



European Securities and  
Markets Authority

# Call for evidence

**Asset segregation and custody services**



## Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **23 September 2016**.

Responses to this consultation paper can be sent using the [response form](#), via the [ESMA website](#), under the heading 'Your input/Consultations'.

### Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. 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 not to disclose the response 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](http://www.esma.europa.eu) under the heading [Legal Notice](#).

### Who should read this paper

This document will be of interest to (i) depositaries of alternative investment funds and UCITS and their delegates (including prime brokers and collateral managers) and their trade associations, (ii) alternative investment funds and UCITS managers and their trade

associations, as well as (iii) institutional and retail investors investing into such funds and their associations.



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# 1 Executive Summary

## Reasons for publication

On 1 December 2014 ESMA issued a consultation paper (CP) on [Guidelines on asset segregation under the AIFMD](#) (ESMA/2014/1326)<sup>1</sup>. The majority of respondents to this consultation strongly objected to both options on which ESMA consulted and expressed a preference for some of the options which were mentioned in the cost-benefit analysis accompanying the proposal. Moreover, Directive 2014/91/EU (UCITS V Directive) and its implementing measures recently introduced asset segregation requirements under the UCITS framework which are broadly aligned to the AIFMD. Therefore, the asset segregation issues became in the meantime a horizontal matter relevant to both AIF and UCITS.

Against this background, and before determining any of its policy orientations, ESMA decided to carry out a further consultation aimed at (i) gathering further evidence on the arguments set out by the majority of stakeholders in their responses to the CP and (ii) broadening the scope of this workstream to cover also the asset segregation rules under the UCITS Directive, as well as any residual uncertainty on how the depositary delegation rules should apply to CSDs.

## Contents

This paper identifies a number of areas on which further stakeholder input is needed. These are as follows:

- 1) mapping of asset segregation models;
- 2) understanding how investor protection in the event of insolvency would be ensured under the various models;
- 3) understanding the issues linked to complexity and operational costs that arise from the current legislative framework;
- 4) understanding the issues linked to collateral management/prime brokerage;
- 5) understanding the issues linked to the T2S system;
- 6) understanding the impact of segregation requirements on 3rd countries;
- 7) gathering views on the optimal asset segregation regime for achieving a strong level of investor protection without imposing unnecessary requirements; and
- 8) gathering views on any uncertainties that could remain on how the depositary delegation rules should apply to CSDs.

## Next Steps

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ESMA will consider the feedback it receives to this consultation with the aim of finalising its work on asset segregation by the end of 2016. Depending on the outcome of its analysis, ESMA will consider what is the best approach.

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<sup>1</sup> Available at [https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1326\\_cp\\_-\\_guidelines\\_on\\_aifmd\\_asset\\_segregation.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1326_cp_-_guidelines_on_aifmd_asset_segregation.pdf).

## 2 Background

1. On 1 December 2014, ESMA issued a CP on Guidelines on asset segregation under the AIFMD. A summary of the responses to the CP is included under Annex 2 of the present call for evidence. The majority of respondents to this consultation strongly objected to both options on which ESMA consulted and expressed a preference for some of the options which were mentioned in the cost-benefit analysis accompanying the proposal. Those respondents set out a number of supporting arguments, including the operational challenges that would be faced in the custody chain should any of the two proposed options be retained. Various other respondents expressed support for either of the two options on which ESMA consulted.
2. ESMA looked further into the compatibility with the AIFMD legal framework of the various options which were mentioned in the CP and considered that – with the UCITS V Directive having come into force – the issues at stake are not only relevant under the AIFMD.
3. In this context, ESMA made an in-depth review of the relevant documentation. These included not only the responses to the CP, but also, inter alia, a number of responses to the recent Commission Call for evidence on the EU regulatory framework for financial services<sup>2</sup> which touched upon the asset segregation issue.
4. Based on this review, ESMA identified a number of assertions about the challenges and costs arising from the current EU framework on asset segregation which were mentioned by stakeholders and is issuing this call for evidence in order to gather input that will inform an assessment of the best way forward on this workstream.
5. ESMA is also interested in gathering stakeholders' views on a discrete (but related) issue which relates to any need to provide additional guidance on the notion of custody services and any residual uncertainty on how the depositary delegation rules should apply to CSDs.
6. The following policy objective has driven ESMA's work while developing the part of the present call for evidence relating to asset segregation matters.

