrument to make sure that there will never be any mis-use of assets, for example re-hypothecation or re-use when forbidden.

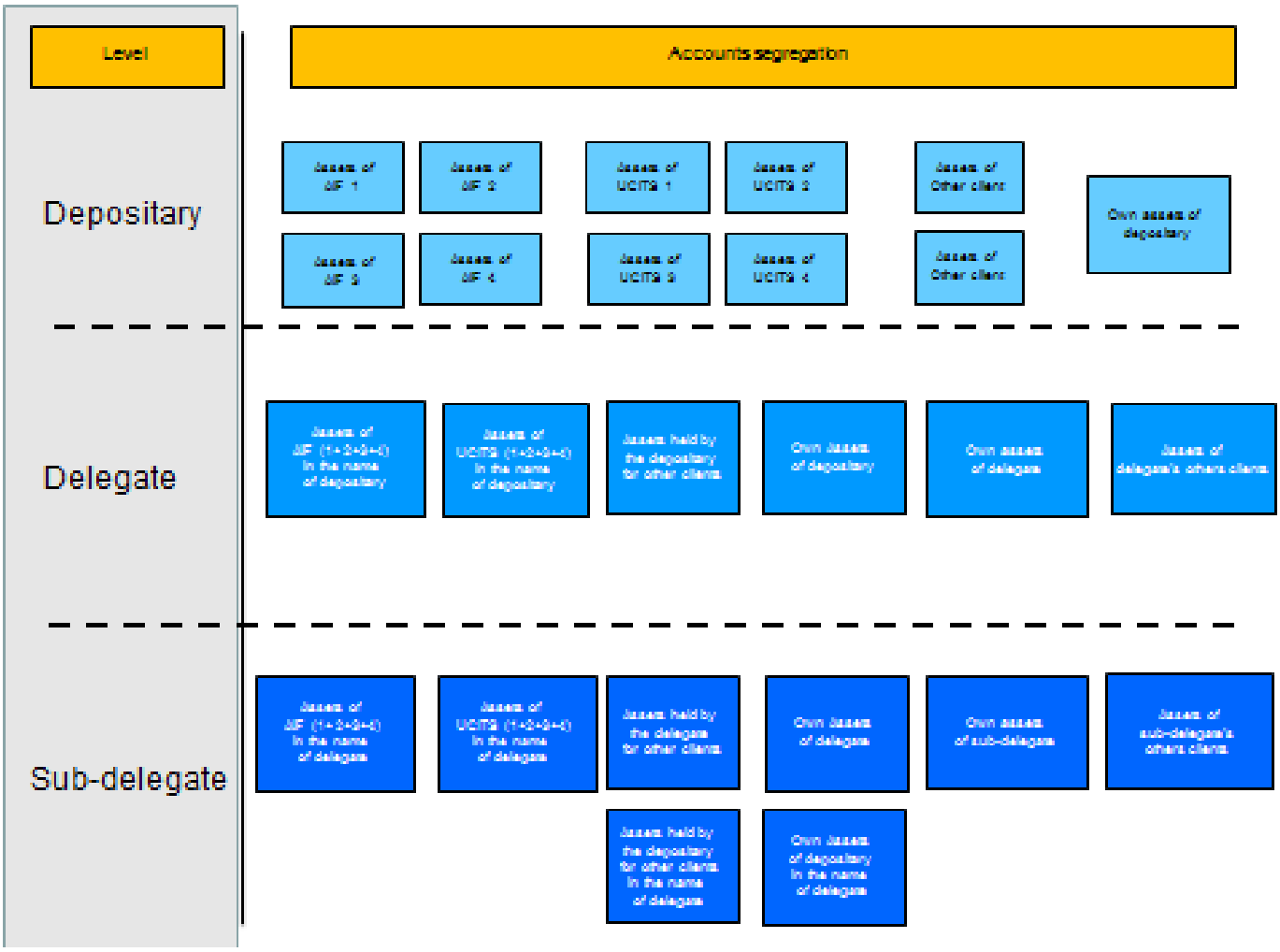
c) there are not many instances when there is no omnibus at a given stage, especially when we go one step further to the CSD, especially with cross border custody.

