

Consultation Deadline – 29th January 2021

Full [Online questionnaire](#) available here

[AIFMD Regulatory Text](#) available here

Section 2 – Investor Protection

The AIFMD aims to protect investors by requiring AIFMs to act with the requisite transparency before and after investors commit capital to a particular AIF. Conflicts of interest must be managed in the best interest of the investors in the AIF. AIFMs must also ensure that the AIF's assets are valued in accordance with appropriate and consistent valuation procedures established for each AIF. The AIF assets are then placed in safekeeping with an appointed depositary that also oversees AIF's cash flows and ensures regulatory compliance. Questions in this section cover the topic of investor categorisation referencing to MiFID II, stopping short of repeating the same questions that have been raised in its, rather inviting [recent public consultation on MiFID II](#) comments on the most appropriate way forward. Views are also sought on the conditions that would make it possible to open up the AIF universe to a larger pool of investors while considering their varying degrees of financial literacy and risk awareness.

Examples of redundant or insufficient investor disclosures are invited. Greater clarity on stakeholders' views of the AIFMD rules on depositaries is sought in particular, where such rules may require clarification or amending. The introduction of the depositary passport is desirable from an internal market point of view, but stakeholders are invited to propose other potential legal solutions, if any, that could address the issue of the short supply and concentration of depositary services in smaller markets.

a) Investor classification and investor access:

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

No

Question 25.1 Please explain your answer to question 25:

For firms engaging in Securities Lending, where use of a tri-party collateral manager (TCM) is required, ISLA advise that the asset manager or lending agent exercise the requirements of Article 20 of the [AIFM Regulation](#) (EU) No 231/2013 'Due diligence in the selection and appointment of counterparties and prime brokers - When selecting prime brokers or counterparties of an AIFM or an AIF in an OTC derivatives transaction, in a securities lending or in a repurchase agreement, AIFMs shall ensure that those prime brokers and counterparties fulfil all of the following conditions: (a) they are subject to ongoing supervision by a public authority; (b) they are financially sound; (c) they have the necessary organisational structure and resources for performing the services which are to be provided by them to the AIFM or the AIF' and that this alone is sufficient. As outlined in the regulation, the appointment of the TCM is already appropriately governed in accordance with Article 20. TCM's as global custodians/ central securities depositories are under obligation to carry out reconciliation and reporting as a legal requirement. As regulated entities, they carry out daily reconciliations for their custody network and are under an obligation to report the positions they hold (at end of day) on a daily basis to depositaries, under the requirements of AIFMD at current. ISLA would like to stress that they are fully regulated as global custodians/central securities depositories to carry out the relevant due diligence for their custody networks, on the safekeeping of assets.

Tri-party collateral managers optimise the use of their portfolios of securities when collateralising credit and other exposures across different products and instruments (e.g., securities lending, amongst others). As part of their daily operations, TCM's provide services such as valuation, substitution, and optimisation of the tri-party pool, and in the majority of cases, accounts are maintained at the underlying fund/principal level.

ISLA does not consider that the way in which the market currently operates, requires further detailed regulation, however, see below response to question 27, requesting further clarity around the practicalities.

Question 26. Should there be more specific rules for the delegation process, where the assets are in the custody of tri-party collateral managers?

No

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:

Under the concept of delegation, there are two broad industry models operating in the market at present; firstly, where the depositary appoints the tri-party collateral manager as its sub-custodian and therefore, the TCM views the depositary as their custody client, and as such they remain in the custody chain. This is commonly referred to as the 'intermediary model' (See Figure 1 + 2 below for Securities Lending & Repo flows) which reflects the following:

- The agreements in place between a depositary and tri-party collateral manager for a securities lending/repo transaction, with regards to an agency lending structure.
- The custody arrangement between the depositary and the tri-Party collateral manager, as evidenced by the sub-custody agreement that exists between both parties.
- The sub-custody flows from the AIFM and Dealer to each of the depositary, tri-party collateral manager and the dealer's custodian.
- The reporting flow from both the depositary and the tri-party collateral manager to each of the AIFM, the dealer, as well as between the tri-party collateral manager and the depositary.
- The internalised and actual settlements that take place with respect to the loan leg and the collateral leg, of a securities lending transaction.
- The custody network end of day reconciliations that are required from the tri-party collateral manager and the depositary under the current AIFMD requirements.
- The depositary utilising the reconciliation of the tri-party collateral manager's custody reconciliation, when undertaking its own combined reconciliation, of both its custody network, and that of the tri-party collateral manager.