### Policy objective

7. The policy goal is to provide an EU framework with strong client asset protection, especially in insolvency, for the safe-keeping of assets which are, in accordance with both UCITS and AIFM Directives, required to be held in custody. Insolvency and property law are different in all EU jurisdictions. A given type of segregation model intended to provide strong protection in jurisdiction X may in fact offer more, less or no change in protection if imposed on jurisdiction Y or Z.
8. Therefore, ESMA is interested in gathering views on any asset segregation regime which ensures:

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<sup>2</sup> Available at [http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index\\_en.htm](http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index_en.htm).



- a) assets are clearly identifiable as belonging to the AIF/UCITS, and
- b) investors receive adequately robust protection by avoiding the ownership of the assets being called into question in case of the insolvency of any of the entities in the custody chain.

### 3 Asset segregation

#### 3.1 Mapping of asset segregation models

##### Introduction

9. In order to inform any future policy orientations on which asset segregation regime(s) could best achieve the policy objective set out above, ESMA is seeking stakeholders' input in order to understand the different models of asset segregation which are currently used in the different markets and the insolvency regimes in which they operate.

##### Questions

- 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 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 situations 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<sup>3</sup> published by ECON in 2011, there are five basic models for holding securities with an intermediary: the trust model<sup>4</sup>, the security entitlement model<sup>5</sup>, the undivided property model<sup>6</sup>, the pooled property model<sup>7</sup> and the transparent model<sup>8</sup>. 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.

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<sup>3</sup> <http://www.europarl.europa.eu/document/activities/cont/201106/20110606ATT20781/20110606ATT20781EN.pdf>

<sup>4</sup> See pages 14-15 of the Briefing Note.

<sup>5</sup> See page 16 of the Briefing Note.

<sup>6</sup> See page 17 of the Briefing Note.

<sup>7</sup> See page 18 of the Briefing Note.

<sup>8</sup> See page 19 of the Briefing Note.

**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.**

## **3.2 Investor protection in the event of insolvency**

### Introduction

10. Many respondents to the CP said that asset segregation pursuant to options 1 and 2 of the CP does not provide any additional protection in case of insolvency and even physically segregated individual accounts do not guarantee the return of assets in an insolvency scenario. Moreover, some stakeholders argue that asset segregation (as set forth in AIFMD) would not be the key factor in determining the recoverability of assets in the event of the sub-delegate's insolvency.
11. Comments were also made on the enforceability of property rights through the custody chain.
12. Some respondents to the CP argued that – under the concept of PRIMA ('place of the relevant intermediary approach') – each link in the chain of custody has a directly enforceable property right against the next link. Therefore, according to these respondents, there is no additional benefit in imposing segregation requirements throughout the chain, as one party can only enforce property rights directly against the immediate next level, but not against further levels in the chain.
13. ESMA is seeking stakeholders' input on the above issues in order to understand the impact that an insolvency (or potential insolvency) event in the custody chain may have on the protection of investors.

### Questions

- 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?**
- 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.

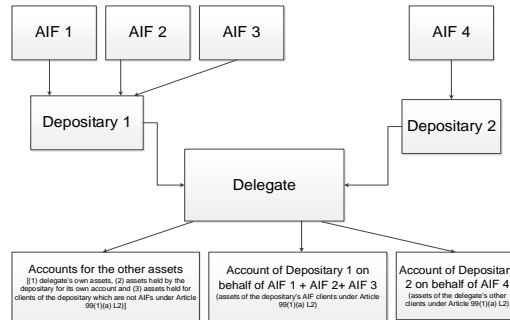
**Q4:** Should you consider that asset segregation pursuant to options 1 and 2 of the CP does not provide any additional protection to the existing arrangements you described in your response to Q1 in case of insolvency, and that these arrangements provide adequate investor protection, please explain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

- i) effective reconciliation,
- ii) traceability (e.g. books and records), or
- iii) 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.