d) option 1 is what we expect, knowing that there are a few occurrences like with some Investor CSDs, tripartite collateral agent and prime brokers who refuse to go further than a segregation between own accounts and client accounts.

e): there is no difference between AIFs and UCITS as regulations are very similar on their requirements.

f) the undivided property model is the reference in France and we consider it as a very protective model that avoids any conflict on ownership and as a consequence enables a strict and continuous certainty that there are not more securities circulating than those effectively issued. This model suggests a certain level of segregation to facilitate exact identification of the owner.

g). There are cases where an account will be opened in the name of the fund on a pure segregated manner (meaning in accordance with option 5) at the request of the manager or of the end client(s) (particularly for dedicated funds)



.<ESMA_QUESTION_CE_ASCS_1>

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

<ESMA_QUESTION_CE_ASCS_2>
As mentioned in our general comment, this assessment would require a thorough investigation of the solvency laws of different countries. We have not had the time nor the material means to conduct such a study and would welcome a working group to address these issues. We support the initiative of European Commission to start with a review of solvency laws in the Member states of the EU and wish it might be extended to other large countries by ESMA with a view to assess risk for EU investors.
<ESMA_QUESTION_CE_ASCS_2>

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

<ESMA_QUESTION_CE_ASCS_3>
We are very much disappointed not to be able to answer to this question in details. We believe that there is an urgent need for a working group with professionals and regulators from different countries to examine the impact of insolvency in different jurisdictions.
AFG has a strong conviction that portability is key when fearing insolvency. We further consider that the more clearly the assets are identified and segregated, the easier it is to operate portability. We believe that prevention, that means good monitoring of delegates, is far more protective than post default remedies. Protection in case of insolvency, eventually, is far more dependent on the insolvency and securities laws of a jurisdiction than on the structure of segregation.
<ESMA_QUESTION_CE_ASCS_3>

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

a) effective reconciliation,

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

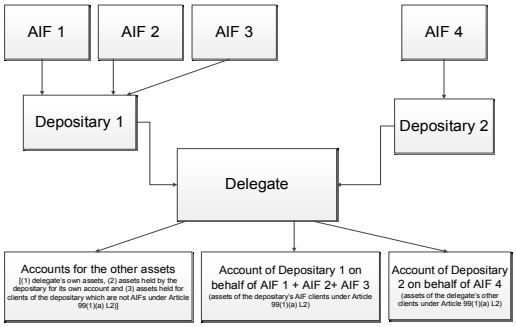
c) any other means (e.g. legal mechanisms).

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

<ESMA_QUESTION_CE_ASCS_4>
We consider that option 1 is far more protective for investors.
<ESMA_QUESTION_CE_ASCS_4>

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

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



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

<ESMA_QUESTION_CE_ASCS_5>
a): Yes, the fact to be segregated and not to suffer pollution when another depositary defaults is a clear advantage of Option 1.
b): It does not mean that in case of subsequent default of the Delegate would be sufficient to avoid trouble. It is a matter of local insolvency law. The main advantage of segregation is to facilitate reconciliation that can lead to a swifter treatment in some countries. It is a free option where there is nothing to lose and there are possible gains depending on proceedings.
<ESMA_QUESTION_CE_ASCS_5>

Q6: Many respondents to the CP argued that, in an insolvency scenario, imposing a model where investors have individual accounts throughout the custody chain would not necessarily provide any particular benefit over the use of IT book segregation in

an omnibus account (i.e. books and records instead of separate accounts). Please explain how the level of protection indicated in the policy objective at the start of this paper can be achieved through the use of omnibus accounts. Please also:

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

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

c) explain how the above-mentioned segregation in books and records would address any of the risks of 'omnibus accounts' mentioned in recent IOSCO work[7].