The second, known as the 'delegation model' is where the depositary delegates the safekeeping role, and hence no longer remains in the custody chain. It is important to note that most tri-party collateral arrangements do not operate under this delegation model.

ISLA has broad consensus that the majority of TCM's under our membership treat depositaries as an intermediary in the custody chain and regard them as a custody client in their books and records (whilst in the majority of cases, still maintaining separate accounts for each underlying AIF). The same holds true for the central securities depositories active in tri-party operations as financial market infrastructures, which are regulated by their specific rules and regulations. Both models are compliant with AIFMD, as long as books and records are appropriately maintained, there is no need for further clarity on the rules for delegation.

Question 27. Where AIFMs use tri-party collateral managers' services, which of the aspects should be explicitly regulated by the AIFMD? Please select as many answers as you like

- the obligation for the asset manager to provide the depositary with the contract it has concluded with the tri-party collateral manager.
- the flow of information between the tri-party collateral manager and the depositary
- the frequency at which the tri-party collateral manager should transmit the positions on a fund-by-fund basis to the depositary in order to enable it to record the movements in the financial instrument's accounts opened in its books
- **no additional rules are necessary, the current regulation is appropriate**
- other

Please explain why you think the obligation for the asset manager to provide the depositary with the contract it has concluded with the tri-party collateral manager should be explicitly regulated by the AIFMD. Please present benefits and disadvantages of this approach as well as potential costs of the change, where possible:

ISLA understand that these contracts are provided during the course of business as current practice.

Please explain why you think the flow of information between the tri-party collateral manager and the depositary should be explicitly regulated by the AIFMD. Please present benefits and disadvantages of this approach as well as potential costs of the change, where possible:

ISLA request that although the flow of information between tri-party collateral manager and the depositary is not required to be mandated into law, it would be helpful to the industry, if the Commission could outline the minimum

requirements for transfer of information between depositories and TCM's, to promote a level of standardisation and to ensure the depositories have the necessary information to appropriately maintain their books and records. ISLA notes that as current practice today, the TCM provides at a minimum end of day reporting, on the assets they hold in custody for the depository.

Please explain why you think the frequency at which the tri-party collateral manager should transmit the positions on a fund-by-fund basis to the depository in order to enable it to record the movements in the financial instrument's accounts opened in its books should be explicitly regulated by the AIFMD. Please present benefits and disadvantages of this approach as well as potential costs of the change, where possible:

ISLA members do not feel that the frequency of transmissions between the TCM and the depository needs to be mandated in the directive however, from a tri-party perspective, intra-day optimisation and constant re-allocation of collateral, would only allow for an end of day reconciliation. Therefore, ISLA would advocate that any further guidance from the Commission (in the form of Level 3/Q&A) explicitly recognises this.

Please specify what are the other aspect(s) that should be explicitly regulated by the AIFMD.

Please present benefits and disadvantages of this/these approach(es) as well as potential costs of the change, where possible:

ISLA understands that there may be concern from market participants surrounding reconciliation of the depository books and records. Where there is a delegation, there would be reconciliation between the depository to the TCM via end of day statements. There is a contractual obligation for the TCM that is providing the custody, to ensure that they are reconciled down the chain to the central securities depository, which, as a regulated custodian, is completed on a daily basis. It is important to note that this is a two-step process, TCM 's will reconcile all the way down the chain vs the central securities depository and the depository reconciles to the TCM.

There is uncertainty from the industry regarding the scope of the depositories reconciliation obligations vis a vis TCM's – ISLA would request the Commission provide further guidance to market participants and recognise that TCM's already perform a reconciliation obligation between their holdings and the transaction instructions, on an end of day basis, through their own custody networks, as they are required to do so under regulation. The depository should be able to rely on the reconciliation already performed and only have a requirement to reconcile between their records and the TCM, to ensure consistency. If the depository is required to perform transaction level reconciliation, this would be a duplicated effort and thus lead to increased costs. Furthermore, current market practice is that the transaction instructions are provided directly to the TCM, by the AIFM and the trading counterparty, and are not routed via the depository. Under the current legislation, depositories are already required to undertake a significant level of due diligence when appointing a TCM to act as a sub-custodian, and to maintain a level of oversight throughout the lifetime of that relationship.

