ECSDA
European Central Securities Depositories Association

23 September 2016

CSDs, asset segregation, and custody services under UCITS and AIFMD

This paper constitutes ECSDA's response to the call for evidence on asset segregation and custody services issued by the European Securities and Markets Authority (ESMA) on 15 July 2016. We only comment on selected questions of the call for evidence, focusing on those issues which are most relevant from the perspective of central securities depositories (CSDs).

Introduction

Section VI, Question and Answer 8 of the ESMA AIFMD Q&A of 1 October 2015 generated a lot of uncertainty as regards the extent to which depositary delegation rules should apply to CSDs. ECSDA thus welcomes ESMA's recognition, in the call for evidence, that this issue should be clarified.

CSDs are financial market infrastructures which operate at the top tier level of the custody chain. They are regulated by the CSD Regulation (CSDR), which provides harmonised requirements for all EU-authorised CSDs, including in terms of account segregation, reconciliation and record keeping. Treating CSDs as "delegates" under AIFMD and/or UCITS would directly conflict with the scope and spirit of the CSDR, and would negatively affect the operation of cross-CSD links, potentially making the value proposition of TARGET2-Securities less appealing. Meanwhile, it would not bring additional safety benefits for funds and their investors, and it could actually discourage the use of low risk infrastructures.

ECSDA firmly believes that the provision of CSDR-authorised services should not result in CSDs being considered as delegates within the meaning of Article 21(11) of the AIFMD and Article 22a of the UCITS Directive. The recently adopted CSDR requirements on asset segregation and CSD safekeeping services are adequate to protect the assets of all CSD participants and their clients, including CSD participants acting as fund depositaries.

1. Mapping of asset segregation models

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. (…)

CSDs do not "manage" any funds and Question 1 is thus not directly relevant for them. Generally speaking, the AIFM and UCITS directives were drafted from the point of view of investment funds. This explains why certain attempts at applying AIFMD and UCITS provisions to CSDs are creating a lot of confusion.

CSDs are financial market infrastructures which operate at the top tier level of the custody chain. They are regulated by the CSD Regulation (CSDR), which provides harmonised requirements for all EU-authorised CSDs, including in terms of account segregation, reconciliation and record keeping. According to the CSDR, CSD participants must distinguish proprietary and third party assets at the level of CSD accounts. When holding securities on behalf of clients, CSD participants can opt for omnibus or individual client segregation, provided they disclose the costs and risks associated with each option to their clients in a transparent way. The choice of segregation type is available for all CSD participants, including fund depositaries. CSD participants are subject to harmonised and non-discriminatory participation criteria, and they are treated equally regardless of the type of entity that they represent (credit institutions, MIFID investment firms, etc.) and regardless of the specific services/functions they perform for their clients.

Securities held in CSD accounts include, among others, underlying assets of investment funds (e.g. shares, bonds, money market instruments) as well as fund units (UCITS and AIF units, as well as shares in exchange traded funds). Participants in CSDs, i.e. wholesale financial institutions such as local and global custodian banks, including some institutions acting as fund depositaries for UCITS and/or AIFs, determine the appropriate level of asset segregation to be used for their securities accounts at a CSD based on the available options, their business needs, and applicable legal requirements.

An overview of account segregation options available at European CSDs was published by ECSDA in October 2015 and shows a multiplicity of segregation models across Europe, as well as different segregation requirements for domestic and cross-border securities transactions. Indeed, even in markets where segregated end investor accounts are maintained at the level of the CSD, cross-border securities transactions processed via CSD links operate on the basis of omnibus accounts.

In the vast majority of cases, segregation rules at CSD level are identical for all types of financial instruments and for all types of participants (e.g. whether or not they act as fund depositaries). Only in a limited number of cases does national law impose a different level of segregation for different asset classes (e.g. In Norway, end investor segregation is required for shares but not for debt instruments).