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

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

**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:

- describe how segregation in books and records would ensure the aforementioned investor protection;
- 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
- explain how the above-mentioned segregation in books and records would address any of the risks of 'omnibus accounts' mentioned in recent IOSCO work<sup>9</sup>.

<sup>9</sup> 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

### 3.3 Complexity/operational costs

#### Introduction

14. Many respondents to the CP argued that the increased number of accounts and complexity in the reconciliation process will increase the probability of operational errors, and the need for multiple settlement instructions for each market will impact settlement efficiency and potentially increase the likelihood of failed trades across the market, as well as increasing costs.
15. ESMA is interested in gathering additional input on the above issues as well as in understanding whether additional issues may arise as a consequence of any potential interaction of the asset management rules with other sectoral legislation (e.g. Regulation (EU) No 648/2012 (EMIR))<sup>10</sup>.

#### Questions

##### *Complexity*

**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**
  - **Through CSD Links**
  - **In relation to cross-border investments through CSD links, what are the functions of an investor CSD<sup>11</sup>?**
  - **Through T2S**
- **Prime broker services**
- **Tri-party collateral management / securities lending.**

**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**

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*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 \(FR05/11\)](#).*

<sup>10</sup> In this context, in addition to the provisions under Article 39 of EMIR, it is also worth mentioning that section 2.3 of ESMA's [Final Report on Draft regulatory technical standards on indirect clearing arrangements under EMIR and MiFIR \(ESMA/2016/725\)](#) relates to issues which are tangential to the present consultation as it focuses on account structures and segregation models in the context of indirect clearing arrangements under EMIR and MiFIR.

<sup>11</sup> 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](http://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457_-_annex_ii_-_csdr_ts_on_csd_requirements_and_internalised_settlement.pdf)).



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.

**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)?

**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.

*Costs*

**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?

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

**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<sup>12</sup> (including if this may raise any operational difficulties)? Should you consider that there is any impact, please explain why.

## **3.4 Collateral management/prime brokerage**

### Introduction

16. Many respondents to the CP argued that option 1 of the CP would negatively impact the efficiency of cross-border settlement, the use of tri-party collateral and the prime brokerage market.

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<sup>12</sup> 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".

17. In particular, respondents to the CP highlighted that tri-party collateral management arrangements rely on the use of omnibus accounts at the delegate (and sub-delegate) level to ensure efficient movements of collateral on an intra-day books and records basis. On this basis, respondents argued that option 1 would have the following impact on this market:

- a. fragmentation of collateral pools at local market level by forcing 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 opportunity for funds to generate additional income;
- b. restrict collateral managers providing their services to smaller AIFs, as they will not be willing to provide these services if assets cannot be held in a single comingled account; and
- c. substantially increase costs for clients as a result of the operational complexity and other risks described above.

#### Questions

**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.

**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?**

**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?**

**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.**

## **3.5 T2S**

### Introduction



18. Many respondents to the CP argued that option 1 of the CP would negatively impact the efficiency of cross-border settlement and the use of T2S<sup>13</sup>.

#### Question

**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.**

### **3.6 Impact on 3rd countries**

#### Introduction

19. Various respondents to the CP highlighted that non-EU entities in the custody chain may not be subject to the segregation requirements envisaged in the CP, in particular the ones under option 1.

20. ESMA is interested in gathering further evidence on this issue.

#### Questions

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

- a) 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**
- b) 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.**

**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.**

**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?**

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<sup>13</sup> For more information on T2S please see the following address: <https://www.ecb.europa.eu/paym/t2s/html/index.en.html>.



