

FINAL REPORT

ALFI MADOFF TASK FORCE

September 2009

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1. Scope and mission

The magnitude of the Ponzi scheme set up by Mr. Bernard Madoff (“BM”) has caused severe harm to the market and to the international investment fund industry. Investors from all over the globe, including investment funds have been affected.

Following a recommendation made by the Chairman of ALFI, the Board of Directors agreed in December 2008 to set up a dedicated ALFI Madoff Task Force (“AMTF”)* under the chairmanship of the Director General of the Association to assess the impact of this fraud on all the different elements of the value chain, to consider best practices that in the future may help deal better with fraud and, more generally, to maintain and where necessary, reinstate investor confidence.

The AMTF decided primarily to

- Identify questions and topics (i.e. legal, regulatory, operational, disclosure and transparency) related to the Madoff case that require in-depth consideration and analysis in order to prevent such situations from repeating themselves.
- Work on and contribute to future national and international industry guidelines and recommendations that would assist in detecting and dealing with fraudulent behaviour.
- Consult with all the parties involved in the current debate, including notably investor representatives.

The interim report published on 13, March 2009 gave initial indications of the assessment of the situation and of actions taken by the AMTF, i.e.

- the issuance of technical guidelines dealing with valuation of investments exposed to BM and with related financial statement disclosures.
- the review of the current ALFI code of conduct taking into account recent market events
- the giving of a mandate to dedicated ALFI working groups commissioned to elaborate best practice recommendations for depositaries when setting up and managing standard and/or non-standard (Prime Broker, Derivative/Clearing Broker, Collateral Agent, Transfer Agent...) custodial arrangements on behalf of a fund.

2. Consultation of interested parties

The fraud perpetrated by BM has attracted worldwide attention and many interested parties have made public statements and declared an interest in this topic.

From the outset, the AMTF agreed to hear and to consult acknowledged experts in Luxembourg and abroad, stakeholders as well as various parties involved in the current public debate, including investor representatives in key distribution markets for Luxembourg domiciled UCITS funds.

The purpose of these meetings was to gather views on the consequences of this massive fraud, on the way in which the matter is handled in Luxembourg as well as to identify ways forward.

The various parties that representatives of the AMTF had the opportunity to meet over the first half of 2009 welcomed ALFI's initiative and the opportunity to present their views. These meetings have been extremely valuable in hearing the different positions and the analysis of the situation made by the several stakeholders. The comments and ideas gathered in these meetings served as the basis for discussion in the AMTF.

The strengthening of investor protection and the clarification of the role and responsibilities of the depositary were the two main messages received from the different parties interviewed. Looking backwards, the direct contacts made and the input from investors representatives proved very helpful in the discussions at the level of the AMTF, and in the establishment of subsequent recommendations and guidelines as these are reflected in this report.

3. Analyses and recommendations

3.1. Creation of an "ALFI Investor Forum"

The AMTF considers that a key lesson from the Madoff scandal and, to a larger extent, of the financial crisis, is that investors' needs and expectations require more focused attention. The perspective is now changing with a shift from a supply-driven to a demand-driven industry. The industry has to adapt to this new paradigm.

Leading industry players have highlighted the need to rebuild investor confidence. Several of the nine recommendations proposed in a report by the "Thought Leadership in Asset Management" Think Tank, chaired by Jean-Baptiste de Franssu, EFAMA's current President, focus on investors (e.g. recommendation 3: "Reinvigorate the relationship with the end investor by encouraging better information flows up the value chain").

ALFI supports those initiatives and is committed to play an active role in this area both at national and at European level. To this end, the AMTF has suggested to the ALFI Board of Directors to launch an ALFI Investor Forum (the "Forum") whose aim it is to focus on investors and on their needs and expectations towards the asset management industry and products.

A Forum has been created and is invited to engage in an active dialogue with investors and to make recommendations on topics such as transparency, investor education and information, rights and obligations of all parties involved in the value-chain in order to increase and where necessary reinstate investor confidence in investment funds as their prime savings product.

3.2. ALFI Code of Conduct

As indicated in the Interim Report published on 13, March 2009, the AMTF invited the ALFI working group performing a review of the ALFI code of conduct (the "Code") to take into account recent market events when redrafting and finalising its update of the Code.

The attached revised ALFI Code of Conduct (Appendix 1) sets the framework for high-level principles and best-practice recommendations to assist Boards of Directors in the governance of Luxembourg domiciled investment funds.

3.3. Roles and responsibilities of the depositary

Further to public declarations and debates on the status, the role and responsibilities of a UCITS depositary, the AMTF conducted research on the legal regime of fund depositaries in Luxembourg as well as in the other main European UCITS domiciles.

