Approved by the ECSDA Board

29 January 2021

ECSDA response to the European Commission consultation on Alternative Investment Funds Managers Directive (AIFMD) review

The present document contains the ECSDA response to selected questions in the EC consultation paper on AIFMD review. Further to the discussion of the ECSDA Policy WG, it was agreed that the ECSDA response will only focus on questions related to (i) the definition and use of tri-party collateral management services in AIFMD, in addition to the application of depositary rules to tri-party collateral management (Questions 25 to 27) and most importantly (ii) the application of depositary rules to investor-CSDs (Questions 35 & 35.1), restating views and concerns previously passed on to both the EC and ESMA.

Consultation paper questions in section "II. Investor protection"

Question 25.
Is it necessary and appropriate to explicitly define in the AIFMD tri-party collateral management services?

- Yes
- **No**
- Don't know / no opinion / not relevant

Question 25.1.
Please explain your answer to question 25

ECSDA Response

We do not believe this question is relevant from a CSD perspective. While managing participants' collateral as triparty agent can be a CSD service (as it is part of the list of permitted services in Annex (Section B) to CSDR), a CSD itself does not act as fund depositary.

Just like other triparty agents, a CSD that provides collateral management services will typically automate operational collateral management tasks on behalf of its participants as a neutral triparty agent. CSDs do this by offering the mechanics to select and allocate the collateral assets during the duration of the deal between the two counterparties. The resulting triparty movements which are generated will next settle ensuring the assets are transferred either within the SSS of a CSD or outside of the CSD, i.e. triparty collateral management does not alter the possible ways in which assets are safekept. The existing rules should, therefore, be sufficient.

Question 26.

Should there be more specific rules for the delegation process, where the assets are in the custody of tri-party collateral managers?

- Yes
- **No**
- Don't know / no opinion / not relevant

Question 26.1.

Please explain your answer to question 26, presenting benefits and disadvantages of your suggested approach as well as potential costs of the change, where possible:

ECSDA Response

We do not believe this question is relevant from a CSD perspective. While managing participants' collateral as triparty agent can be a CSD service (as it is part of the list of permitted services in Annex (Section B) to CSDR), a CSD itself does not act as fund depositary.

Just like other triparty agents, a CSD that provides collateral management services will typically automate operational collateral management tasks on behalf of its participants as a neutral triparty agent. CSDs do this by offering the mechanics to select and allocate the collateral assets during the duration of the deal between the two counterparties. The resulting triparty movements which are generated will next settle ensuring the assets are transferred either within the SSS of a CSD or outside of the CSD, i.e. triparty collateral management does not alter the possible ways in which assets are safekept. The existing rules should, therefore, be sufficient.

Question 27.

Where AIFMs use tri-party collateral managers' services, which of the aspects should be explicitly regulated by the AIFMD?

ECSDA Response

No additional rules are necessary, the current regulation is appropriate.

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Question 35.
Should the investor CSDs be treated as delegates of the depository?

- Yes
- **No**
- Don't know / no opinion / not relevant

Question 35.1.
Please explain your answer to question 35, providing concrete examples and suggesting improvements to the current rules and presenting benefits and disadvantages as well as costs:

ECSDA Response

ECSDA would advise the European Commission not to amend AIFMD to subject Investor-CSDs to the fund depositary delegation of custody provisions, as CSDs do not act as fund depositary banks and are not meant to take fund depositary bank risks.

The scope of the AIFMD is designed to regulate funds and activities of fund depositary banks, not CSDs. All CSD activities for all types of assets are, at present, regulated either (i) directly under CSDR, or (ii) indirectly, in case of ancillary banking services provision, through the reference in CSDR to MiFID and relevant EU legislation.

Recital (41) AIFMD suggests that entrusting the custody of assets to an operator of an SSS (i.e., a CSD) should not be considered a delegation of custody, and the application of different treatments/rules to Investor and Issuer CSDs would have an undesired impact on CSDs and funds, as it would establish a regime not foreseen by the CSDR and would indirectly make CSDs subject to AIFMD.