### **3.7 The optimal asset segregation regime for achieving a strong level of investor protection without imposing unnecessary requirements**

#### Introduction

21. The majority of respondents to the CP strongly objected to both options 1 and 2 on which ESMA consulted and expressed a preference for some of the options which were mentioned in the cost benefit analysis accompanying the proposal. Those respondents set out a number of supporting arguments, including the operational challenges that would be faced in the custody chain should options 1 or 2 of the CP be retained. Various other respondents expressed support for either of the two options on which ESMA consulted.
22. Against this background, ESMA is further considering the asset segregation issues arising from the current sectoral legislative requirements under both the AIFMD and UCITS Directive<sup>14</sup>. In particular, ESMA would like to better understand the CP respondents' claims that the proposed levels of segregation would not result in any benefit for clients in the event of the insolvency of a depository or its delegate, the cost implications of these levels of segregation and that accurate books and records are of greater importance to protect investors in the event of insolvency.
23. Depending on the outcome of its analysis, ESMA will consider what is the best approach. This may include addressing the EU institutions to ask for legislative changes under the AIFMD and UCITS Directive if it is considered that the current legislative framework imposes requirements that are unnecessary to achieve the policy objective of ensuring a strong level of investor protection, in the event of the insolvency of any of the entities in the custody chain.
24. In order to inform its possible policy orientations, ESMA is seeking stakeholders' views on which asset segregation regime would be optimal for achieving the aforementioned policy objective.

#### Questions

**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**

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<sup>14</sup> Asset segregation requirements equivalent to the ones under the AIFMD framework were recently introduced in the UCITS framework through Directive 2014/91/EU and Commission Delegated Regulation (EU) 2016/438.

to UCITS, references to ‘AIF’ should be read as ‘UCITS’ and references to ‘non-AIF’ should be read as ‘non-UCITS’.

<p><b>Option 1</b></p>	<p>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.</p> <p>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.</p>
<p><b>Option 2</b></p>	<p>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.</p>
<p><b>Option 3</b></p>	<p>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.</p> <p>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.</p>
<p><b>Option 4</b></p>	<p>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.</p> <p>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).</p>
<p><b>Option 5</b></p>	<p>AIF assets should be segregated on an AIF-by-AIF basis at the level of the delegate or sub- delegate.</p>

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

- i) ‘omnibus client segregation’ at the CSD level (holding in one securities account the securities that belong to different clients of that participant);
- ii) ‘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<sup>15</sup>.

- 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.

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

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<sup>15</sup> 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.

## 4 Provision of custody services

25. Recital 41 of the AIFMD provides that *“Entrusting the custody of assets to the operator of a securities settlement system as designated for the purposes of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems or entrusting the provision of similar services to third-country securities settlement systems should not be considered to be a delegation of custody functions”*.
26. The enacting terms of the AIFMD reflect these provisions under Article 21(11), last subparagraph, which states that *“[...] the provision of services as specified by Directive 98/26/EC by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement systems shall not be considered a delegation of its custody functions”*.
27. Questions arose on the interpretation to be given to the aforementioned provisions given the alleged inconsistency between, on the one hand, the enacting terms of the AIFMD which provide for an exemption from the depositary’s delegation rules in relation to “the provision of services” by securities settlement systems and, on the other hand, recital 41 which refers to entrusting the custody of the assets to the operator of a securities settlement system.
28. A common approach on the interpretation of the above mentioned provisions of the AIFMD was sought, in particular following the adoption of Directive 2014/91/EU (“UCITS V Directive”) which introduced depositary rules similar to those of AIFMD under Directive 2009/65/EC (“UCITS Directive”). The UCITS V Directive introduced a new Article 22a(4) of the UCITS Directive which mirrors the provisions of the above mentioned Article 21(11), last subparagraph, of the AIFMD<sup>16</sup>. Recital 21 of the UCITS V Directive accompanies these provisions and states the following: *“When a Central Securities Depository (CSD), as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council, or a third-country CSD provides the services of operating a securities settlement system as well as at least either the initial recording of securities in a book-entry system through initial crediting or providing and maintaining securities accounts at the top tier level, as specified in Section A of the Annex to that Regulation, the provision of those services by that CSD with respect to the securities of the UCITS that are initially recorded in a book-entry system through initial crediting by that CSD should not be considered to be a delegation of custody functions. However, entrusting the custody of securities of the UCITS to any CSD, or to any third-country CSD should be considered to be a delegation of custody functions”*.
29. Against this background, ESMA felt it was appropriate to ensure convergence on how to apply the provisions under Article 21(11), last subparagraph, of the AIFMD. On 1 October

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<sup>16</sup> Article 22a(4) of the UCITS Directive states the following: *“For the purposes of this Article, the provision of services as specified by Directive 98/26/EC of the European Parliament and of the Council by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement systems shall not be considered to be a delegation of custody functions”*.

