Asset segregation and use of CSDs under AIFMD and UCITS V – ESMA's call for evidence

On 15 July 2016, ESMA published a paper entitled "Call for evidence – Asset segregation and custody services" (comments to be received by 23 September 2016). The publication of this paper was rather overshadowed by the aftermath of reactions to the UK referendum result on 24 June 2016, but the issues are significant, and this is an important opportunity for [1]AIF and [2]UCITS depositaries (and their delegates) to provide clarity to ESMA regarding issues which have considerable impact on the holding of assets for AIFs and UCITS.

ESMA's July paper should be read in detail, but the following summarises the main issues raised.

Asset segregation

Information requested by ESMA: The July paper is the long awaited follow-up to the ESMA Consultation Paper dated 1 December 2014 entitled "Guidelines of asset segregation under the AIFMD". The July paper notes that the asset segregation requirements in AIFMD and UCITS V are essentially the same, and requests information from fund depositaries and fund managers regarding the manner in which assets are segregated in practice, including the nature of the accounts maintained with the depositary, the depositary's delegate, and the delegate's sub-delegate (whether the sub-delegate is a CSD or another subcustodian). An explanation of how omnibus accounts are used is also requested.

Issues useful to cover in responses: This is an important opportunity for depositaries (and also subcustodians, including prime brokers, for depositaries) to educate ESMA on the way in which the holding of financial instruments for AIFs and UCITS through a chain of intermediaries works in practice, and to explain any respects in which maintaining separate accounts for each fund, or accounts recording AIF assets separately, at each level of the chain of intermediaries, may be difficult or impractical. Naturally, arguments regarding the preferred approach to asset segregation are likely carry more weight if accompanied by an explanation of the reasons why it is considered that separate accounts at each level of the chain is not necessary for the protection of the assets (and/or may be disadvantageous due to additional cost and administrative complexity). For example, it might justifiably be argued that there is no reason to assume that "segregation" of assets means, or inevitably requires, maintenance of separate accounts for assets but that other solutions, such as flagging securities within one account, could provide the same clarity regarding the assets held by a depositary for the relevant funds, or by a delegate for the depositary. There is also the argument that, provided that a depositary maintains a separate account for each fund which records the assets held by the depositary for each fund, the maintenance of individual segregated accounts for each fund with delegates of the depositary or sub-delegates (or sub-sub-delegates, etc) is unnecessary. This is because a fund only has a claim against the depositary, and appropriate clarity regarding the assets held for each fund is provided by the depositary's

compliance with its obligations to maintain and regularly reconcile separate records of the assets held by it (whether directly or through an intermediary) for each fund.

Obligation for depositary to offer omnibus or individual accounts: ESMA also raises the question of whether, by analogy with the [3]EMIR requirement to offer clients the choice of individual client segregation or omnibus client segregation, the depositary should give the manager of each fund the choice of whether the fund assets are, *throughout the custody chain*, held in an individual account for the fund or an omnibus account. Such an approach goes well beyond what is required by the UCITS V and AIFMD Directives and Level 2 measures (which currently only contain requirements regarding segregation in the books of the depositary, the depositary's delegate and sub-delegates of such delegate). Moreover, it seems debateable whether such an approach would be appropriate, given that it is the depositary, rather than the manager, who will have a better idea of what level of segregation of assets is possible. Also, it seems likely to be complex and onerous for a depositary to administer such an arrangement, because a depositary would need to maintain systems capable of setting up both omnibus and individual accounts with all of its subcustodians, and to maintain records and systems reflecting the different approach chosen for each fund (even where funds have the same manager), and the same would apply to subcustodians and all other intermediaries through which the assets are held even though such entities have no direct relationship with the manager or the funds.

Holding AIF/UCITS assets with CSDs

In addition to the question of asset segregation, in the July paper ESMA also considers how to approach the use of CSDs to hold financial instruments owned by AIFs or UCITS.

AIFMD and UCITS V requirements: At present, AIFMD clearly states in Recital (41) that entrusting custody of assets to a CSD is not delegation of custody functions, and in Article 21(11), final paragraph, that the provision of services by a CSD is not delegation of custody functions. In relation to UCITS, the corresponding wording is in Recital (21) of the UCITS Amending Directive and Article 22a(4) of UCITS V. The text of Article 22a(4) is essentially the same as the text of AIFMD Article 21(11), final paragraph, stating that the provision of services by a CSD is not delegation of custody functions. However, the wording in Recital (21) is confused, and can be read as conflicting with Article 22a(4) and suggesting that use of a CSD should be treated as a delegation of custody functions.