Finally, while relevant safeguards are provided through the CSD's legislative framework, CSD's have a liability framework as part of normal business conduct to cater for negligence, misconduct and fraud. Such liability framework will depend on the CSDs local jurisdiction and set-up. In the context of CSDR, we have not identified a need to have an identical liability regime amongst European CSDs.

Furthermore, ECSDA takes the opportunity to remind the below points, previously addressed by the Association to the European Commission in separate more detailed documents:

1. **A transfer of liability from a fund depositary to a CSD will not enhance investor protection**

Such transfer would in fact, inappropriately shift risks. The SSS-related provisions contained in the level 1 texts of Article 21 AIFMD aim to protect fund depositary banks from the (theoretical) consequences of a permanent loss of assets at the level of the CSD. Amending the fund depositary custody delegation rules will instead expose CSDs to fund depositaries' liability which includes such permanent loss of assets in the chain (not just at the level of CSD). *This will not enhance investor protection but would shift risks onto CSDs*. It would indeed increase the overall risk to the financial markets due to the systemic importance and critical nature of the services provided by CSDs.

2. The establishment of safe and efficient CSD links should not be discouraged

The contractual transfer of liability from a commercial bank (intermediary operating a broad range of banking, trading and investment services – including custody) to a CSD, will negatively impact the end investor. Considering a CSD as a custody delegate of the Fund Depositary will expose the CSD to requests for a contractual transfer of liability. There would be concerns if AIFMD rules applied to CSDs, as this would adversely affect cross-CSD linked operations and increase CSD liabilities, going against the principles stated in CSDR. We also note the conclusion of the KPMG study on the AIFMD review: AIFMD exempts CSDs from scope, which allows efficient functioning of the CSD-dedicated regulatory framework.

3. CSDs should not be incentivised to accept more risks

The ESMA opinion on the delegation of custody functions has created an environment of legal and operational uncertainty.

This has led fund depositary banks to seek assurance that they can get compensation from CSDs, including for the losses for which the CSD would not be directly responsible, in addition to, and independently from, prevailing legislation as well as CSD's Terms and conditions.

4. Creation of two operational regimes

From a practical perspective, CSDs would be forced into creating two different operational regimes: 1) the existing general regime under CSDR for CSD services on all instruments, and 2) for Investor-CSDs as delegate of UCITS/AIFM depositary bank, a regime following AIFMD/UCITS delegation rules for Funds. If this were to occur, the risk of regulatory arbitrage would increase and, therefore, the risk to the stability of the financial markets and the safeguarding of investor protection would also be put into question.

5. Creation of a different level of asset protection for different participant types of a CSD

As a consequence of the application to investor-CSDs of fund depositary delegation of custody rules, custodians serving funds would get a different legal and contractual regime in comparison with other types of CSD participants, such as national treasury offices, other FMIs, broker/dealers representing institutional and private investors or even custodians serving other than funds investors.

We recall that CSDR caters for the same level of assurance in asset protection for any CSD participant and domestic and cross-border assets held in a CSD.

6. Authorities should consider structural and regulatory differences between custodian banks and CSDs

CSDs are not acting as fund depositary banks and are not meant to take fund depositary bank risks. Any discussion with regard to level playing fields between CSDs and fund depositary banks, and/or any other market actors should take into account such structural and regulatory differences.

CSDs share the principle '*same business, same risk, same rules*'. In this context, we stress the difference in the logic of AIFMD and CSDR: the former is functional legislation, while the latter

is institutional, i.e., covering all activities of clearly defined entities. Furthermore, we recall another fundamental principle, of no lesser importance, which states '*no double regulation*', imposing AIFMD on part of CSD activities would be in breach of this principle.

For any question or information concerning the consultation response, please contact the ECSDA Secretariat at +32 2 230 99 01 or info@ecsda.eu.