Naming conventions for securities accounts depend on CSD participants. As explained in the ECSDA report, the definition of "individual client segregation" in article 38 of the CSDR allow for a variety of set-ups:

- The accounts may be fully independent accounts or subaccounts of the CSD participant;
- The accounts may be opened in the name of the participant, or they may be opened in the name of clients of the CSD participant;
- The CSD may or may not have access to information on the identity of clients of CSD participants, and it may or may not know that the securities held in the individually segregated accounts are held on behalf of a given client;
- Clients of CSD participants for whom a segregated account is maintained at the CSD may or may not be end investors. They may be intermediaries holding securities on behalf of other investors.

Actual practices largely depend on CSD participants' preferences and on their assessment of risks and costs.

2. Investor protection in the event of insolvency

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?

The reason why account segregation is perceived as beneficial to investor protection is that it provides a way to "ring-fence" client securities in case an intermediary becomes insolvent. Segregated securities accounts can contribute to a swift and reliable identification of client assets in default scenarios, but these segregation details can also be found at the level of intermediaries rather than CSDs.

As mentioned in paragraph 10 of the Call for evidence, asset segregation is often not the most important factor in determining the recoverability of assets in the event of a sub-delegate's insolvency. Paragraph 7 also acknowledges that, in the absence of harmonised securities laws in EU countries, *"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."* Securities shortfalls, when they occur, are typically caused by poor bookkeeping, rather than by a lack of segregation. The use of several segregated and/or sub- accounts does not necessarily make it easier for insolvency administrators to identify "who owns what".

Other factors than segregation are crucial for determining whether investor assets are adequately protected in various insolvency scenarios. The national insolvency regime in particular determines how and under which timeframe assets can be returned to their legitimate holders. At CSD level, factors

contributing to enhanced investor protection include a solid legal framework ensuring the portability of investor holdings as well as efficient CSD procedures for handling the default of a participant. Article 41 of the CSDR, for instance, requires CSDs to disclose and regularly test their rules and procedures as regards participant defaults. Article 20(5) of the same Regulation goes even further by foreseeing a mechanism to protect client securities in case a CSD were to lose its licence.

As far as CSDs' liability is concerned, ECSDA would like to insist that there is no "liability gap" that would justify the imposition of AIFMD requirements on CSDs. When a fund depositary holds assets in a CSD, the fund depositary remains liable to the fund or to the investors of the fund, in accordance with article 21(12) of the AIFMD. Moreover, as stated in Recital 38 of the AIFMD, a *"depositary should act honestly, fairly, professionally, independently and in the interest of the AIF or of the investors of the AIF".* Whether an AIF depositary decides to hold the AIF's assets at a CSD or at a custodian bank will be guided by these considerations, pertaining to asset protection. Liability considerations as regards the depositary itself are unlikely to be a key differentiator, and overall asset protection for the fund and the fund's investors should be the determining factor.

As per article 21(12), second sub-paragraph, the burden of the proof would fall on the fund depositary to show that the loss qualifies as an "external event" beyond its reasonable control and that the consequences of the event were unavoidable despite all reasonable efforts to the contrary. In the theoretical and highly unlikely case where a loss would occur at the level of a CSD, the requirements imposed on account maintenance services provided by CSDs would differ from the criteria in Article 21(8) of the AIFMD, given the specific framework in place for CSDs and CSD participants under the CSDR. In its capacity as CSD participant, the fund depositary would have to prove its compliance with the obligations of article 38 of the CSDR, including the need to reconcile its records with the information received from the CSD on a daily basis. It would not be able to transfer liability towards its clients to the CSD.

Allowing for a transfer of liability to CSDs under the delegation of custody regime in the AIFMD and/or UCITS would not be appropriate and would not enhance investor protection. CSDs' status as highly regulated market infrastructures means that they are considered to be safe havens for holding securities, having a much lower risk profile than custodians. CSDs maintain robust risk management systems and procedures which are based on the CPMI-IOSCO Principles for financial market infrastructures (PFMI) and which are regularly assessed by central banks and securities regulators. The "delegation of custody" regime could actually negatively impact CSDs' risk profile and financial stability, since the provision of custody is likely to be deemed critical for the market under the CSD recovery and resolution framework.