<ESMA_QUESTION_CE_ASCS_6>
AFG does not agree with the initial proposition in the question. Books and records that rely on the internal organisation of one intermediary do not offer as good a protection as segregated accounts. We have to remember that it is precisely when such an intermediary defaults that investors will appreciate not to rely exclusively on it to have the confirmation of the status of their holdings.
If it is arguable that in certain circumstances (mainly due to local solvency laws) segregation of accounts may not offer a better protection, nobody has never suggested that it offers lower protection. Asset segregation is a free option in favour of the investor and we follow the rationale of legislators when they decided in level 1 texts to require it. We do agree that many details have to be defined but do not consider that it is in the scope of ESMA's mandate to ask for arguments in favour of a solution that is clearly contradicting level 1 texts.

a) It is not possible that books and records would ensure adequate investor protection.
b) Insolvency proceedings vary very much from one jurisdiction to another. Providing an example is not conclusive and should not be considered as sufficiently supportive of a decision.
c) The cross reading of the security law, the insolvency law and the organisation of omnibus accounts in different jurisdictions makes it impossible to demonstrate what is asked without a thorough examination of all jurisdictions in which an investor may hold assets.

<ESMA_QUESTION_CE_ASCS_6>

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

- **Cross-border investments**

[7] See paragraphs 29 and 30 of the Standards for the Custody of Collective Investment Schemes' Assets – Final Report (FR25/2015): "*Depending on the operational framework in the jurisdiction, there is a risk that CIS assets in the custodian's care can become co-mingled with (i) assets of the responsible entity; (ii) assets of the custodian; or (iii) the assets of other clients of the custodian (although it should be noted that CIS assets may be held in a permissible "omnibus account"). The consequences of these risks could result in the ownership of the assets being called into question in the event of misuse or insolvency of the custodian, which may create difficulties differentiating ownership of the assets*". The positive and negative aspects of omnibus accounts are also mentioned on page 11 of the IOSCO Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets – Final Report (FR05/11).

i) **Through CSD Links**

ii) **In relation to cross-border investments through CSD links, what are the functions of an investor CSD[8]?**

iii) **Through T2S**

- **Prime broker services**
- **Tri-party collateral management / securities lending.**

<ESMA_QUESTION_CE_ASCS_7>
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Q8: It has been argued that each time a new end investor or new AIF or UCITS is added as a customer, instead of one new account being created, many new accounts would need to be created at multiple levels in the chain of custody. If you agree with this statement, please provide further details of how this would work in practice.

<ESMA_QUESTION_CE_ASCS_8>
This statement is true with option 5 of the CP that is based on individual segregation (by end investor) all along the custody chain. To comply with option 5, each time a new investment fund is added as a customer, the Depositary is expected to open a new account (at level 2 according to ESMA definition) per delegate and per country where the investment fund operates. Depending of the length of the custody chain, each sub-delegate should then open itself a specific account at lower level (3 and above) until reaching the local issuer CSD. It is important to note, that several countries in the world impose segregation per final investor at issuer level and as such all custodian/depositary have to operate under option 5 for those countries. This does not prevent AIFs and UCITS from investing in such countries. However, option 5 was discarded by ESMA itself in its CP after a costs/ benefits assessment.

With regards to option 1 , which relies on omnibus accounts , it is important to note that when Option 1 has be implemented once by a depositary, when a new AIF/UCITS is added as customer, only a Client securities account in the Depositary's books and records need to be opened. The underlying custody network (level 2 and above) is not impacted.

