Legal high Committee for
Financial markets of Paris

LEGAL OPINION

of the Legal High Committee for Financial Markets of Paris (HCJP) on AIFM Directive and principle of segregation of assets

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AIFM DIRECTIVE
AND PRINCIPLE OF SEGREGATION OF ASSET

The *Haut Comité Juridique de la Place Financière de Paris* (Legal High Advisory Committee for Financial Markets of Paris) («**HCJP**») was consulted on the level of segregation that depositaries of alternative investment funds («**AIFs**»), and their sub-depositaries, should implement to ensure an optimal protection of the assets they hold in custody.

It became clear following a preliminary analysis of the issue that greater the level of segregation is at each step of the custody chain, better the protection for investors is. It also appeared, however, that the implementation of an individual segregation throughout the custody chain of AIF assets could have other implications when these AIFs invest in instruments located outside the European Union, both in terms of cost and technical feasibility.

Acknowledging the fact that the appropriate level of segregation ultimately depends on finding a balance between the need to protect investors, the technical feasibility of a high level of segregation and the resulting costs, this memorandum aims to set out the **legal benefits** of a high level of segregation, as well as the minimum level of segregation that depositaries of AIFs and their sub-depositaries should implement to ensure the safe-keeping of the AIF assets they hold in custody.

1. Background

Article 21(8)(a) of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (the «**AIFM Directive**»), governing the safe-keeping of AIF assets by their depositary provides, with respect to the financial instruments held by the AIF, that:

(i) the depositary must hold in custody all financial instruments that can be registered in a financial instruments account opened in its books and all financial instruments that can be physically delivered to it; and

(ii) the depositary must ensure that all financial instruments that can be registered in a financial instruments account opened in its books are registered in segregated accounts, in accordance with the principles set out in Article 16 of Directive 2006/73/EC, opened in the name of that AIF, or the manager acting on behalf of that AIF, so that they can be clearly identified as belonging to the AIF in accordance with the applicable law at all times.

Article 21(11) of the AIFM Directive also provides that, where a depositary delegates to a third party its custody and safe-keeping functions regarding AIF assets, the latter must ensure that its sub-depositary meets certain conditions at all times. In particular, the depositary must ensure that the sub-depositary segregates the assets of the depositary's clients (i) from its own assets and (ii) from the depositary's assets, so that they can be clearly identified as belonging to the depositary's clients at all times. The third party sub-depositary may in turn sub-delegate its functions, provided its sub-depositary meets the same requirements, and so forth throughout the custody chain.

In addition, Article 99(1) of Commission Delegated Regulation (EU) 231/2013 of 19 December 2012 supplementing the AIFM Directive (the «**AIFM Delegated Regulation**») provides, with respect to the segregation obligations of the depositary of the AIF, that where safe-keeping functions have been delegated totally or partially to a sub-depositary, the depositary must ensure that this sub-depositary keeps such records and accounts as are necessary to enable it at any time and without delay to distinguish assets of the depositary's AIF clients from:

(i) its own assets;

(ii) assets of its other clients;

(iii) assets held by the depositary on its own account; and

(iv) assets held for clients of the depositary which are not AIFs

Following an ESMA consultation paper dated 1 December 2014 [1]) which considers the various levels of segregation that could be implemented by the depositaries and their sub-depositaries, the European Commission restated the need for a segregation of AIF assets by depositaries, and also for a segregation of the AIF assets held by each depositary at the sub-depositary level, since the European Commission tends to consider that this is the only way of complying with the requirements of the AIFM Directive.

As the regulators of a number of Member States have pointed out that this double level of segregation is not technically possible, there is currently no harmonisation of the rules governing the segregation of AIF assets at European level. It should be noted that this argument is often put forward but rarely proven.

[1] *Consultation Paper - Guidelines on asset segregation under AIFMD - ESMA/2014/1326.*

2. Benefits associated with segregation

2.1 Concept of segregation

The segregation of accounts is in first instance a bookkeeping mechanism ([2]) that enables a financial intermediary (i) to separate the assets it holds for its own account from those it holds on behalf of its clients when they are «held» by a third party (central depositary or sub-custodian), and (ii) to identify and credit the assets it holds on behalf of its clients to specific accounts.

As such, there is no national or European legal definition of the concept of segregation.

Nevertheless, many national, European and international legislations have made the use of this bookkeeping mechanism mandatory, in particular with respect to custody account keepers, investment firms ([3]), central depositaries ([4]),central counterparties and their clearing members ([5]) or, as mentioned in paragraph 1 above, for AIF depositaries and sub-depositaries.