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. (…)

Generally speaking, the return of assets to investors in case of an insolvency of a CSD is subject to the insolvency law of the market in which the CSD operates, and the actual return is subject to the full

reconciliation of the books and the processes by the appointed liquidator. In most markets, the same legal regime applies irrespective of the type of account used at CSD level (i.e. omnibus or segregated).

Asked whether end investor accounts at CSD level afforded investors with a higher level of legal protection on their assets, around 3/4 of the CSDs which contributed to the 2015 ECSDA report on account segregation indicated that there was no difference in terms of investor protection. For example, in all markets, when a CSD participant or another intermediary is unable to return assets belonging to an investor, the investor can claim compensation with the relevant investor compensation scheme. This applies equally to investor assets held in omnibus accounts, individual client accounts, and end investor accounts.

In a limited number of EEA markets (Bulgaria, Denmark, Finland, Greece, Norway, Romania, the UK), the use of end investor accounts at CSD level have an impact on the nature of the legal rights of investors. Where end investor accounts are used, investors' rights may be enforceable against the CSD (e.g. Denmark) or directly against the issuer (e.g. Finland), whereas they will be enforceable against the relevant intermediary where omnibus accounts are used. In Denmark for example, the Securities Trading Act (§66) considers the account holder as the rightful owner of the securities whenever end investor accounts are used at the CSD, whereas for omnibus accounts, determining the rightful owner requires an examination of the CSD participant's records (since the information is not visible in the CSD).

In the other EU markets however, there is no legal recognition of end investor accounts: national law protects the rights of all investors irrespective of the type of account used at CSD level. In other words, the fact that a segregated account is used at CSD level affects neither the legal nature of the holdings nor the rights of the investor, including in case of an intermediary's insolvency.

Account segregation practices are in fact largely a consequence of the domestic legal regime in force, rather than as a determinant of the level of investor protection. In other words, in the absence of a harmonisation of securities laws across EU countries, investor rights are more dependent on the national legal framework than they are on the type of account used in the CSD.

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.

CSDs are subject to strict reconciliation obligations under the CSDR These requirements apply equally to securities held as investor and as issuer CSD.

3. Complexity/operational costs

Q7: Please describe the impact of settlement process and account structures on the different levels through the custody chain in the case of
o Cross-border investments
- Through CSD Links
- In relation to cross-border investments through CSD links, what are the functions of an investor CSD?
- Through T2S
o Prime broker services
o Tri-party collateral management / securities lending.

- **Cross-border investment through CSD links**

Omnibus accounts are the basis on which CSD links operate and the CSDR does not provide for segregation requirements in the context of links between CSDs.

In a 2013 report on CSD account segregation practices, the T2S Harmonisation Steering Group explains that *"current national account segregation rules go against the concept of T2S interoperability and, in a wider sense, the EU financial integration agenda".* The report stresses that the reason why segregated accounts are not used for CSD links is not because of segregation in itself, but because today, every domestic market segregates in a different way, and this lack of harmonisation creates a high level of risk and complexity. This complexity is unlikely to disappear in the near future – There are currently no plans for a substantial harmonisation of national securities laws.

CSD links, which are assessed for Eurosystem monetary policy operations, are critical for the movement of capital across the EU. As stressed in the response of the Eurosystem Contact Group of Experts on Securities Infrastructures (COGESI) to the European Commission CMU call for evidence published on 13 May 2015, given the volumes at stake, applying AIFMD requirements to CSDs would make reconciliation of securities transfers more complex, increase the number of necessary realignments, (and hence operational risk), and make the T2S value proposition less appealing. Several other responses to the CMU call for evidence, including responses by banking associations, further agreed with ECSDA that CSDs cannot realistically be expected to re-engineer cross-CSD links to adjust to AIFMD and UCITS V requirements.