Therefore implementation of Option 1 by the industry is fully manageable, would generate a limited increase of accounts per Depositary. Option 1 is also an incentive to shorten custody chains leading to

[8] According to Article 1(g) of the ESMA draft technical standards under CSDR (ESMA/2015/1457/Annex II), 'investor CSD' means a CSD that is a participant in the securities settlement system operated by another CSD or that uses an intermediary that is a participant in the securities settlement system operated by another CSD in relation to a securities issue (available at www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457_-_annex_ii_-_csdr_ts_on_csd_requirements_and_internalised_settlement.pdf).

increased efficiency of the settlement process and reduced risks for investors and depositary with regards to the safety of assets.
<ESMA_QUESTION_CE_ASCS_8>

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

<ESMA_QUESTION_CE_ASCS_9>
Existing securities settlement arrangements/systems have been designed and implemented in order to accommodate and support large volumes with many actors servicing millions of clients and accounts. Efficiency will not be affected by an increase of accounts prompted by segregation requirements.
After having implemented option 1 since 2014, AFG's members have not noticed any changes in the efficiency of our settlement process. Neither our market STP (Straight Trough Processing) rate, neither our Failed/Late settlement rate have increased.
On client's side, and post securities migration due to changes in their SSI (Standard Settlement Instructions) in markets where we have delegates, we have not been advised of particular difficulties introduced by Option 1 implementation.
<ESMA_QUESTION_CE_ASCS_9>

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

a) executing block trades; and

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

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

<ESMA_QUESTION_CE_ASCS_10>
We disagree with these statements.

a/ block trades:

Settlement of block trades is possible only when the have the same common following characteristics:
- (Operation type – buy or sell –,
- trade date,
- settlement date, securities,
- counterparty,
- same depositary,
- same existing SSI (no tax or other segregation needs).

Such existing technical requirements already exclude de facto block trades on mandatory segregated markets (under option 5 setup) and any commingling between end investors (clients, AIFs, UCITS …) having different tax status which is often the case.

Option 1 effectively introduces a new requirement linked to the change of SSI due to segregation between AIFs, UCITS and other clients. In such cases, the Asset manager will have to "split" its original commingled settlement in 1 or 2 additional settlements depending of the number or "investor type" involved in the block. Although we have no statistics to provide on such cases, the number of settlements has not significantly increased due to implementation of option 1.

b/ internalised settlements

We do not see significant impacts.
<ESMA_QUESTION_CE_ASCS_10>

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

<ESMA_QUESTION_CE_ASCS_11>
AFG's members do not experience extra cost in relation to segregated accounts for securities custody under option 1. They have, however, difficulties to get an offer at a reasonable price for ISA by Clearing Members that are necessary for them to get access to CCPs. We are confident on that point that new types of quasi or indirect membership will bring the solution we expect in the coming months.
<ESMA_QUESTION_CE_ASCS_11>

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

<ESMA_QUESTION_CE_ASCS_12>
Option 1 provides for omnibus accounts per type of fund, UCITS or AIFs. We see it as protective enough and not too expensive when compared to option 5. Option 1 is far from being too burdensome or difficult to manage. <ESMA_QUESTION_CE_ASCS_12>

Q13: Please consider the case where a third-party delegate or sub-delegate in the custody chain also acts as a clearing member under EMIR. What would be the impact (if any) of the interaction between the approaches described under each of the options in the table under Q22 below and the choices provided for under Article 39 (2) and (3) of

EMIR[9] (including if this may raise any operational difficulties)? Should you consider that there is any impact, please explain why.

<ESMA_QUESTION_CE_ASCS_13>
The case where a custodian is also the clearing member used to access a CCP is typical of the importance to establish clear rules that make sure that there is no confusion nor opacity on what belongs to whom and might not be re-used at all for UCITS or without proper explicit consent otherwise. One has to build a consistent framework and associate segregation with segregation to benefit on all the chain of custody of the potentially highest level of protection. EMIR introduced a real debate on the benefits of ISA as opposed to Omnibus accounts. The level 1 text was not explicit enough and did not take stake of all the intermediary possibilities of "gross omnibus" or "limited segregation" not responding to ISA requirements.