Based on this analysis, the AMTF was able to conclude that the Luxembourg legislation on fund depositaries faithfully reflects the provisions of European Council Directive 85/611/EEC (the UCITS Directive) and that Luxembourg has an appropriate framework for the protection of investment fund assets and investors, in line with applicable European standards. The AMTF concluded that the Luxembourg legal and regulatory environment is equivalent to that of the other major European jurisdictions. The AMTF acknowledged further that the depositary regime provided by the UCITS Directive has worked well over many years and has set an appropriate standard for the vast majority of instances encountered.

Following the Madoff scandal and as a consequence thereof, the European Commission requested CESR in January 2009 to *“review the manner in which member states have implemented the relevant provisions of the Directive and evaluate how responsibilities and liabilities of depositaries are defined having regard to national civil law”*. In May 2009, the European Commission announced that the *“outcome of this review by CESR is now known”* without disclosing any of the findings of the review. On 24, August 2009, it was reported that the CESR review had not in fact been completed and that CESR was now postponing its review.

The AMTF took however note of the fact that the European Commission considers *“that the Directive clearly establishes the basic responsibilities and liabilities of the depositary. It clearly assigns responsibility for safekeeping fund assets to the depositary and imposes liability on the depositary in the event of wrongdoing or negligent performance of its duties. Determination of liability and its extent must be established in accordance with the relevant national civil law.”* (IP/09/126 issued on 26, January 2009)

The AMTF welcomed the initiative of the European Commission to *“take the lead in bringing forward any actions needed to codify depositary responsibilities”* (as expressed by Commissioner McCreevy on 26, January 2009 in IP/09/126). The AMTF supports European efforts and regulatory initiatives destined at enhancing investor protection and if needed, at harmonizing European regulation in this field.

The AMTF supports the Commission’s public consultation on the UCITS depositary function and took note of ALFI’s contribution to such consultation.

The AMTF considers however that, in the first place, it is essential to know and understand so as to assess how it has been implemented in the several member States, how it is enforced in the various member States, whether the existing regime is deficient and, if so, in precisely what way(s) before any changes can be envisaged.

In the AMTF's view, the situation must be clearly established and a need to act clearly proven before any possible changes are being considered. In relation to the Madoff fraud, it needs to be demonstrated whether there was a failure in the standards which the Directive sets. If there is evidence of failure, it is the AMTF's view that the nature of that failure needs to be understood in order to be able to determine how that failure is best addressed.

In the AMTF's view, it is also essential that any proposals for change be supported by an appropriate cost-benefit analysis including a clear investor perspective, as the impact on the cost structure cannot be ignored. In this respect, the AMTF is confident that the EU Commission's consultation will assist in clarifying a debate that is a complex and difficult one.

The option to harmonise the depositary's responsibilities by imposing the most demanding standards on the depositary and to force the latter to become an "all risks" insurer has been put forward in the wider debate on the standard of liability applying to fund depositaries. This option would obviously ensure strong investor protection by forcing a depositary bank to return the assets at first demand in all circumstances.

However, such a scenario, apart from the question whether in practice it can be implemented and whether it can deal with the complexities of fund and custody set ups, would trigger a fundamental review of revenue flows and distribution of cost across the entire value chain. It would require that depositaries set an adequate remuneration for an increased scope of risk they manage and that they are able to perform their duties and meet the expectations then placed on them at viable economic terms.

Potential shortcomings of such a solution are, amongst others, that the burden would be shifted primarily on the depositary and would not be shared with other stakeholders in the fund value chain of which the AMTF wonders whether it is a sensible and realistic way forward.

Considering the above, the AMTF is of the view that any possible future regulation will have to strike the right balance between, on one hand, an optimal investor protection at an affordable price and, on the other hand, an adequate allocation of responsibilities amongst the various parties in the value chain (e.g. depositary, CSDs, asset manager, management company, distributor,...).

Considering the wider debate and the ongoing discussions on the matter the AMTF, as many others, is dependent on the outcome of this wider debate and is unable, at present, to draw any final conclusions. The AMTF has, however, without waiting further, resolved to initiate specific industry guidelines on the due diligence process to be followed by depositaries in case of delegation of duties by a fund depositary.

3.4. Guidelines on due diligence by the depositary

Luxembourg legislation and CSSF regulation impose a set of supervisory and monitoring duties incumbent on a depositary.

The cases currently under investigation have fuelled a debate on the aforementioned duties of the depositary in the scenario where some or all of the assets are entrusted to a third party appointed by the depositary or by a UCITS.