Interpretation: Interpretation of the relevant provisions is not aided by the fact that Recital (41) and Article 21(11), final paragraph, of AIFMD, and Article 22a(4) of UCITS V do not refer to CSDs as such but to "the provision of services as specified by Directive 98/26/EC [the Settlement Finality Directive] by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement systems". The Settlement Finality Directive does not contain any specific Article specifying the services provided by a securities settlement system therefore the relevant services must be all those services contemplated by the Directive as provided by a securities settlement system. Such services including the holding of securities for the participants in such system, as well as acting as the record of legal title to securities.

In contrast, [4]Recital (21) of the UCITS Amending Directive refers to CSDs as defined in Regulation (EU) No 909/2014 (the "CSDR"). In the CSDR, a CSD "means a legal person that operates a securities settlement system referred to in point (3) of Section A of the Annex and provides at least one other core service listed in Section A of the Annex." In Section A of the Annex to the CSDR (which is entitled "Core services of central securities depositories"), point (3) is "Operating a securities settlement system ('settlement service')", and the other two points are "(1) Initial recording of securities in a book-entry system ('notary service')" and "(2) Providing and maintaining securities accounts at the top tier level ('central maintenance service')". Since Section A of the Annex to the CSDR lists the only core services which may be performed by a CSD, this must include settlement systems which hold securities for the participants in such system, as well as those which act as the record of legal title to securities (because if settlement

systems holding securities were not included, settlement systems such as the system operated by Euroclear Bank, SA/NV would be excluded from the definition of CSD, which would be an odd and unexpected result.)

ESMA's view: The July paper indicates that ESMA is inclined to take the view that a CSD should be regarded as a delegate, whether in the context of AIFMD or UCITS V, and seeks to support this by redefining the meaning of "custody".

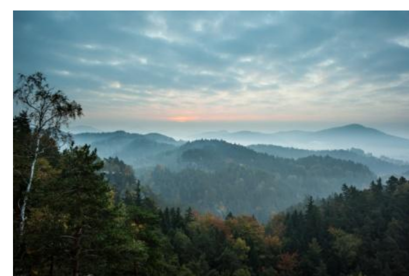
This is a concern, because if a CSD is regarded as a delegate, this will mean that a depositary is subject to the same high level of liability for CSDs as it has under AIFMD and UCITS V for subcustodians. In addition, this will create extensive additional compliance issues for depositaries and their delegates. A depositary or its delegate will be subject to all relevant requirements applicable to appointment of delegates, including the requirements to impose certain obligations on delegates/sub-delegates, which would be extremely difficult to apply to a CSD.

In principle, the following arguments could be made regarding the appropriate interpretation of AIFMD and UCITS V:

- In Recital (21) of the UCITS Amending Directive, it is clearly the intention that where a CSD provides services within the scope of Section A of the Annex to the CSDR, the provision of such services is not to be regarded as a delegation of custody functions. Since such CSD services inevitably (unless the CSD is simply a registrar service) include the holding of securities by a CSD for its participants, this means that where a depositary (or its delegate) holds fund securities through a CSD, this is not a delegation of custody functions.
- The terms of UCITS V cannot have been intended to conflict, therefore, in view of the specific wording in Article 22a(4) of UCITS V, Recital (21) of the UCITS Amending Directive should be interpreted as simply clarifying that if a CSD provides custody services separately from its CSD functions (i.e. provides custody services other than in its capacity as CSD), the CSD would in respect of such separate services be a delegate for such purpose. (It should be noted that a CSD which is authorised under the CSDR is not permitted to provide services other than the core services listed in Section A of the Annex to the CSDR and certain ancillary services specified in such Annex, therefore provision of custody services by a CSD separately from its CSD services would be a breach of its authorisation for the purposes of the CSDR. However, since the UCITS Amending Directive took effect before any CSD could be authorised under the CSDR, it seems reasonable to conclude that the additional clarification was considered appropriate prior to the CSDR requirements coming into full force and effect.)
- There is no reason to regard CSDs as delegates, and therefore impose AIFMD and UCITS V requirements regarding delegates on depositaries and delegates holding securities with CSDs, because there is not the same wide choice of CSDs as of subcustodians generally.
- It is unnecessary to require CSDs to comply with the provisions of AIFMD or UCITS V, or the Level 2 measures, which apply to delegates because CSDs are already subject to considerable scrutiny and regulation, which will increase with the application of the CSDR. The application of additional requirements risks causing conflicts of requirements and confusion regarding compliance.
- In relation to CSDs, there is no reason why the approach under AIFMD and UCITS V should be different. It is clear in AIFMD that a CSD is not regarded as a delegate. The fact that the wording of AIFMD Article 21(11), final paragraph, and UCITS V Article 22a(4) are the same shows that (notwithstanding Recital (21) of the UCITS Amending Directive) the intention is that the approach should be the same, namely that a CSD should not be regarded as a delegate.
- [5]There is no meaningful distinction between custody functions and "the provisions of services as specified by Directive 98/26/EC [the Settlement Finality Directive]", because custody (the holding of securities) is plainly included in the services of securities settlement systems contemplated by the Settlement Finality Directive. Since the Settlement Finality Directive does not contain any specific Article specifying the services provided by a securities settlement system, the relevant services must be all those services contemplated by the Directive as provided by a securities settlement system. Such services include the holding

