Brussels, 23 September 2016

EACB comments on the ESMA Call for evidence

Asset segregation and custody services

The European Association of Co-operative Banks (EACB) has taken note of the ESMA Call for Evidence- Asset Segregation and Custody Services as many co-operative banks offer custody services and/or fund administration services while some might have depository banks and/or asset management in the group structures. We understand that there has been a lot of uncertainty regarding segregation which is damaging to the European Market. The outcome of this Call for evidence should ensure market participants have legal certainty as to their relevant obligations.[1]

The EACB has not provided individual responses to the questions as we believe that other industry associations and market participants are better placed to address the detailed questions raised in the Call for evidence. However, we would like to share with you some key observations of the EACB member on this issue.

One of the main purpose of both AIFMD and UCITS V has been to increase investor's assets protection to restore investors' confidence in the investment fund industry. Indeed, AIFMD and UCITSV have introduced a specific custody regime with the strict liability regime of the depositary for assets held in custody and the obligation to take necessary actions in case of custody risks, ideally before a delegate or a sub-delegate goes bankrupt. Segregation requirements in AIFMD Level2 text (Article 99) and UCITSV level 2 text (Article 16) to be implemented by delegates and sub-delegates of the depositary's custody function (a) introduced protection in in case of bankruptcy of delegates/sub-delegates and (b) provided the depositary with a look-trough view of assets whatever the number of level of delegation to facilitate the monitoring of custody risks (e.g. risks of fraud , misuse of assets) and the transfer of assets to back-up delegates when there are at risk of being bankrupt.

Indeed, AIFMD and UCITS V require transparency on the custody chain as mitigating custody risks is essential for asset managers and investors and financial markets, given the amounts at stake, the importance of reputational risks and the need to keep investor's confidence It is a cornerstone for investors protection and trust in the system.

[1] The EACB would like to stress that the International Organization of Securities Commissions (IOSCO) Recommendations Regarding the Protection of Client Assets are a very good basis to go forward (link: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf)

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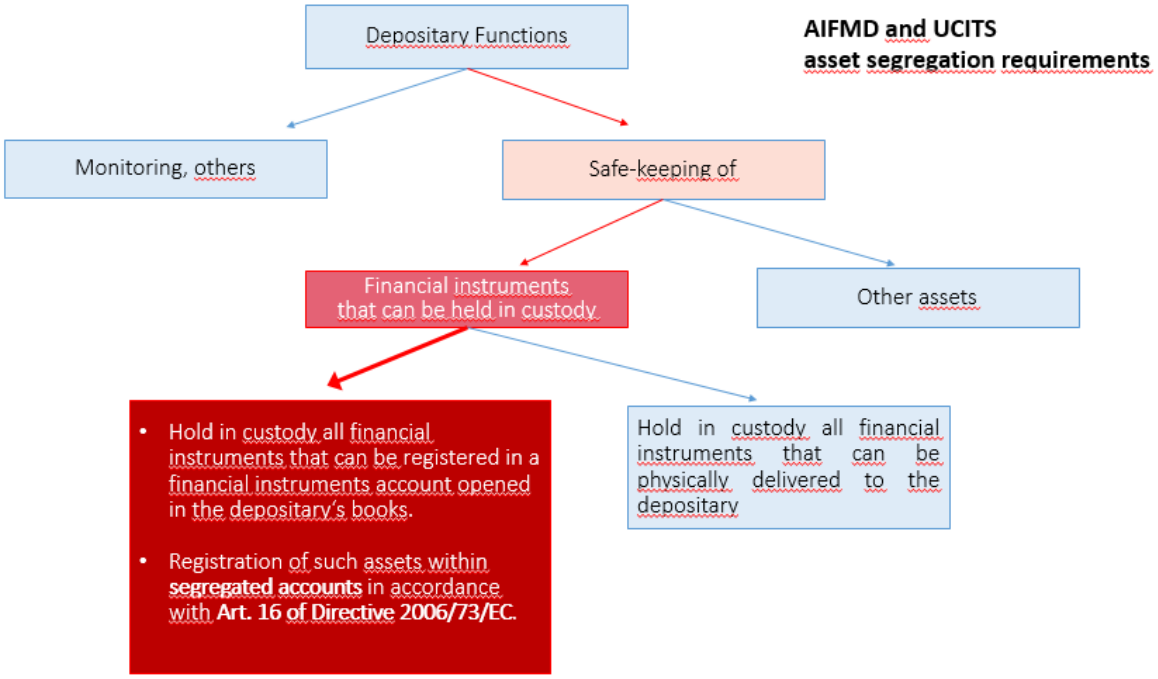
Whatever the level in a custody chain, the enforcement of the ownership rights of a client (or of a client of the custodian 's client) relies on accurate recordings of those rights at both the custodian and at client level, which need to reconcile. In general, the quantity of securities returned to an AIF or a UCITS in case the depositary has gone bankrupt would depend on:

- the actual enforcement of insolvency law applicable to the delegates/sub-delegates.
- the quantity returned by the delegate/sub-delegate. This will depend on the accuracy and traceability of the quantity of securities recorded at the delegate/sub-delegate level as belonging to the depositary 's clients and on the total quantity recorded at the issuer CSD as belonging to the delegate's clients (or to the sub-delegate 's clients).

We would like to emphasise that the asset segregation requirements for AIF and UCITS assets can however **refer only to financial instruments**, and not to other assets, as only financial instruments are to be held in custody by the depositary according to Art. 21 (8) AIFMD and Art. 22 (5) UCITS Directive. To be even more precise, the asset segregation requirements refer only to financial instruments that can be registered in a financial instruments account (cf. Art. 21 (8) (a) (ii) AIFMD and Art. 22 (5) (a) (ii) UCITS Directive).

These directives require that the assets need to be held in custody by registering them in the depositary's books ensuring that they are "clearly identified as belonging to the AIF [UCITS] in accordance with the applicable law at all times". For this reason they impose a requirement that "those financial instruments that can be registered in a financial instruments account opened in the depositary's books are registered in the depositary's books within segregated accounts in accordance with the principles set out in **Article 16 of Directive 2006/73/EC**".



Typically, depositaries that are entrusted with the safekeeping of AIF or UCITS financial instruments are investment firms according to MiFID that also offer safekeeping and administration of financial instruments for the account of (other) clients as an ancillary service according to MiFID II Annex I Section B point (1). For such depositaries, the MiFID requirements (including the principles set out in Art. 16 of Directive 2006/73/EC) apply anyway.

Furthermore, we would like to invite ESMA to take into consideration that even for the very small percentage of financial instruments that can be physically kept in custody, custodians apply the same rules although they do not necessarily have to be applied by depositaries under the AIFMD or UCITS Directive (cf. Art. 21 (8) (a) (ii))/22 (5) (a) (ii)). We would also like to point out that most financial instruments in which AIFs and UCITS invest, need to be registered in book-entry form according to Art. 3 (1) CSDR[2]. Therefore, most AIF or UCITS financial instruments are assets that can be registered in financial instruments accounts with banks already.

Hence, we welcome the fact that both the AIFMD and the UCITS Directive require the principles of Art. 16 of Directive 2006/73/EC for all depositaries in the same way.

Account structure:

The asset segregation model depends on different factors such as EU and local regulation, market structure, tax and clients needs and demands and is a combination thereof. In many cases where there is no local obligation or no specific client's demand segregation requirements under AIFMD and UCITS V are met using nominee omnibus accounts along the custody chain provided it has ascertained that that the nominee concept is recognised at the delegate/sub-delegate. Subject to local law Nominee omnibus accounts are protected in case of bankruptcy of delegates/sub-delegate. These accounts do not record assets belonging to those delegates/sub-delegates. Therefore they are not available for distribution to their creditors in the event of their insolvency. The insolvency of a delegate/sub-delegate may be dealt with in accordance with the law of the jurisdiction where the securities are located. Different jurisdictions have different insolvency regimes and the timeline for recovery against an insolvent estate will depend on the administrator proceedings.

We understand that the most important and critical consideration for depositaries -whether a local sub-custodian, global custodian or prime broker is appointed- is that assets are identified through the custodial chain in a manner that best protects and ensures the speediest return of assets in the event of an insolvency of one of the participants in the chain. This necessitates the use of omnibus accounts, having regard to local as well as cross border market practices and legal frameworks that have evolved to support those practices.

In any case, complexity of custody chain should not be overstated. Unless mandated by their clients, or the regulations depositaries are keen to maintain "short" custody models.

Whatever the level in a custody chain, the enforcement of the ownership rights of a client (or of a client of the custodian 's client) relies on accurate recordings of how client assets are held at both the custodian and at client level, which all need to make reconciliation processes.