In light of these discussions and in the overall context of fraud, the AMTF recommended that thought be given to and that (without interfering with pending contentious matters) *practical/industry guidance* be issued, dealing with the due skills, care and diligence (initial as well as ongoing) a depositary should apply when entering into a relationship with third parties.

The AMTF has requested dedicated industry working groups to work out general principles and “best practice” guidelines for depositaries when setting up and managing standard and/or non-standard (Prime Broker, Derivative/Clearing Broker, Collateral Agent, Transfer Agent...) custodial arrangements on behalf of a fund. Guidelines have been drafted.

These guidelines in the form of high level principles cover aspects such as the review of the legal documentation, account structuring and registration of assets, professional competence and profile of counterparties, resources and credit ratings of counterparties, initial and ongoing due diligence, information flow and reconciliation.

The guidelines are attached as Appendix 2 to this report.

It is planned that over the course of the following months more detailed guidelines dealing with specific aspects of the matter be released.

The AMTF would like to extend its appreciation to the representatives of the various stakeholders and interested parties for sharing their valuable comments and recommendations with the AMTF throughout this process.

Finally, the members of AMTF express their gratitude to the numerous members of the working groups for their active involvement and support in drafting the various guidelines and recommendations attached to this report.

*

The AMTF is composed of the following seven members of the ALFI Board of Directors, of one member of the Executive Committee of the Luxembourg Bankers Association (ABBL) and representatives from the ALFI Secretariat.

ALFI Board Members

Freddy Brausch - Partner, Linklaters LLP, Luxembourg
Rafik Fischer - Head of Global Investor Services, KBL European Private Bankers
Jon Griffin - Managing Director, JP Morgan Asset Management (Europe) S.à.r.l.
Pierre Etienne - Member of the Executive Committee, Pictet & Cie (Europe)
John Li - Chairman of the Supervisory Board, KPMG Luxembourg,
José-Benjamin Longrée - Managing Director, CACEIS Bank Luxembourg
Julien Zimmer - General Manager Investment Funds, DZ BANK International S.A.,

ABBL

Serge De Cillia – Member of the Executive Committee

ALFI Secretariat

Camille Thommes - Director General
Pierre Oberlé - Business Development Officer

[Appendix 1](#)

ALFI Code of Conduct for Luxembourg Investment Funds

Introduction

The purpose of the ALFI Code of Conduct is to provide boards of directors with a framework of high-level principles and best practice recommendations for the governance of Luxembourg investment funds. The Code is “principles” rather than “rules” based in that it relies upon good judgement rather than prescription. As such, the recommendations recognise that the “right approach” for many issues depends on the circumstances.

The Code is not designed to supersede applicable law and regulations.

In addition to this Code, ALFI may issue in due course detailed guidelines on specific issues, which require more practical guidance.

The Code has been introduced to formalise and encapsulate existing best practice in the light of the implementation of EU Directive 2006/46/EC into Luxembourg law. This Directive aims to facilitate cross-border investment and improve EU-wide comparability and public confidence in financial statements and reports. Notably, the Directive calls for enhanced and consistent disclosures including an annual corporate governance statement as a clearly identifiable section in annual financial reports. The corporate governance statement should make clear whether the company applies provisions on corporate governance other than those provided for in law.

While the Directive strictly applies only to listed companies including listed funds, ALFI believes it is appropriate to extend the Code to all funds – listed or unlisted – in order to have a uniform and consistent approach in the marketplace. References to “fund” in the Code cover all types of regulated Luxembourg undertakings for collective investment supervised by the CSSF, whether UCITS or non-UCITS (including SIFs) under whatever form, including Sicavs, Sicafs, FCPs, Asseps or Sepcavs. References in the Code to the “Board” are to the body responsible by law for managing, administering and supervising the relevant fund.

To improve transparency and demonstrate commitment to high standards of corporate governance, it should be best practice for Boards of Luxembourg funds to confirm adherence to the Code in their annual financial statements. Such confirmation demonstrates to investors a Board’s explicit commitment to good governance.