of securities for the participants in such system, as well as acting as the record of legal title to securities, as demonstrated by the terms of the Settlement Finality Directive. For example, Recital (19) refers to "a register, account or centralized deposit system which evidences the existence of proprietary rights in or for the delivery or transfer of the securities concerned". Where a settlement system holds securities for its participants, and, under the participation terms of such settlement system and the law to which the settlement system is subject, the rights of participants to securities held by the settlement system are protected in the event of the insolvency of the settlement system, the participants clearly have some form of proprietary right in the securities or for delivery or transfer (the exact nature of such right will of course depend on the characterisation under applicable law). Recital (21) is clear that securities held in a settlement system are not limited to securities for which the settlement system records constitute the record of legal title, because reference is made to "the operation and effect of the law of the Member State under which the securities are constituted or of the law of the Member State where the securities may otherwise be located". The definition of "system" in Article 2 includes the requirement that there are "arrangements for the execution of transfer orders between the participants [in the system]", and the definition of "transfer order" in relation to securities means "an instruction by a participant to transfer the title to, or interest in, a security or securities by means of a book entry on a register, or otherwise", thus showing that securities settlement systems are not limited to those which record legal title to securities, therefore include settlement systems which hold securities for participants.

- The meaning of "custody" of securities in both AIFMD and UCITS V is clear. It refers to the holding of securities (whether directly or indirectly through an intermediary), whereas "safekeeping" is a broader term, used to mean both the function of providing custody of financial instruments, and the function of verifying ownership of assets which are not financial instruments. This may be seen from the wording of AIFMD Art 21(8), in which the first lines refer to "safe-keeping" which is then sub-divided into the depositary's obligation to "hold in custody all financial instruments" in 21(8)(a), and the depositary's obligation "verify the ownership of the AIF" in 21(8)(b). The wording in UCITS V Art 22(5) is similar, and the same terms are used in a similar manner throughout the AIFMD and UCITS V Level 2 legislation. Any attempt to vary the plain meaning of "custody" would be inconsistent with the manner in which such term is used in both AIFMD and UCITS V, and would cause confusion. It would also conflict with the understanding of such term in other contexts, such as MiFID. None of the additional services listed by ESMA should be included within the concept of custody, since they do not constitute the function of holding of assets (even if may be carried out in connection with holding assets). Expanding the concept of custody would result in persons other than the holder of the assets being regarded as providing custody services, which would cause major regulatory concerns, particularly in the context of the regulation of custody services under MiFID.



In our view there is a significant risk that if ESMA receives only a few responses, or responses lacking clear arguments to the contrary, ESMA will conclude for both AIFMD and UCITS V purposes that, in relation to asset segregation requirements, onerous segregation requirements at each level of the chain of intermediaries are appropriate, and in relation to holding fund assets with a CSD, this should be regarded as delegation of custody to the CSD, and the meaning of "custody" should be expanded. Such developments are likely to have a significant effect on fund depositaries' liabilities, and also on the compliance obligations of not only depositaries but also any other entity in the chain of intermediaries holding fund assets.

Notes

1. An Alternative Investment Fund, being a fund falling within the definition of "AIFs" in Directive 2011/61/EU.
2. An undertaking for collective investments in transferable securities, being a collective investment undertaking falling within the definition of "UCITS" in Directive 2009/65/EC as amended by Directive 2014/91/EU (the "UCITS Amending Directive" and together with Directive 2009/65/EC "UCITS V").
3. Regulation (EU) 648/2012.
4. The UCITS Amending Directive does not amend the Recital in Directive 2009/65/EC, therefore it might be argued that Article 22a(4) of UCITS V should be given greater weight than Recital (21), and override in the event of inconsistency.
5. During the drafting stage, there was some debate on whether both "issuer CSDs" and "investor CSDs" should not be regarded as "delegates" for the purposes of UCITS V. It is possible that Recital (21) results from some confusion on the points debated. In the draft CSDR RTS "issuer CSD" means "a CSD which provides the core service referred to in point 1 or 2 of Section A of the Annex to ... [the CSDR] in relation to a securities issue" (as explained in this note, given the definition of CSD in CSDR, all CSDs must be issuer CSDs); and an "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". It would be odd and impractical to conclude that use of an ‘issuer CSD’ does not involve delegation of custody functions but use of an "investor CSD" does. Such an approach would be impossible to monitor and document, since a CSD could be both an issuer CSD and an investor CSD for the same participant, depending on the securities held and the manner in which such securities are held by the CSD from time to time.

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