- **The notion of "investor CSD"**

ESMA asks, in question 7 of the Call for evidence, "what are the functions of an investor CSD?". ECSDA would like to stress that both issuer and investor CSDs perform infrastructure services which are regulated in their entirety by the CSDR. Services listed in Section B and Section C of the CSDR Annex, such as the processing of corporate actions, fund order routing, reporting, etc. may be performed as issuer or investor CSD. What is defined by the draft CSDR Level 2 standards as "investor CSD" is merely a CSD which maintains a securities account at another CSD on behalf of its participants. There is no

additional "function" compared to services already regulated under the CSDR. Not all CSDs in Europe offer the full list of services regulated under the CSDR, and it is up to each CSD, based on the needs of its participants, to determine whether a link to a particular CSD is beneficial for the provision of its services.

It is also worth remembering that the reason why CSDs act as investor CSDs is because some of their participants want to be able to settle cross-border securities with their counterparties "locally" on the platform of the investor CSD, without needing to become a participant in multiple foreign CSDs. This motivation contrasts with the approach of global custodians which use a network of agent banks in several foreign markets in order to aggregate and internalise settlement within their books whenever possible.

On 19 July 2016, ECSDA published an overview of CSD links which shows that EEA CSDs currently operate a dense network of links. Imposing AIFMD and/or UCITS segregation rules at CSD level would mean that those CSD participants which are not allowed to hold assets in omnibus accounts are *de facto* prevented from making use of these links. This could have a trickle down negative impact on the underlying funds.

- **Cross-border investment through CSD links in T2S**

The problems highlighted above are valid for all EEA CSDs, irrespective of whether or not they participate in the Eurosystem TARGET2-Securities project. The reason why segregation rules could have a negative impact on the efficiencies generated by T2S is because the T2S project precisely aims at facilitating CSD links, allowing market participants to centralise their securities holdings in one CSD, rather than having to hold securities at multiple CSDs, or via intermediaries maintaining accounts on their behalf at multiple CSDs.

Unless a CSD acts as investor CSD, i.e. maintains accounts on behalf of its participants at other CSDs, there is little benefit in T2S participation. T2S precisely allows CSDs and their participants to interact with one another in a standardised way, thereby making cross-border securities transactions easier, safer and cheaper. A key principle of T2S is actually that issuer (domestic) CSDs should not impose restrictions on the use of omnibus accounts by investor (foreign) CSDs. This principle has been monitored on a regular basis by the T2S Harmonisation Steering Group.

Imposing the use of segregated accounts by certain market participants (fund depositaries) at CSD level would restrict these participants' ability to make use of CSD links, which operate on the basis of omnibus accounts, and thus to reap the benefits of T2S.

- **Tri-party collateral management / securities lending**

Several CSDs in the EU offer bilateral or triparty collateral management services, as well as securities lending and borrowing services. These services make it possible to automate the mobilisation of securities, an operation made easier where securities are commingled in a single account, since the

pooled assets provide a more liquid "basket" from which substitution and realignment of securities can be performed.

If funds' assets are segregated, they become part of a smaller pool. Collateral takers might find it costly and inefficient to handle the collateral givers multiple segregated accounts (e.g. because of multiple deliveries and being required to have more frequent substitutions of securities) - preferring the simplicity of a single delivery from a single pooled account.

Fund managers need to source eligible collateral to post as margin to satisfy EMIR obligations. The bigger the pool of collateral held for them at a CSD or a third party by the fund depository, the lower the costs and the higher the efficiency of sourcing. As a consequence of the required collateral being held in multiple segregated accounts for them by fund depositories, fund managers may see their efficiency and costs to source the inventory impacted negatively.

Moreover, tri-party collateral management agents may not be able to perform tri-party collateral management services for funds if all collateral transfers also need to occur in the local market. This is due to the delay that results from the necessary movements in the local market (or at sub-custodian level). It would mean that intraday books and records movements of collateral, on which the market relies, could not occur. The non-funds market would continue to operate under a tri-party collateral management model. The funds and their counterparties might be forced to move to a bilateral collateral management world in which counterparty, credit, settlement and operational risk would be increased.