Principles:

I. The Board should ensure that high standards of corporate governance are applied at all times

II. The Board should have good professional standing and appropriate experience and use best efforts to ensure that it is collectively competent to fulfil its responsibilities

III. The Board should act fairly and independently in the best interests of the investors

IV. The Board should act with due care and diligence in the performance of their duties

V. The Board should ensure compliance with all applicable laws, regulations and with the fund's constitutional documents

VI. The Board should ensure that investors are properly informed, are fairly and equitably treated, and receive the benefits and services to which they are entitled

VII. The Board should ensure that an effective risk management process and appropriate internal controls are in place

VIII. The Board should identify and manage fairly and effectively, to the best of its ability, any actual, potential or apparent conflict of interest and ensure appropriate disclosure

Recommendations:

I. The Board should ensure that high standards of corporate governance are applied at all times

Recommendations

1. The Board is accountable to the investors for good governance.
2. The Board should ensure that sound management is in place.
3. The Board should discharge its functions soundly, honestly and professionally.
4. The Board should place emphasis on promoting transparency, good practices and conduct of business rules and efficiently manage conflicts of interest.
5. The Board should provide independent review and oversight, including effective oversight of delegated functions.
6. The Board should demonstrate leadership, integrity, ethical behaviour and expertise.

II. The Board should have good professional standing and appropriate experience and use best efforts to ensure that it is collectively competent to fulfil its responsibilities

Recommendations

1. The composition of the Board should be balanced so it can make well-informed decisions. Members of the Board should therefore have appropriate experience, with complementary knowledge and skills, relative to the size, complexity and activities of the fund.
2. The Board should ensure that it keeps abreast of relevant laws and regulations and that it remains vigilant about evolving risks and market developments.
3. The Board may call upon expert assistance and/or create special committees for the proper fulfilment of its duties. The establishment of special committees should not affect the collective responsibility of the Board.
4. The members of the Board are expected to understand the activities of the fund and devote sufficient time to their role.

III. The Board should act fairly and independently in the best interests of the investors

Recommendations

1. The Board should at all times put the interests of the investors first. In this context, particular care should be taken when affiliated parties are involved.

2. The Board should arrive at decisions taking into consideration, where possible, any broader potential impact of such decisions on the wider community and on market integrity.

IV. The Board should act with due care and diligence in the performance of their duties

Recommendations

1. Board members should participate actively at Board meetings.
2. The Board is responsible for the fund's strategy.
3. The Board should oversee the activities and the performance of investment managers and service providers.
4. The Board should ensure it acts on a fully informed basis.
5. Where required, the Board should seek external professional advice or information to assist it in its duties.

V. The Board should ensure compliance with all applicable laws and regulations and with the fund's constitutional documents

Recommendations

1. The Board should verify that adequate organisation, procedures and safeguards are established to ensure compliance with all relevant laws and regulations and with the fund's constitutional documents.
2. The Board should verify that regular monitoring of such compliance is in place and that it receives regular reports to that effect.

VI. The Board should ensure that investors are properly informed, are fairly and equitably treated, and receive the benefits and services to which they are entitled

Recommendations

Investor Information

1. The Board should ensure that the information received by the investors about the fund, particularly with regard to the fund's investment objectives, risks and costs, is true, fair, timely and not misleading.
2. The Board should ensure that investors are kept informed of matters relevant to their investment in a form and language that is clear and easy to understand.

3. In particular, the Board should ensure that information relating to the fund's financial situation and performance be prepared and disclosed in accordance with relevant accounting standards (e.g. Lux GAAP, IFRS) and applicable legal and regulatory requirements.

Fair and equitable treatment of investors

4. The Board should take into account the interest of all investors, in particular where Board decisions may affect investor groups differently.

5. The Board should ensure each investor complaint is reviewed and, if it is upheld, that redress is provided within a reasonable time.

Investors' interest

6. The Board should ensure that investors receive the benefits and level of services to which they are entitled as defined by law, contractual arrangements and the fund's constitutional documents.

VII. The Board should ensure that an effective risk management process and appropriate internal controls are in place

Recommendations

Risk management

1. The Board should ensure that an appropriate risk management system is in place which appropriately covers all types of risks including but not limited to investment risk.

2. The Board should ensure that the risk management function is adequately staffed, or properly managed when provided on any outsourced basis.

3. The Board should ensure that there is an adequate and effective investment risk management process. It should be appropriately documented and formalized and should be regularly reviewed and revised when required. The Board should ensure that it receives regular risk management reporting.

4. The Board should ensure that the investment risk management process covers not only derivative instruments but also the overall portfolio of the fund. Furthermore, the Board should ensure that they understand the impact of any complex financial products on the risk profile of the portfolio and the aggregate exposure of the fund to these products.

5. The Board should ensure that the investment risk management process is exercised independently of the investment management activity.

Internal controls

6. The Board should ensure that investment managers and service providers comply with Compliance and Internal Audit obligations.

7. The Board should ensure these Compliance and Internal Audit functions are independent of the investment and operational processes.
8. The Board should require direct and immediate reporting on any material compliance issues.
9. The Board should ensure that the investment managers and service providers have appropriate business continuity plans in place.