At international level, the International Organization of Securities Commissions («**IOSCO**») also made it clear that the notion of segregation is key and necessary to ensure asset protection, and in particular with respect to fund assets ([6]).

The bookkeeping mechanism consisting for financial intermediaries tosegragate financial instrument accounts is thus seen as the only efficient tool to (i) ensure the protection of the rights of the owner of those financial instruments by facilitating their identification and hence their claim, and (ii) guarantee the proper safe-keeping of the financial instruments held by a financial intermediary by facilitating their identification to prevent any unauthorised use.

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[2] *H.de Vauplane, «Collateral - La ségrégation des comptes comme mode de protection des actifs», Revue Banque, May 2012, no. 748 p.79. Ph. Goutay, «Qualification et régime du contrat de conservation des titres financiers – Pour une approche moderne et non conservatrice», Banque & Droit no. 126 July-August 2009. Articles 13(7) and (8) of Directive 2004/39/EC (MIFID Directive) and Article 16 of Directive 2006/73/EC.*

[3] *Articles 13(7) and (8) of Directive 2004/39/EC (MIFID Directive) and Article 16 of Directive 2006/73/EC.*

[4] *Article 38 of Regulation (EU) 909/2014 of 23 July 2014 on improving securities settlement in the European Union and on central securities depositaries (CSD Regulation).*

[5] *Article 39 of Regulation (EU) 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR Regulation).*

[6] *OICV-IOSCO "Standards for the custody of Collective Investment Schemes' Assets", November 2015.*

2.2 Legal benefits

2.2.1 Improved asset protection

The main benefit of a segregation is the protection of financial instruments in the event insolvency proceedings are brought against the financial intermediary responsible for their safe-keeping. Indeed, in such a situation, it is essential that the financial intermediary's creditors are not in a position to assert their rights over the assets belonging to the clients' assets. This requires an accurate and prompt identification of the assets not falling within the ambit of the insolvency proceedings. To achieve this it is necessary to identify in the intermediary's books those assets belonging to it and those deposited by their owners.

At international level, this principle can be found in Article 25(2) of the Unidroit Convention on Substantive Rules regarding Intermediated Securities, which states that:

«*Securities and intermediated securities allocated [to the rights of the account holders of that intermediary] shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of creditors of the intermediary*».

At European level, this principle was made an «organisational requirement» by Article 13(7) of Directive 2004/39/EC («**MIFID**») for investment firms acting as custody account keepers:

«*An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency […]*».

In the work done by its «*Legal Certainty Group*» in 2008, the European Commission drew a direct connection between segregation of accounts and investor protection. This group, monitored by the Commission, tends to consider that the segregation of book-entry assets helps enhancing investor protection by sheltering their assets (i) from the rights of creditors of a financial intermediary in insolvency proceedings and (ii) from any form of appropriation by that very intermediary ([7]). In other words, the legal experts seem to consider that this technique should be the preferred tool for investors protection.

If it is thus possible, by means of bookkeeping segregation, to distinguish the assets belonging to clients of a depositary from the own assets of the latter, it should be possible to guarantee their

[7] *«Second Advice of the Legal Certainty Group, Solutions to Legal Barriers related to Post-Trading within EU – August 2008» Recommendation 9.4 (Segregation) p.72-73 and Recommendation 11.3 (Prohibition of attachments of segregated client accounts by creditors of the account provider) p.76-77.*

full recovery by their owners, or at least facilitate their recovery in the event of insolvency of the depositary, and any event affecting similar securities belonging to the depositary.

In the case of a custody chain, this protection could nevertheless only be ensured if at least an equivalent level of segregation is implemented at each level of the chain, such that it is possible to identify at each level the securities to be protected by virtue of their recognised ownership by the intermediary's clients. The implementation of such protection is possible at European level with legal harmonisation undertaken within the EU, but is more complicated where the assets are ultimately held in custody by a depositary or sub-depositary located outside the EU. Indeed, unless the laws of the country of the non-EU sub-depositary require the same level of segregation, it could only be ensured through application of a contractual agreement between the depositary established within the EU and the sub-depositary established outside the EU.

It appears therefore easier to impose a high level of segregation within the EU (i.e. for assets located within the EU) than outside the EU.

2.2.2 Improved asset traceability

In a legal system in which financial instruments are registered by book entries, or even dematerialised, evidence of ownership of financial instruments takes the form of a series of book entries.

In such a system of securities bookkeeping, segregation is a tool that makes it possible to evidence the rights of each account holder (or of beneficiaries when the account holder acts on behalf of third parties) with respect to the financial securities credited to its account.