Central banks hold their reserves and collateral directly at CSDs, because of their low risk profile. Moreover, CCPs are required to hold their clearing members' margin contributions at a CSD as a result of a regulatory requirement in article 47(3) of EMIR. It would be odd if EU funds would not be able to be part of this collateral ecosystem.

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)?

If CSDs were required to hold segregated accounts cross-border, all CSDs would have to open thousands (and, for a few, potentially millions) of accounts registered in the name of investors or groups of investors in any CSD with which they operate a link. Segregated accounts for cross-border CSD links would result in final settlement occurring only at the level of the local (issuer) CSD, which would require investor CSDs to open, maintain and reconcile securities accounts with issuer CSDs across the globe for each individual transaction. This would add significant costs to cross-border settlement and it would be inefficient because of the multiple additional re-alignments that would be required between the accounts of the linked CSDs. As outlined in the response of the T2S Advisory Group to this consultation, a marked increase in the number of securities accounts at CSD level is not simply a technical or a cost issue. It is a source of concern because the additional information that would have to be maintained for each account, and which differs from market to market, would create a high degree of complexity and

would thus negatively impact cross-border matching and settlement. This would increase operational risk and could lead to an increase in settlement fails (which would be subject to fines under the CSDR).

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?

ECSDA cannot assess the costs that option 1 of the ESMA Consultation Paper would generate for different market actors in the fund custody chain. Although it is difficult to calculate the costs involved, we believe that they are likely to be significant. We wish to stress that EU fund managers and EU infrastructures could find themselves at a competitive disadvantage compared to their global counterparts as a result of segregation rules extending to the infrastructure (CSD) space. Indeed, CSDs are major providers of secured financial connectivity between EU markets and other markets around the globe and preventing EU fund depositaries from using CSDs links with foreign CSDs could put them at a disadvantage. Imposing AIFMD segregation requirements to assets held at CSDs would also affect the attractiveness of the EU market infrastructure for international investors, and create new barriers to the development of links with non-EU CSDs.

4. The optimal asset segregation regime for achieving a strong level of investor protection without imposing unnecessary requirements

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? (…)

ECSDA did not respond to the ESMA consultation paper of 1 December 2014 given that CSDs were not thought to fall under the scope of the AIFMD "delegation of custody". Should CSDs ever be considered as "delegates" under the AIFMD and UCITS, options 1 and 2 would clearly have highly detrimental consequences on CSD services, as explained in our answers to the previous questions. Should option 3 or option 4 ever be considered, we would like to stress that CSDs can offer the necessary segregation facilities, as per CSDR article 38, but that responsibility for segregating will always rest with the fund depositary, not with the CSD. Segregation will remain an optional service of CSDs for their participants.

Q23 Articles 38(3) and (4) of the CSDR state that a CSD shall offer its participants the choice between: omnibus client segregation and individual client segregation' (…)
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.

ECSDA believes that the approach adopted in article 38 of the CSDR provides for investor protection and maximum transparency while having the advantage of accommodating different national legal approaches as regards segregation. The principle of investor choice embedded in the CSDR allows each investor and/or fund to determine the appropriate level of segregation depending on the legal protection attached to segregation at national level. It applies to CSD participants and their clients, excluding CSD links which are addressed in separate articles of the CSDR. Disclosure requirements included in article 38(6) further ensure that investors are aware of the risks and costs associated with each segregation option, allowing them to make an informed choice.

ECSDA therefore supports the CSDR approach and does not think that different or overlapping requirements are required for assets of UCITS and AIFs, at least as far as securities accounts maintained by CSDs are concerned.