ISLA contemplates that if the industry moves away from the current model, it could potentially lead to tri-party collateral management and depository services, being consolidated into the same legal entity, which could subsequently reduce competitiveness in the market.

Figure 1: Agent Lender vs TCM / Depository Model - Securities Lending

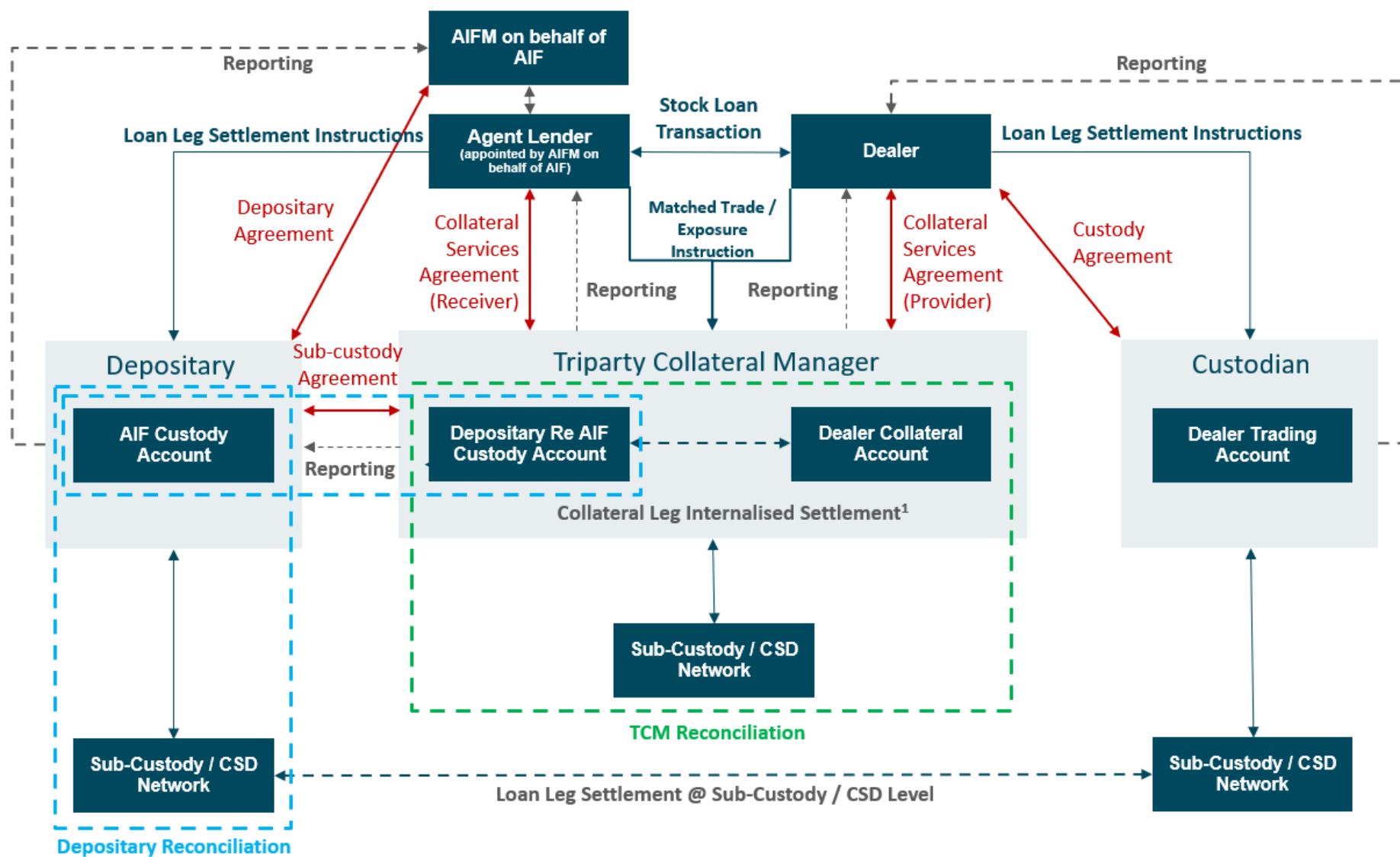


Figure 2: Agent Lender vs TCM / Depository Model – Repo