Individual segregation thereby increases the traceability of the rights of the effective owners of securities by distinguishing them from securities belonging to the intermediary. Thus, in the event of insolvency of the depositary or sub-depositary, such segregation shall accelerate the process of claiming the securities by identifying the securities that were the subject of the claim.

In the case of a custody chain, the difficulty lies in achieving a complete traceability throughout the custody chain. In any event, the greater the level of segregation is, the better the investor protection is in the event of default of their account keeper intermediary. Otherwise, the insolvency of an intermediary involved in this custody chain that would not have undertook such a segregation with a central depositary, or sub-custodian, would jeopardise the success of claim by the effective owners, and possibly make it impossible (depending on the insolvency procedures to which the intermediary is subject).

2.2.3 Improved asset custody

Individual segregation also prevents the risk of «technical» drawing on the pool. Once again, greater the granularity of the level of segregation is, which should ideally be individual throughout the holding chain, better is the protection enjoyed by holders of financial instruments. Thus, in the event that a depositary gives transfer instructions, on its own account, for a number of financial securities but does not have sufficient financial securities in its account with a sub-depositary (as a result, for example, of a reconciliation error) the transfer instruction will be rejected or only partially executed (for the number of financial securities actually held), whereas if this depositary's financial securities were «mixed» with equivalent financial securities held by other depositaries in an «omnibus» account, transfer instructions for a number of financial securities in excess of those held on its account could be executed.

Thus, the appropriate degree of segregation is in first instance an economic policy issue. To which extent should investors be protected? While a segregation between proprietary and non-proprietary accounts makes it possible to separate the assets belonging to account keepers from those belonging to their clients, this level of segregation remains largely inadequate to ensure satisfactory protection for investors if this segregation is not applied at each level of the chain.

We will therefore now discuss what the minimum level of segregation should be at a EU level/non EU level.

3. Minimum level of segregation

3.1 Issues to be considered

3.1.1 Foreign insolvency law

To ensure a maximum protection, the intended segregation must be implemented at each level of the custody chain, which raises the issue of the effectiveness of segregation rules when sub-depositaries are located in non-Member States of the European Union. It should therefore be noted that rules on segregation are currently not harmonised at European or International level.

A high level of segregation would thus be effective only if it exists, in the countries of the various sub-depositaries involved, a legal regime establishing a procedure for claiming segregated financial instruments in the event of insolvency of that sub-depositary, or any proceedings having similar effects. The mere fact that contractual provisions organise a segregation at the sub-depositary level will not be enough to make it enforceable against the creditors of the sub-depositary under the applicable national law.

Article 21(11) of the AIFM Directive therefore contemplates the situation in which a depositary has no other alternative than delegating the custody of financial securities to an entity located in a non-Member State of the European Union which does not satisfy all the same delegation requirements, including those relating to segregation ([8]). In such a situation:

(i) the investors of the relevant AIF(s) must be informed, prior to investing, that such delegation is required due to legal constraints of the law of the third country; and

(ii) the AIFs, or the managers on behalf of those AIFs, must instruct the depositary to delegate the custody of the financial instruments to such local entity.

3.1.2 Form of securities

The segregation must also accommodate, if necessary, the form of the financial securities involved (*i.e.* bearer securities vs. registered securities, fully dematerialised securities vs. partially dematerialised securities), which may in particular raise issues of compatibility with local company law.

It should also be noted that, when financial securities are issued by a foreign entity and the use of a foreign custody system is required, local law will apply at the start of the custody chain.

3.1.3 Technical feasibility and associated costs

We understand that the regulators of a number of Member States indicated, in the course of the ESMA consultation dated 1 December 2014, that a double level of segregation was not technically possible.

Without being truly able to assess the technical feasibility of a high level of segregation, we believe that strengthening the segregation obligations of depositaries and sub-depositaries could lead them to review their pricing and cost structure of compliance with the AIFM Directive. Rather than a technical impossibility, it is the cost of developing IT chains within the depositaries that is the issue. As indicated above, a sub-depositary may in general contractually agree to the segregation of the assets entrusted to it by a depositary established within the EU.

In practice, the implementation of an individual segregation will have a cost, since it will require more detailed bookkeeping and additional information in the instructions between an account

[8] *These provisions of the AIFM Directive were transposed to Article 323-32 II of the French Réglement Général de l'Autorité des Marchés Financiers.*

holder (depositary) and sub-custodian (sub-depositary). The depositary will thus have to indicate, for each instruction, the account or sub-account in question and, similarly, the sub-depositary will have to identify, for each instruction, the relevant sub-account (the sole account holder identifier not being enough, because it involves a party that has multiple accounts/sub-accounts as a result of this segregation).

These additional costs shall be assessed and will be borne by a participant of the custody chain.