AFG's members are very attentive at the progresses that are currently made by CCPs to amend their rules and statutes in order to grant end investor an operational access to the CCP without having all the constraints that full member have. They expect to have clear offers from a few dynamic CCPs and would favour that type of solution. For the time being, they are not satisfied to start on a gross omnibus account type of relationship with their clearing members and welcome new developments that will enable them to open accounts in the books of the CCP itself.
<ESMA_QUESTION_CE_ASCS_13>

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

a) tri-party collateral management arrangements;

b) prime brokerage arrangements.

<ESMA_QUESTION_CE_ASCS_14>
a) it is common language to assert that tripartite collateral management as well as securities lending activities cannot be carried under option 1 of assets segregation. It is not AFG's view. Some depositaries of AFG's members are currently working on a process that will conciliate tripartite and segregation. It is a matter of organisation, and willingness. It is not easy to negotiate as it means changing processes and clearly stating each party's responsibilities. Under segregation, they can work day long on the basis of a pool of assets as long as at the end of the day we are able to confirm the exact allocation…on time for confirmations to be exchanged and transfers made. For trades with collateral managers who are International CSDs and have direct access to issuer CSDs it seems workable to segregate UCITS and AIF.
b) On prime brokerage, just one general comment to say that contracts are practically not negotiable and very much dependent of the internal obligation and the usages of the main market the prime broker is active on. The distinction between unencumbered and rehypothecated assets of UCITS and AIFs is fundamental in AFG's view. On unencumbered assets we do expect prime brokers to

[9] Article 39(2) and (3) of EMIR states the following: "*2. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients ('omnibus client segregation'). 3. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients ('individual client segregation'). Upon request, the CCP shall offer clearing members the possibility to open more accounts in their own name or for the account of their clients*".

fully comply with option 1 requirements as any other custodian and do not see any rationale for exemption.
<ESMA_QUESTION_CE_ASCS_14>

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

<ESMA_QUESTION_CE_ASCS_15>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_CE_ASCS_15>

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

<ESMA_QUESTION_CE_ASCS_16>
No, we do not share that view. We believe that we should avoid the confusion between segregation rules (which are essentially operational decisions), securities and insolvency laws whose differences do create conflict of laws and legal uncertainty.
<ESMA_QUESTION_CE_ASCS_16>

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

<ESMA_QUESTION_CE_ASCS_17>
Some AFG's members are currently discussing a format that would enable tripartite transactions under segregation rules.
<ESMA_QUESTION_CE_ASCS_17>

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

<ESMA_QUESTION_CE_ASCS_18>

No.<ESMA_QUESTION_CE_ASCS_18>

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

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

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

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

<ESMA_QUESTION_CE_ASCS_19>
We are not able to substantiate this affirmation, and believe that operational difficulties arise in some markets. We think that ESMA should address proven difficulties on a case by case basis and clarify the impact of local constraints in terms of responsibilities and needs to inform fund holders. For example, in cases of conflicts of laws the asset manager should be authorised to take the decision to document it with the depository and, if he decides to use an omnibus or large nominee, to duly inform holders and explain consequences and risks.
<ESMA_QUESTION_CE_ASCS_19>

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

<ESMA_QUESTION_CE_ASCS_20>
See response to question 1<ESMA_QUESTION_CE_ASCS_20>

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

<ESMA_QUESTION_CE_ASCS_21>
It is not the experience of AFG's members that the opening and running of segregated account in the limited proportion as required under option 1 impact the cost in a significant manner. Furthermore intermediaries do realise that segregated accounts eases control, identification and traceability of errors.

<ESMA_QUESTION_CE_ASCS_21>

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

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

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

	from different depositary clients. When the delegate appoints a sub-delegate, this could commingle in the same account AIF and non-AIF assets and assets coming from different depositaries and the delegates' clients (but should not be mixed with the delegate's or depositaries' own assets).
Option 5	AIF assets should be segregated on an AIF-by-AIF basis at the level of the delegate or sub- delegate.