2015 ESMA issued a Q&A aimed at providing guidance on the extent to which the provisions on delegation by depositaries under the AIFMD apply to CSDs<sup>17</sup>. The Q&A stated that whenever assets are provided to a CSD in order to be held in custody in accordance with Article 21(8) of the AIFMD, the AIFMD delegation rules should apply.

30. Following the release of the Q&A, residual uncertainties seem to remain on how to interpret the relevant provisions and, in particular, in relation to which services the exemption applies, including in the context of the distinction between issuer CSD<sup>18</sup> and investor CSD<sup>19</sup> roles. This is mainly linked to the lack of common understanding on the notion of “custody” of financial instruments in relation to CSDs under both the AIFMD and UCITS Directive and to the different service models used by different CSDs. Moreover, questions may arise on how the notion of “custody” relates to “safekeeping” which both Article 21(8) of the AIFMD<sup>20</sup> and Article 22(5) of the UCITS Directive<sup>21</sup> also refer to. In this respect, ESMA notes that in some official languages of the EU, the translations of the AIFMD and UCITS Directive use the same word to refer to both concepts.
31. Without prejudice to the aforementioned ESMA Q&A, which remains valid, ESMA is interested in gathering further input from stakeholders on their understanding of the concept of “custody” and the impact that this may have on the extent to which CSDs are subject to the AIFMD and UCITS Directive delegation rules on depositaries.

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

**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:**

- a) initial recording of securities in a book-entry system (‘notary service’);**
- b) providing and maintaining securities accounts at the top tier level (‘central maintenance service’)<sup>22</sup>;**

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<sup>17</sup> See Q&A 8 under Section VI of the Questions and Answers on the Application of the AIFMD (ESMA/2016/568), which states the following: “**Question 8 [last update 1 October 2015]:** *When assets of an AIF held in custody by the depositary of the AIF are provided by that depositary to a CSD or a third country CSD as defined under Regulation (EU) No 909/2014 (CSDR) in order to be held in custody in accordance with Article 21(8) of the AIFMD, does the CSD or third country CSD have to comply with the provisions on delegation set out under Article 21(11) of the AIFMD? **Answer 8:** Yes”.*

<sup>18</sup> According to Article 1(f) of the ESMA draft RTS on CSD Requirements, ‘issuer CSD’ means a CSD which provides the core service referred to in point 1 or 2 of Section A of the Annex to Regulation (EU) No 909/2014 in relation to a securities issue; ([www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457\\_-\\_annex\\_ii\\_-\\_csdr\\_ts\\_on\\_csd\\_requirements\\_and\\_internalised\\_settlement.pdf](http://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457_-_annex_ii_-_csdr_ts_on_csd_requirements_and_internalised_settlement.pdf))

<sup>19</sup> According to Article 1(g) of the ESMA draft RTS on CSD Requirements published, ‘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; ([www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457\\_-\\_annex\\_ii\\_-\\_csdr\\_ts\\_on\\_csd\\_requirements\\_and\\_internalised\\_settlement.pdf](http://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457_-_annex_ii_-_csdr_ts_on_csd_requirements_and_internalised_settlement.pdf))

<sup>20</sup> Article 21(8) of the AIFMD states that “*The assets of the AIF or the AIFM acting on behalf of the AIF shall be entrusted to the depositary for safe-keeping, as follows: (a) for financial instruments that can be held in custody [...]*”.

<sup>21</sup> Article 22(5) of the UCITS Directive provides that “*The assets of the UCITS shall be entrusted to the depositary for safekeeping as follows: (a) for financial instruments that may be held in custody [...]*”.

<sup>22</sup> 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”).