3.2 Minimum level of segregation

With respect to the depositary, Article 21(8)(a) of the AIFM Directive makes an express reference to the principles for safeguarding financial instruments set out in Article 16 of Directive 2006/73/EC, implementing MIFID. These principles indicate in particular that investment firms must keep all records and accounts as necessary to enable them at any time and without delay to distinguish assets held for one specific client from assets held for any other clients, and from their own assets. This is the first level of segregation.

The issue of sub-depositaries is more complicated. It has to be distinguished the scenario in which the financial instruments are only held by sub-depositaries established within the EU, from the one in which one or several sub-depositaries are established outside the EU.

3.2.1 When all the sub-depositaries are established within the EU

From a purely legal perspective, the HCJP considers that the most effective technique for (i) protecting the assets of AIFs in the event of insolvency of a sub-depositary or fraud, and (ii) ensuring the proper safekeeping of assets throughout the custody chain is to impose in a level 2 regulation to each depositary an individual segregation of the assets of each AIF throughout the custody chain.

Unless such individual segregation can be achieved and a mechanism built around the principles of Article 16 of Directive 2006/73/EC can be put in place, the HCJP is of the opinion that the only possible interpretation of Article 99(1) of the AIFM Delegated Regulation is the one of the European Commission. Each sub-depositary should thus ensure at all times a level of segregation of accounts that would enable it to without delay distinguish the assets of each depositary's AIF clients from:

(i) its own assets;

(ii) assets of its other clients;

(iii) assets held by the depositary on its own account; and

(iv) assets held for clients of the depositary which are not AIFs.

In fact, this minimum level of segregation creates some sort of solidarity between the various AIFs, insofar as their assets will be credited to a single «omnibus» account. That is why the HCJP recommends encouraging each depositary to put in place individual segregation, on a voluntary and contractual basis.

3.2.2 When one or several sub-depositaries are established outside the EU

In its final report on the *Standards for the Custody of Collective Investment Schemes' Assets* ([9]), IOSCO noted that, in most jurisdictions, there is a common level of segregation consisting of distinguishing fund assets from:

(i) the assets of related entities;

(ii) the assets of the depositary or, as the case may be, of the account keeper sub-depositary;

(iii) the assets of the other clients of the depositary or, as the case may be, of the account keeper sub-depositary; and

(iv) the assets of other funds, except in the case of an «omnibus» account.

European legislation could thus require depositaries or sub-depositaries having recourse to sub-depositaries established outside the EU, to contractually ensure that these sub-depositaries implement an «equivalent» level of segregation to that required of sub-depositaries established within the EU.

It may be found that, in certain scenarios, a high level of segregation is not technically possible or is ineffective given the specific nature of a local legal regime. In these circumstances, it seems advisable that the non-EU sub-depositaries should not be required to implement an «equivalent» level of segregation to that required of sub-depositaries established within the EU, provided they can demonstrate that they have taken more appropriate measures, in particular having regard to local company and insolvency law, to ensure the protection of the assets they hold in custody.

The appropriate level of segregation would in this instance be the result of dialogue initiated by the depositary or, as the case may be, the sub-depositary established within the EU with the sub-depositary

[9] *Op.cit, Standard 2, paragraphs 47 to 51.*

established outside the EU, provided they demonstrate, if they do not implement a level of segregation «equivalent» to that of depositaries established within the EU, that they have taken the appropriate measures to ensure improved investor protection.

It may also be necessary to limit possible recourse to sub-depositaries established outside the EU to situations where this is objectively justified, particularly as a result of the form of ownership of the relevant financial instruments.

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In conclusion, the issue of the adequate level of segregation of financial assets held by depositaries and their sub-depositaries is in first instance an economic policy issue, and must take into account the relevant local law outside the EU and associated costs.

It appears preferable to impose a very high level of segregation, up to individual segregation, for depositaries and their sub-depositaries established within the EU. Otherwise, to stick to the Commission's interpretation of Article 99(1) of the AIFM Delegated Regulation.

It also appears necessary to expand this principle of protection when the custody chain involves a sub-depositary that is not established within the European Union. Insofar as European law cannot export its rules beyond its borders, the solution would involve requiring European depositaries to ensure, contractually or otherwise, that their sub-depositaries comply with a level of segregation at least equivalent to the one required by Article 99(1) of the AIFM Delegated Regulation.

In such circumstances, it may be appropriate that depositaries or sub-depositaries having recourse to sub-depositaries established outside the EU (i) be forbidden from doing so unless this is justified by objective considerations and (ii) be required to contractually impose an equivalent level of segregation to the one required within the European Union, unless evidence can be provided that more appropriate measures having regard to local law have been or will be taken.