[2]Regulation (EU) No 909/2014

CSD:

It is necessary to have a clear distinction between the "issuer CSD" concept (i.e. the CSD where the initial issuance of the securities is recorded) and the "investor CSD" concept (i.e. a CSD that provides custody services in relation to securities initially issued in another CSD and for which the investor CSD acts in a capacity similar to a global custodian). We support a clear definition of delegation of custody[3]. We have been receiving reports that "investor CSDs" challenge any qualification as depositaries' delegates and consequently insist they are not subject to the segregation requirements introduced by AIDMD and UCITS V. It should be clarified that issuer CSDs are not delegate /sub-delegate of the depositary. At the issuer CSD level only the segregation between its own assets (or its delegate/sub-delegate' assets), and the assets of its clients (or its delegate/sub-delegate' clients) in a nominee omnibus account is required. However, investor CSD should be classified as falling within the scope of depositary delegation arrangements under the UCITS/AIFM Directives. Ideally this distinction should be introduced in the relevant articles of the Directives and not only be addressed in the recitals, - although Recital 21 of UCIT V is, in our view, welcome as it is intended to provides clarity and address this issue.

Moreover, the nature of the links between CSDs, relayed or direct, does not bring any additional legal safety and guarantee that could justify a distinct regime in favor of Investor CSDs versus global custodians as what is at stake is the maintenance of the integrity of clients positions and not the technical monitoring of settlement instructions.

T2S:

Concerns have been raised on how the function of T2S is impacted by segregation requirements. However, AIFMD and UCITS V segregation requirements do not affect the number of accounts opend at an issuer CSD by an investor CSD as issuer CSDs are not delegate /sub-delegate of the depositary. Consequently there are not subject to AIFMD/UCITS segregation requirements and the only segregation required is a distinction between the own assets of the custodian, which is the last level of the custody chain, and this custodian clients' assets.

In addition, T2S and CSD links in general are designed for an omnibus account structure, allowing for cross-border deliveries. While some solutions have been created to accommodate the greater segregation levels associated with direct holding markets, any future regulation should consider possible limitations of relevant infrastructures. Local limitations on omnibus accounts in direct holding markets may also limit competition giving incumbent local CSDs de facto monopoly position on domestic settlement and safekeeping.

Conclusion:

Having said that, the EACB would like to make a more general point with regard to this issue and which is that it should always be borne in mind that segregation is only one technical tool to protect the assets of investors and not a panacea. Segregation between clients assets and own

[3] Custody cannot be performed for all assets owned by an investment fund. It only relates to financial instruments that are capable of being registered directly or indirectly in the name of the depositary .There is a specific process for each type of assets (e.g, non-financial assets such as commodities, unlisted debt, derivatives) and those processes do not overlap.

assets at all levels on the custody chain is essential. Depositaries do comply with this rule. Additional segregation requirements could facilitate, under certain circumstances, risk monitoring by the depositary, access and transferability of assets at the request of the depositary. We are not aware that additional segregation provides any additional legal protection in case of insolvency and even physically segregated individual accounts do not guarantee the return of assets in an insolvency scenario.

In any case, segregation requirements, per se, do not deliver 100% security for investors. Segregation requires to be supported with effective rules for the purpose of insolvency distribution in case of insolvency of intermediaries.

With this in mind, we consider that any ESMA work on this topic should make sure that it does not take initiatives that add unnecessary complexity without really added value for the investor. Investor protection, should be re-instated as the overarching objective of any further action/ decision in this regard.

Moreover, it could be a good idea to refer to other MiFID requirements additionally to Art. 16 of Directive 2006/73/2006 (see above) when regulating the safekeeping of AIF or UCITS financial instruments.[4] This would ensure that depositaries and delegates also operating as MiFID investment firms could rely on their established account holding models and would not have to set up completely new systems and account structures for no benefit at all, while all depositaries could follow the same rules for the safekeeping of AIF or UCITS financial instruments. We therefore take the view that the introduction of specific account holding options is not necessary.

We thank you in advance for taking the time to consider our views, and remain at your disposal to further discuss this issue and to provide any additional information necessary in that regard.

Contact:

The EACB trusts that its comments will be taken into account.

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[4] For example, MiFID requirements like Art. 19 of Directive 2006/73/EC could be introduced in ESMA guidelines for the asset segregation of AIF or UCITS assets.