- c) maintaining or operating securities accounts in relation to the settlement service;
- d) having any kind of access to the assets of the AIF/UCITS; or
- e) 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?

**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.

**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<sup>23</sup>) and Article 22(5) of the UCITS Directive (as well as Article 13 of the UCITS V Level 2<sup>24</sup>).

**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.

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<sup>23</sup> Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012.

<sup>24</sup> Commission Delegated Regulation (EU) 2016/438 of 17 December 2015.

## 5 Annexes

### 5.1 Annex 1

#### Summary of questions

**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 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 situations 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<sup>25</sup> published by ECON in 2011, there are five basic models for holding securities with an intermediary: the trust model<sup>26</sup>, the security entitlement model<sup>27</sup>, the undivided property model<sup>28</sup>, the pooled property model<sup>29</sup> and the transparent model<sup>30</sup>. 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.

**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

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<sup>25</sup> <http://www.europarl.europa.eu/document/activities/cont/201106/20110606ATT20781/20110606ATT20781EN.pdf>

<sup>26</sup> See pages 14-15 of the Briefing Note.

<sup>27</sup> See page 16 of the Briefing Note.

<sup>28</sup> See page 17 of the Briefing Note.

<sup>29</sup> See page 18 of the Briefing Note.

<sup>30</sup> See page 19 of the Briefing Note.



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?

**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.

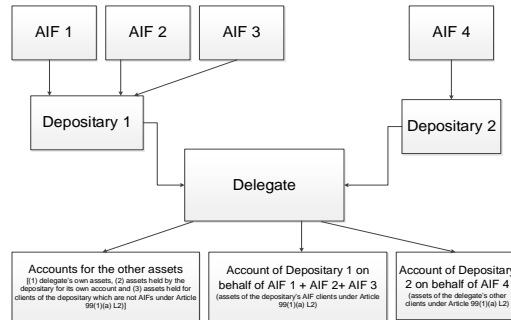
**Q4:** Should you consider that asset segregation pursuant to options 1 and 2 of the CP does not provide any additional protection to the existing arrangements you described in your response to Q1 in case of insolvency, and that these arrangements provide adequate investor protection, please explain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

- i) effective reconciliation,
- ii) traceability (e.g. books and records), or
- iii) 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.

**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 Depository 1 and Depository 2 to enforce their rights in respect of the assets held in the account on their behalf against the Delegate or its liquidators?

**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:

- describe how segregation in books and records would ensure the aforementioned investor protection;
- 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
- explain how the above-mentioned segregation in books and records would address any of the risks of 'omnibus accounts' mentioned in recent IOSCO work<sup>31</sup>.

<sup>31</sup> 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



**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**
  - **Through CSD Links**
  - **In relation to cross-border investments through CSD links, what are the functions of an investor CSD<sup>32</sup>?**
  - **Through T2S**
- **Prime broker services**
- **Tri-party collateral management / securities lending.**

**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.**

**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)?**

**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.**

**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?**

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*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 \(FR05/11\)](#).*

<sup>32</sup> 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\\_-\\_cldr\\_ts\\_on\\_csd\\_requirements\\_and\\_internalised\\_settlement.pdf](http://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1457_-_annex_ii_-_cldr_ts_on_csd_requirements_and_internalised_settlement.pdf)).

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

**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<sup>33</sup> (including if this may raise any operational difficulties)? Should you consider that there is any impact, please explain why.**

**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.

**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?**

**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?**

**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.**

**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.**

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

- a) 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

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<sup>33</sup> 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”.



- b) 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.

**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.

**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?

**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'.

<b>Option 1</b>	<p>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.</p> <p>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.</p>
<b>Option 2</b>	<p>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.</p>
<b>Option 3</b>	<p>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.</p>

	<p>However, the delegate could not commingle in this account assets coming from different depositaries.</p> <p>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.</p>
<b>Option 4</b>	<p>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.</p> <p>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).</p>
<b>Option 5</b>	<p>AIF assets should be segregated on an AIF-by-AIF basis at the level of the delegate or sub- delegate.</p>

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

- i) 'omnibus client segregation' at the CSD level (holding in one securities account the securities that belong to different clients of that participant);**
- ii) '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<sup>34</sup>.**

- 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**

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<sup>34</sup> 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.