5. Provision of custody services

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

Unless Section VI, Question and Answer 8 of the ESMA AIFMD Q&A of 1 October 2015 is redrafted or removed, ESMA will need to clarify the concept of "custody" in relation to services provided by CSDs. Indeed, the use of the term "custody" in this Q&A has given rise to legal uncertainty in the absence of the term "custody" in the list of authorised CSD services in the CSDR. The current ESMA Q&A fails to clarify the exact scope of article 21(11) of the AIFMD which until now had excluded services provided by CSDs from requirements on the delegation of custody[1].

Defining "custody" should however be done very carefully given the potential impact on CSD activities (see our answer to Question 26 below).

[1] The exemption of CSD services from the AIFMD and UCITS requirements on the delegation of custody is reflected in several pieces of national law (transposing the directives). As rightly mentioned by the British Bankers Association (BBA) in their response of 2 February 2016 to the EC call for evidence on financial legislation, "*CSDs/SSSs have never been treated as delegates since the beginning of the UCITS regime. AIF depositaries are also not required to treat CSDs/SSSs as delegates and so introduction of such an approach would be hugely disruptive to industry*."

An alternative to defining custody in relation to CSD services would be for the ESMA Q&A to be redrafted to clarify that fund depositaries should only be considered to "delegate custody" to CSDs when CSDs do not provide services according to the requirements of the CSD Regulation and the Settlement Finality Directive (SFD) on asset protection and finality. In the absence of the CSDR in other regions of the world, we suggest making it clear that there is delegation of custody by fund depositaries where a CSD is not subject to requirements equivalent to the CSDR.

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');
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?

ECSDA does not think that any of the following services should be considered as "custody" in the context of the AIFMD and UCTS delegation of custody provisions:

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

The notary service is conceptually different from custody and is only performed by authorised CSDs. All EU CSDs perform the notary service, at least for some financial instruments, and applying AIFMD and/or UCITS requirements on the activities of all EU CSDs would directly conflict with the scope and spirit of the CSDR, which already strictly regulates these activities.

b) providing and maintaining securities accounts at the top tier level ('central maintenance service');

The EU legislator deliberately created the term "central maintenance" in the CSDR to outline the unique nature of securities accounts at CSD level. Intermediaries, unlike CSDs, do not offer central maintenance, and this service can therefore not be considered equivalent to "custody", as provided by intermediaries.

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

All CSDs maintain securities accounts for their participants in relation to the settlement service. When a CSD accepts securities for settlement, by definition it allows its participants to hold these securities in their accounts at the CSD. Subsequently, whenever an event occurs on the securities, such as the payment of a dividend or an interest payment, the CSD ensures that the event initiated by the issuer of the securities is duly processed on all participant accounts. This service is commonly understood as being part of custody or safekeeping performed by a CSD, but considering it as "custody" in the context

of AIFMD and/or UCITS requirements would affect all CSDs in the EU and would directly conflict with the scope and spirit of the CSDR.

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?

CSDs maintain securities accounts for their participants but are prohibited from using participants' securities held in these accounts for any purpose other than providing services to which the participants have agreed. Unlike CCPs which act as principals in financial market transactions and maintain default funds and margins to protect themselves against counterparty credit risk, CSDs are not exposed to the default of their participants. Moreover, unlike CCPs, non-bank CSDs are not directly exposed to liquidity risk and do not guarantee the performance of settlement with their own assets.

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.

No. ECSDA does not think that CSD services regulated by the CSDR should be considered as "custody" services under the AIFMD and UCITS.

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 and Article 22(5) of the UCITS Directive (as well as Article 13 of the UCITS V Level 2).

In the case of MiFID II and the CSDR, certainty has been achieved thanks to consistent cross-references between both texts. Article 73 of the CSDR and article 2(1)(o) of MiFID II provide clarity on cases when the MiFID rules apply to CSDs. The ESMA technical advice on MiFID II of 19 December 2014 further clarifies in paragraph 56 (page 73) that segregation requirements under MiFID apply to assets held by clients at third parties whereas separate segregation requirements apply to assets held at CSDs (cf. article 38 of the CSDR).