<ESMA_QUESTION_CE_ASCS_22>
The objective is to achieve a strong level of investor protection without imposing unnecessary requirements.
Option 1 presents the strongest potential to achieve the objective. It may be argued that it does not ensure an effective protection in all instances, but it is not disputed that there is no better alternative except for costly option 5. The discussion is limited to showing that insolvency law is more relevant in some instances and that it applies irrespective of the segregation regime. There are alternative to reach a comparable level of protection, but in the AFG's view they introduce an operational risk that is far higher since earmarking is not as straight as inscription in a separate account.
Option 2 is not consistent with the objective of better investor protection as it mixes, at delegate level, assets of AIFs/UCITS deposited by the depositary that an asset manager has chosen with assets of another depositary that this asset manager would not accept to work with (possibly for doubt on its capacity or its financial strength).
AFG tends to think that option 3 is a solution not as bad as option 2 but not as secure as option 1. AFG thinks that the distinction between UCITS and AIFs is not totally relevant and is more the result of a legislative process conducted in silos than of a necessity in terms of investor protection. The most effective requirement would be to ask for total individual segregation for AIFs using substantial leverage. Other AIFs and UCITS could be mixed in a single pool.
The option 4 is less safe than the option 2 since it separates, at delegate level, only between the depositories' and the delegate's own assets and their other assets when option 2 maintains a separation between AIF, UCITS and the others funds.
Option 5 is definitely the most efficient to achieve asset segregation. This option has been already implemented in China and other Asian countries, which are not considered as having a long track record in finance, and it works with a huge number of clients. Moreover, a significant part of current European custody functions have been outsourced in Asian countries, countries in which the same providers or subcontractors are at the same time managing full segregation services for other clients (countries). We would like also to draw your attention on the fact that Chinese and other Asian markets might have a stronger structure (than others) thanks to their full segregation structures. We believe that one day such robust services will flow from such countries to Europe, and we believe that it is better to anticipate such offer. <ESMA_QUESTION_CE_ASCS_22>

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

a) 'omnibus client segregation' at the CSD level (holding in one securities account the securities that belong to different clients of that participant);

b) **'individual client segregation' at the CSD level (segregating the securities of any of the participant's clients, if and as required by the participant).**

In addition, under Article 38 (5) of CSDR, a participant shall offer its clients at least the choice between omnibus client segregation and individual client segregation and inform them of the costs and risks associated with each option[10].

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

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

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

<ESMA_QUESTION_CE_ASCS_23>
AIFMD and UCITS V have introduced a specific custody regime for collective investment funds in particular the strict liability regime applicable to the depositary, with associated due diligence and segregation requirements which must enable depositary to alert the asset manager in case of custody risks and take necessary actions, including the transfer of assets to a back-up delegate when a delegate or a sub-delegate goes bankrupt.
Otherwise, we consider that investor protection is a characteristic of funds offered to the public, UCITS or UCITS like AIFs. Leaving an option open is not advisable when retail investors are concerned: the franchise of such a brand as UCITS could be jeopardized. In that respect, the missing part today is a clear definition providing a legal basis for depositaries to demand separate omnibus accounts for UCITS and AIFs. For funds offered to professional investor and eligible counterparties, there is room for different funds with different operational frameworks in terms of custody. Transparency is key in that case.

[10] However, under Article 38(5) of the CSDR a CSD and its participant shall provide individual clients segregation for citizens and residents of, and legal persons established in, a Member State where required under the national law under which the securities are constituted as it stands at 17 September 2014.