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.

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

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

**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:

- a) initial recording of securities in a book-entry system (‘notary service’);
- b) providing and maintaining securities accounts at the top tier level (‘central maintenance service’)<sup>35</sup>;
- c) maintaining or operating securities accounts in relation to the settlement service;
- d) having any kind of access to the assets of the AIF/UCITS; or
- e) 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?

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<sup>35</sup> 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”).



**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.**

**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<sup>36</sup>) and Article 22(5) of the UCITS Directive (as well as Article 13 of the UCITS V Level 2<sup>37</sup>).**

**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.**

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<sup>36</sup> Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012.

<sup>37</sup> Commission Delegated Regulation (EU) 2016/438 of 17 December 2015.



## 5.2 Annex 2

### Feedback on the consultation paper

1. On 1 December 2014, ESMA published a consultation paper on [Guidelines on asset segregation under the AIFMD](#) (ESMA/2014/1326). The consultation closed on 30 January 2015.
2. ESMA received 38 responses from asset managers, depositaries, prime brokers, collateral managers and their associations. The public responses were published on the ESMA website<sup>38</sup>.

#### **I. Comments on the two options on which ESMA consulted<sup>39</sup>**

##### Either option 1 or 2

3. One respondent perceived itself as compliant with both the segregation requirements under option 1 and option 2 (assuming that the level of segregation envisaged in the CP does not reach the level of the CSD).

##### Option 1

4. 9 respondents supported option 1. It was argued that this option is in line with the requirement of identification and monitoring of the assets entrusted in custody to the depositary under the AIFMD and reinforces the protection of the assets in custody against, in particular, the consequences of mismanaged operational risks.
5. Some of these respondents added that the guidelines should set out minimum requirements under the AIFMD, and that AIFs and their managers should be left free to implement stricter rules, such as option 5.
6. Another respondent – without explicitly expressing a preference for option 1 – mentioned that the segregation requirements should not apply in the same way for assets held in custody and “other assets” that cannot be held in custody: at the depositary level or at its delegate’s level, segregation requirements for assets held in custody take the form of segregated accounts, as opposed to records for “other assets”.

##### Option 2

7. 7 respondents preferred option 2. One of them argued that option 2 is the one that would be the most compatible with the structure of the T2S system.
8. Another respondent mentioned that divergent interpretations of AIFMD requirements for the segregation of assets result in an un-level playing field among depositaries. This

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<sup>38</sup> They are available at the following address: <http://www.esma.europa.eu/consultation/Consultation-Guidelines-asset-segregation-under-AIFMD#responses>.

<sup>39</sup> Please note, that in contrast to the table under Q22 at Section 3.7 of this call for evidence, the tables in the CP did not contain any details on the implications for the sub-delegate level.

respondent argued that, as a result, a depositary that is compliant with the segregation requirements is disadvantaged as it is not selected by an AIF which appoints a prime broker or a collateral manager that is not compliant with the AIFMD requirements.

Neither option 1 nor option 2

9. 20 respondents favoured neither option 1 nor option 2. They argued, inter alia, that:
  - neither of the two options would add any protection in an insolvency scenario;
  - the two options would prevent AIFMs from executing block trades;
  - opportunities for internalised settlements (settling across the account provider's own books rather than the books of the sub-delegate) would be reduced;
  - the increased complexity in the reconciliation process will increase the probability of operational errors, and the need for multiple settlement instructions for each market will impact settlement efficiency and potentially increase the risk of fails across the market;
  - both options go against the principle of proportionality;
  - in case of an insolvency of a sub-custodian, the depositary can repatriate all assets in an omnibus account by way of one quick single instruction as opposed to the need of sending a multitude of instructions to repatriate assets from a multitude of accounts;
  - the segregation obligation can be fulfilled by physically segregated accounts or by IT-based and bookkeeping-based segregation by records which allow the distinction of assets and clients (Article 99(1)(a) Level 2); IT-based and bookkeeping-based segregation is therefore possible and appropriate and is compatible with the AIFMD Level 1 and 2;
  - in the UK, omnibus account structures are permitted under the FCA's Policy Statement 13/5 and CASS 6.5.1, which permits prime brokers to hold omnibus accounts for AIF and non-AIF assets.
10. One of these respondents argued that a potential risk arising from omnibus accounts is the theoretical risk of shortfall in the event of the insolvency of one of the funds or issuers and, on that basis, there may be an argument against commingling. However, this respondent considered that that risk has always theoretically existed but has not materialised to any significant extent.
11. If these respondents had to choose out of the two proposed options:
  - 3 of them would prefer option 1 arguing that option 2 goes against the Level 1 provisions;

