

Clearstream AIFMD

Newsletter



Supporting depositary banks to manage challenges under AIFMD



The Alternative Investment Fund Manager Directive (AIFMD) is considered to be the regulation with the highest impact on the investment fund industry at the moment. The directive aims to create a single European market for AIFs, to provide a clear and consistent framework for the regulation and supervision of AIFMs and to ensure greater investor protection.

Market participants, in particular those appointed as a depositary bank for an AIF, are facing significant operational and legal challenges which may affect their current operating model, including their use of market infrastructure providers. Clearstream is developing innovative solutions to help the AIF market responding to these challenges.

Impact on depositary banks

Under AIFMD, all AIFMs are obliged to appoint a depositary bank for each AIF and the safekeeping of assets¹ of the AIF. Depositary banks will mainly be impacted by strict liability and oversight provisions. For example, the depositary bank will be held liable for the loss² of any assets they directly hold in custody on behalf of the AIF and those they hold in sub-custody accounts with a third party agent they have appointed.

The AIFMD provisions result in three key responsibilities for depositary banks:

- **Safekeeping of assets**
Depositary banks become responsible for the restitution of financial instruments in the event of loss
- **Due diligence**
The depositary bank needs to provide a general oversight of the fund's investment activities to ensure compliance with governing documents and to keep custody risk in a market or a sub-agent under control
- **Cash monitoring**
The monitoring of all cash movements between the AIFM, its funds and all of its counterparties become an essential requirement for depositary banks.

¹ Specifically financial instruments that can be held in custody as defined in the AIFM Directive 2011/61/EU [Article 21 (8)] and Article 88 and 89 of the Level 2 AIFM Regulation.

² Provided the loss is not the direct result of an event beyond the reasonable control of the depositary bank.

We are the right partner

Clearstream is the natural partner of choice for depository banks seeking to take on their responsibilities and manage their risk profile for the safekeeping of assets under AIFMD. We provide a highly compatible and secure infrastructure to support financial institutions in the new regulatory environment. As an (International) Central Securities Depository ((I)CSD) and Securities Settlement System (SSS), our business is subject to the strictest regulatory oversight.

The right tools in place

We are in a position to assist depository banks to fulfil their requirements with regards to:

- Asset monitoring and due diligence
- Asset safekeeping in a stable and secure regulatory environment
- Segregation of assets and streamlined account opening in our books
- Extensive cash reporting tools to facilitate balance monitoring.

Securities Settlement Systems within AIFMD standards

As per the last paragraph of Article 21 (11) of the directive, the use of Securities Settlement Systems (SSS) is not to be considered as a delegation of the custody function by the depository bank. However, based on our close contact with regulatory authorities, we are working towards further clarification alongside our customers. In any case, depository banks can make use of our reliable and secure environment to deposit their assets.

Notwithstanding this exemption, we recognise that depository banks may require additional support for the financial instruments that they hold via Clearstream and it is on this basis that Clearstream has already been working to put in place services and is looking at further ways to support depository banks.

Assessment

Pursuant to Art. 21 (12) of AIFMD and Art. 101 of the Level 2-regulation, the

depository bank will not have to provide immediate restitution of the lost asset if it can also demonstrate that the event was external and beyond its reasonable control and that its consequences were unavoidable despite all reasonable efforts to the contrary. Art. 101 of the Level 2-regulation states the conditions that need to be met for an event to be regarded as external and unavoidable.

Pursuant to ESMA's technical advice to the European Commission (V.V. paragraph 26), a loss event involving assets safekept with an SSS is qualified as an "external event", meaning that the depository bank will not have to provide immediate restitution of the lost asset if it can also demonstrate that the event or its consequences were beyond its reasonable control.

In all such cases, depository banks will need support to be able to demonstrate that they have taken reasonable measures to avoid a loss event.



Coverage of assets

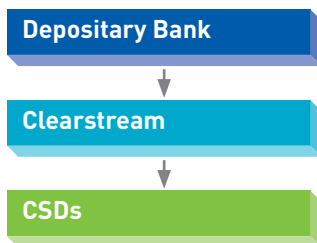
For the vast majority of our customers' assets we provide the most secure custody environment currently possible. In view of AIFMD, Clearstream holds assets in the following way:

Assets issued through Clearstream as an Issuer CSD



We provide the most secure custody environment for assets where Clearstream is the place of issuance and deposit - namely international bonds as well as domestic German and Luxembourg securities.