<ESMA_QUESTION_CE_ASCS_23>

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

<ESMA_QUESTION_CE_ASCS_24>
<ESMA_QUESTION_CE_ASCS_24>

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

<ESMA_QUESTION_CE_ASCS_25>
Custody is clearly defined in the level 2 texts (article 12 for UCITS 5 and article 88 for AIFMD). However, we suggest that a common language transversally on all sectorial legislations be introduced. It would bring clarity and legal certainty.
<ESMA_QUESTION_CE_ASCS_25>

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

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

e) providing and maintaining securities accounts at the top tier level ('central maintenance service')[11];

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

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

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

[11] These services are part of the core services of central securities depositories under Section A, point 2 of the Annex to Regulation (EU) No 909/2014 ("CSDR").

<ESMA_QUESTION_CE_ASCS_26>
First, we think that the definition should outline the specificities of the role of the CSD. The missions and obligations of CSD should be clearly set forth.

a) In our view the notary function lies primarily in the hands of the CSD. A clear description of Issuer CSD's specificities and responsibilities should be made as well as for Investor CSDs, which should not benefit from competitive advantages when compared to custodians.
b) Issuer CSDs as well are in charge or maintenance service.
c) Operational role of the custodian
d) No, custody does not give any access to clients' assets without prior clients' consent.
e) Nor is it possible to pledge without specific contractual approval signed by the AIF/OPCVM.

<ESMA_QUESTION_CE_ASCS_26>

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

<ESMA_QUESTION_CE_ASCS_27>
No, the point is to clarify central maintenance and notary functions as opposed to client's assets custody. We put more trust on those depositaries that do not mix services. There should be a limited custody service (and we recommend a strict definition at two levels CSD and banks) and other ancillary services that do not belong to custody but are additional and should be agreed upon by the clients. We further believe that CSDs that have a notarial role should be prevented from developing a commercial offer that could conflict with their notarial responsibility.
<ESMA_QUESTION_CE_ASCS_27>

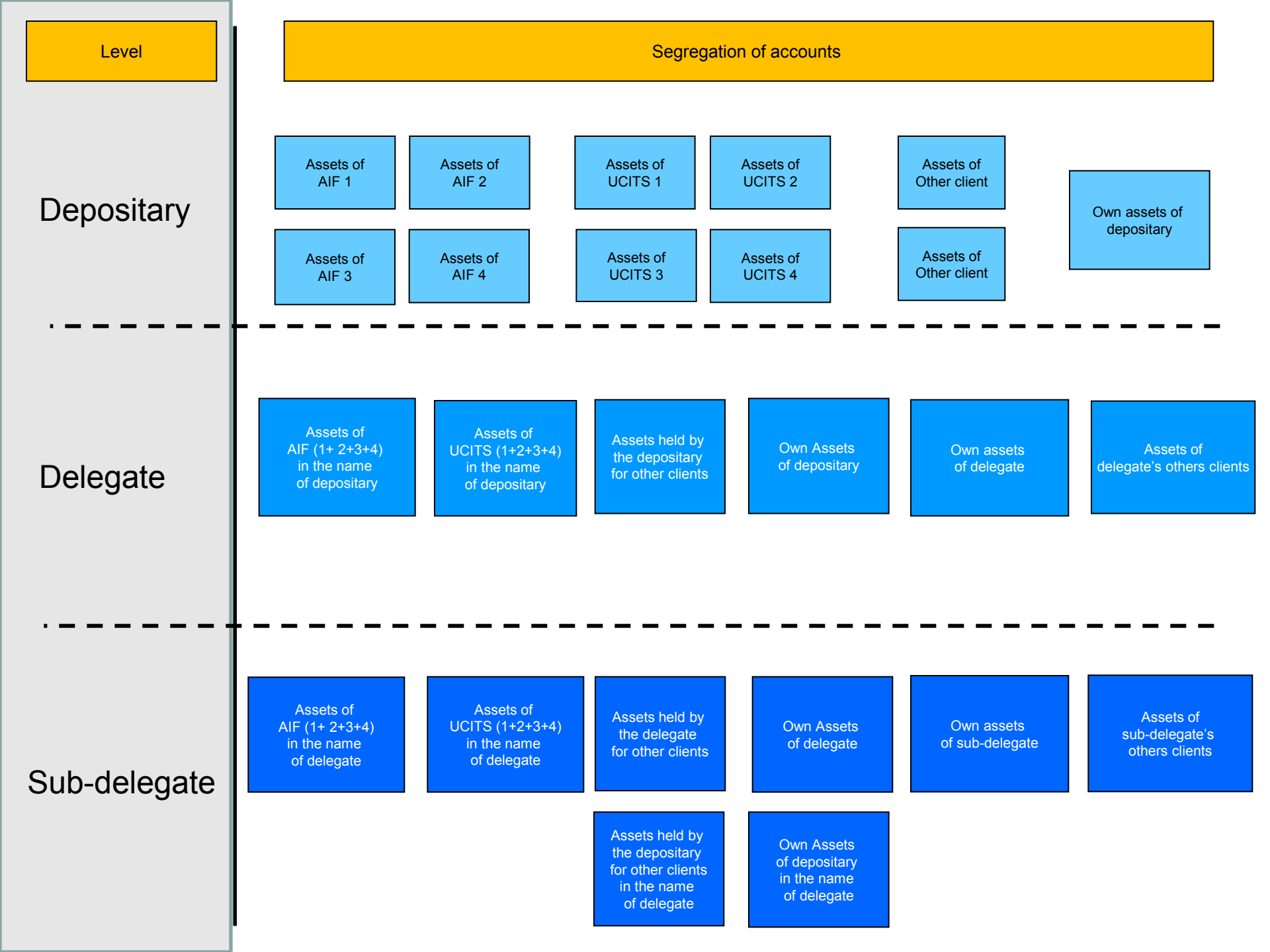
Q28: Please explain how, in your views, "custody" services interact with "safe-keeping" services, in particular those referred to under Article 21(8) of the AIFMD (as well as Article 89 of the AIFMD Level 2[12]) and Article 22(5) of the UCITS Directive (as well as Article 13 of the UCITS V Level 2[13]).