- while 12 others would prefer option 2. Some of the respondents preferring option 2 also raised doubts on its compatibility with the Level 1 provisions referring to “*clients of a particular depositary*” under Article 21(11)(d)(iii).

Two trade associations would favour an amended version of option 2 whereby the depositary segregates / maintains record-keeping of AIFs’ accounts in its books, and ensures that its delegate, at the first level of the custody chain, segregates the assets of the depositary’s clients (AIFs co-mingled with non-AIFs) managed collectively, from its own assets and from the depositary’s own assets (i.e. where each depositary’s own assets are segregated separately). At the level of the sub-delegate of the custody chain and below, the segregation of assets should be done between the “own assets” of the sub-delegate, the “own assets” of the delegate, the delegate’s clients’ assets (including the co-mingled assets of AIF and non-AIFs) and the assets of its eventual other clients.

12. One respondent argued that the implementation of option 1 or 2 would require a minimum period of 12 months.

## **II. Comments on the additional options considered in the CBA**

13. Several respondents (most of them being among those who objected to the proposed options 1 and 2) expressed support for some of the alternative options that were mentioned in the CBA. The views were expressed as follows:

### Option 3

14. 4 respondents supported option 3. It was argued, inter alia, that under option 3 client assets held with delegated third parties (sub-custodians) may be immediately and unambiguously distinguished at any time, regardless of whether they are held in compartmentalised (AIF-only) omnibus accounts or in omnibus accounts spanning all client segments (i.e. UCITS, AIFs and other client assets).

### Option 4

15. 10 respondents favoured option 4. Two trade associations argued that option 4 is the model that is currently being used by the prime brokerage market and is consistent with the MiFID asset segregation provisions and in line with the AIFMD Level 2, which does not require the assets of different classes of client to be held in separate accounts. Similarly, two other respondents argued that option 4 is closest to market standard at present and there would be significant costs and operational issues for market participants if it cannot be employed in the future. Another respondent added that option 4 minimises the operational and settlement risk associated with the prime brokerage business by limiting the settlements required to be managed by all participants in the trading and custody process.
16. One respondent preferred option 4 if the applicable law on rights in rem and on bankruptcy provides that assets of the relevant AIFs are segregated from other assets and e.g. will not be affected by the bankruptcy of owners of such other assets. In all other cases, this respondent expressed a preference for option 2.



#### Option 5

17. One respondent mentioned that it applies individual asset segregation on an AIF by AIF basis with respect to the accounts held at the relevant sub-custodians. This respondent argued that the possibility to opt for fully segregated accounts at both custody and sub-custody level should remain available to investors that consider the marginal benefit of fully segregated accounts to be more important than the marginal cost of such increased level of asset segregation.
  
18. Another respondent mentioned that Option 5 would be the best solution on the basis that stronger segregation requirements would provide a safer system. The benefit of the additional level of segregation (compared to Options 1 and 2), namely envisaging fast and accurate identification, separation and return of assets in the event of the bankruptcy of the sub-depositary, did not seem to be exceeded by its marginal additional cost. However, this respondent recognised that the Level 1 and Level 2 do not seem to require segregation of *“the assets of the depositary’s AIF clients on a AIF-by-AIF basis”*.

#### All five options

19. A depositary argued that market participants should be able to choose between all 5 options (in particular, options 3 and 4).