Assets held directly via Clearstream at the domestic CSD

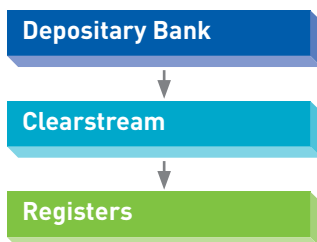


We provide an optimal custody environment for securities held by Clearstream through our extensive network of over 25 direct CSD links, many of which are assessed for Eurosystem monetary policy operations. This is Clearstream's preferred access model for domestic markets and it is being implemented whenever feasible or relevant. Clearstream will also extend its support to depositary bank clients

for managing their obligations under AIFMD as follows:

- Full transparency on the structure of the domestic market and Clearstream's link to the local CSD
- Monitoring of the local CSDs by Clearstream and reporting to the depositary banks
- Monitoring of the local legal and regulatory framework by Clearstream and reporting to the depositary banks.

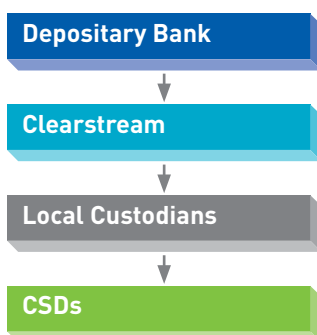
Fund shares held via Clearstream in Transfer Agent registers



Through its Vestima service, Clearstream offers a custody solution for international funds. The registrars used to hold the investment fund shares are not considered a custody delegation under AIFMD. Clearstream will also extend its AIFMD support to depositary bank clients as follows:

- Full transparency on the structure of the Clearstream custody chain
- Monitoring of the transfer agents by Clearstream and detailed reporting to the depositary banks
- Monitoring of the local legal and regulatory framework by Clearstream and reporting to the depositary banks.

Assets held with Clearstream via an indirect local link



For certain domestic assets, Clearstream has indirect network links where access to the domestic market CSD is delivered via a local custodian.

Clearstream will also extend its support to depositary banks clients for managing their obligations under AIFMD as follows:

- Full transparency on the structure of the domestic market and the Clearstream custody chain
- Monitoring of local CSDs by Clearstream and reporting to the depositary banks
- Monitoring of the local legal and regulatory framework by Clearstream and reporting to the depositary banks
- Under certain conditions and for specific markets, Clearstream is assessing whether liability for local custodians³ could also be taken on.

³We are at a consultative stage in the development of the potential service.

New AIFMD-related services

In summary, to optimise our AIFMD solution for depositary banks, we propose two new services:

- New AIFMD network reporting on securities held through our domestic market network, with a possibility of contractual liability coverage for specific markets in Clearstream's sub-custody network
- A specific Transfer Agent monitoring service for securities held directly in the fund's register kept by transfer agents.

AIFMD network reporting

Customer demand has been the key driver for developing a new AIFMD network reporting service to supplement the extensive information that is already available at Clearstream today. The reporting will help depositaries to monitor the performance of their underlying custody chain and support their due diligence obligations.

As part of this service, we will offer information related to the:

- Domestic market's specificities
- Structure of our direct and indirect custody links and indicators of our

relationship with CSDs and/or sub-custodians

- Reports on risks at market, sub-custodian and CSD level
- Details compromising the eventual restitution of securities in the event of loss.

This new reporting service will be available to clients on an individual subscription basis and will be reviewed and updated every six months. Interim updates will be communicated via our customer announcements and as updates to the new country-specific reports.

Revised contractual liability coverage⁴

In our role as (I)CSD, we already commit to the restitution of securities in the event of loss due to our own negligence in our General Terms and Conditions (GTCs). We are in the process of assessing whether this could be extended, subject to specific conditions, to negligence by our local custodians via a dedicated side letter to be signed by Clearstream and the relevant depositary bank. The service would not be offered systematically, its provision is subject to a disclosure of the underlying AIF and a detailed assessment of its portfolio.

Transfer Agent Monitoring Service

Clearstream will offer a Transfer Agent (TA) Monitoring Service to ensure securities held directly in the fund register are safeguarded against external events within reasonable control.

In essence, we conduct a risk-based monitoring of our network of over 1,000 TAs which provides depositary banks with key TA information.

The service includes identifying potential event scenarios, maintaining a comprehensive database of our TA network and their jurisdiction, and subjecting it to continuous due diligence.

Key benefits for depositary banks

- **Reduced risk** due to the
 - SSS status of Clearstream (I)CSDs which demands adherence to the strictest regulatory requirements
 - Most secure custody environment for all international bonds, German and Luxembourg securities where Clearstream is the issuing CSD
 - High-security safekeeping mechanism for securities held by Clearstream through our network of over 25 direct CSD links
 - Stringent requirements applied by Clearstream in selecting sub-custodians for its indirect links.
- **Optimised use of resources** – rely on Clearstream's extensive network coverage as your optimal custody network.
- **Greater transparency and oversight** through extensive network management reporting, market documentation and provision of key information on our network of over 500 TAs
- **Potential extension of contractual liability coverage** for specific markets in our sub-custody network to bring you additional comfort and meet your specific business needs.

Contact information

For further information, please contact your Relationship Manager

www.clearstream.com