<ESMA_QUESTION_CE_ASCS_28>
Custody refers to financial instruments only but it is not enough to ensure full understanding. The discussion in the preceding questions evidences the need for clarification.
Financial contracts settled through a CSD could be part of the full custody services, as there is no difference between settling the purchase/sale of a financial contract and the purchase/sale of a stock through a CSD. In both cases they are dematerialized and liquid and transferred through the CSD.
<ESMA_QUESTION_CE_ASCS_28>

[12] Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012.
[13] Commission Delegated Regulation (EU) 2016/438 of 17 December 2015.

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

<ESMA_QUESTION_CE_ASCS_29>
We are globally not supportive of the development of ancillary services by CSDs. We see them, especially Issuer CSDs, as market infrastructures that should concentrate on their core activity for the benefit and the security of other market participants (with whom they should not compete). Conversely, we do not consider Investor CSDs which offer other services on a competitive basis with other custodians as different from their competitors.
<ESMA_QUESTION_CE_ASCS_29>


Level
Segregation of accounts
Depositary
Assets of AIF 1
Assets of AIF 2
Assets of UCITS 1
Assets of UCITS 2
Assets of Other client
Own assets of depositary
Assets of AIF 3
Assets of AIF 4
Assets of UCITS 3
Assets of UCITS 4
Assets of Other client
Delegate
Assets of AIF (1+ 2+3+4) in the name of depositary
Assets of UCITS (1+2+3+4) in the name of depositary
Assets held by the depositary for other clients
Own Assets of depositary
Own assets of delegate
Assets of delegate's others clients
Sub-delegate
Assets of AIF (1+ 2+3+4) in the name of delegate
Assets of UCITS (1+2+3+4) in the name of delegate
Assets held by the delegate for other clients
Own Assets of delegate
Own assets of sub-delegate
Assets of sub-delegate's others clients
Assets held by the depositary for other clients in the name of delegate
Own Assets of depositary in the name of delegate