Such clarity is unfortunately missing when CSDs perform custody activities for participants acting as fund depositaries. The ESMA Q&A on the AIFMD is particularly misleading as it seems to imply that, when CSDs provide core and ancillary services already regulated under the CSDR, they should be subject to AIFMD requirements on the delegation of custody function as soon as their participants act as AIF depositaries. Given that all CSDs perform "custody" activities for their participants and given that it is very common for CSD participants to act as fund depositaries (for alternative investment funds and/or UCITS funds), this interpretation is highly problematic and would subject EU CSDs to AIFMD requirements "on top of" CSDR requirements for services which are provided as part of CSDs' standard service offering and which are already strictly regulated under the CSDR. We doubt that the EU

legislator's intention is to subject all EU CSDs to AIFM requirements whenever CSD participants happen to act as AIF depositaries.

ECSDA believes that the best way to clarify how "custody" and "safekeeping" services interact is to follow the approach adopted in MiFID II, with the inclusion of cross-references to the CSDR. This would require redrafting UCITS V, the AIFMD and the ESMA Q&A in such a way that CSDs' services are described with CSDR terminology. This would avoid overlapping regulations and remove the current legal uncertainty around the notion of "custody" in a CSD context.

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.

ECSDA considers that the provision of CSDR-authorised services 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 for the following reasons:

1) This would be consistent with the Level 1 AIFMD

Article 21(11) of the AIFMD explicitly states that services of Securities Settlement Systems (SSSs) should not be considered as delegation of custody. EU CSDs are designated under the Settlement Finality Directive (SFD) as operators of SSS. The designation covers the institution as a whole and does not distinguish between different services. When drafting the provision on SSS in article 21 of the AIFMD, the legislator complemented it with Recital 41 confirming the exemption of custody service of CSDs from the requirements on the delegation of custody.

2) CSDs are already subject to strict requirements on segregation and liability. The application of AIFMD and UCITS rules on delegation to accounts held at a CSD will not enhance investor protection.

We understand that the overall objective of segregation requirements in the context of AIFMD and UCITS V is to ensure that in the event of insolvency of the depositary and/or any third party, the assets of an AIF/UCITS are not distributed to the creditors of the liquidated entity. However, the CSDR and local rules already provide appropriate safeguards with reference to assets held in CSDs without that there is the need to impose the AIFMD/UCITS segregation requirements.

First, CSDs are frequently subject to provisions stating that they do not have interest in securities and hence their assets cannot be distributed to their creditors.

Second, they are subject to the global CPMI-IOSCO framework for the recovery and resolution of CSDs and to CSDR rules on participant defaults and orderly wind-down.

Third, CSDs prohibit debit balances and overdrafts and generally have additional positioning or other rules preventing that the securities of one participant can be used to meet the obligations of another participant, making any further segregation requirements redundant.

3) Considering CSD services as delegation of custody would entail significant disadvantages

Our answers to Question 7 in particular highlights the detrimental impact on CSDs links, should ESMA consider CSD services as a delegation of custody.

We would also like to stress that the CSDR already includes a number of obligations for CSD participants, such as complying with strict settlement periods and discipline, complying with asset protection requirements or reconciling records daily with the CSD. Imposing AIFMD requirements on custody provided by CSDs would not bring additional safety benefits for funds but would result in a burden incomparably heavier on CSDs and their clients. It would actually discourage the use of low risk infrastructures and prevent funds from benefiting from the highest quality of protection.

About ECSDA

The European Central Securities Depositories Association (ECSDA) is a member of the EU Transparency Register under number 92773882668-44. The association represents 41 central securities depositories (CSDs) across 37 European countries. As regulated financial market infrastructures, CSDs play a vital role in supporting safe and efficient securities transactions, whether domestic or cross-border. If you have any questions on this paper, please contact Soraya Belghazi, Secretary General, at info@ecsda.eu or +32 2 230 99 01.