VIII. The Board should identify and manage fairly and effectively, to the best of its ability, any actual, potential or apparent conflict of interest and ensure appropriate disclosure

Recommendations

1. The Board should identify where its members' interests (including related party interests) might conflict with the interests of the investors.
 2. The Board should define the means to avoid, manage or disclose conflicts of interest, protecting the interests of the fund's investors.
 3. The Board should maintain sufficient autonomy to resolve conflicts of interest impartially.
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Appendix 2

Best practice guidelines for depositary banks in relation to the safekeeping of assets from UCITS funds held through the traditional custody network

The purpose of the following is to provide general principles and "best practice" guidelines applicable to the Depositary Bank in relation to the safekeeping aspects of assets that are held by sub-custodians either through the standard custody network of the depositary or through the client directed / imposed sub-custodians.

1. Appointment and monitoring of the sub-custodian (local Agents)

As a general principal, the selection process, appointment and monitoring of the sub-custodian in relation to the safekeeping of these assets held inside the traditional sub-custody network remains the responsibility of the Luxembourg Depositary Bank which is as well the Custodian Bank in Luxembourg.

The Depositary Bank performs proper due diligence on those sub-custodians through an assessment process including, but not limited to, the examination of: the legal framework (in case of default, fraud, bankruptcy, ...), the regulatory framework (regulatory principles, supervisory body, regulation existing in relation to liability,...), the political environment (stability,..); credit worthiness, the management and the operational infrastructure; staffing and expertise of the operation; custody volume capacity; sophisticated technology/communications; financial strength; internal control and related risk management infrastructure; external linkages to settlement and registration processes, depositaries, exchanges and clearing entities; income processing, corporate actions and proxy voting capabilities; contingency plans; results of external/internal audits; insurance coverage; etc...

This initial due diligence should be supplemented by ongoing monitoring to ensure that the sub-custodians remain appropriate.

2. Account structure and segregation of assets at the counterparty

The sub-custodian either operates an omnibus client account structure or operates segregated custody accounts for each client as per the provisions of local regulations of each jurisdiction. In case of omnibus accounts maintained at sub-custody level, the depository has to ensure segregation at fund/sub-fund level within its systems. At sub-custody level the assets should also be "ring-fenced" and held separately from the sub-custodian's accounts and (non-cash) assets.

In no circumstances proprietary assets of sub-custodian should be co-mingled in its books with the custody client assets to ensure that ownership on the client assets can be easily evidenced and therefore claimed.

As a general principle, the security account with the sub-custodian would ideally be opened on behalf of the Bank with express reference to the relevant client. In some markets (e.g. India) there are possibilities that the assets are registered directly in the name of the client with no reference to the custodian .

Cash related assets held by the fund/sub-fund with the Luxembourg depository bank are not subject to segregation rules due to the nature of these assets and fall under the counterparty risk of the Luxembourg depository bank.

3. Re-hypothecation of assets

Re-hypothecation of assets, where authorised by regulation applicable to the Fund and the sub-custodian, should be specifically disclosed and governed, including necessary reporting requirements, in a provision of the sub-custody contract and, as the case may be, in the Fund's prospectus.

4. Periodic reconciliation and audit confirmation

Depository Bank's records of holdings are reconciled to statements of holdings from the local sub-custodians at least monthly. Differences are identified, investigated and resolved on a timely basis.

Book/records from the depository associated with a SAS70 report or similar control report is provided.

5. Disclosure in the Fund's Prospectus

Sub-custodians are generally not disclosed in the Fund's prospectus. For market directed sub-custodians a disclosure in the prospectus highlighting the specific risks of the market could be recommended.

Best practice guidelines for depositary banks in relation to the safekeeping of assets from UCITS funds NOT held through the traditional custody network

The purpose of the following is to provide general principles and "best practice" guidelines applicable to the Depositary Bank in relation to the safekeeping aspects of assets that are not held through the traditional custody network, due to the nature of those investments (namely but not limited to derivatives, third party foreign exchange and deposits, investments into target funds not eligible through the traditional clearing systems, repurchase agreements and lending transactions...).

1. Appointment and monitoring of the counterparties

With the enlargement of the notion of eligible investments under the UCITS Directive, a broad range of asset classes are now dealt through and held by third parties, directly selected and/or appointed by Board of Directors of the Fund or the Management Company, which are not and often cannot be part of the Depositary's global network. In this context, Depositaries cannot be liable for the selection of these third parties and ultimately the counterparty risk associated to them. On that basis, the selection process, appointment and monitoring of the counterparties in relation to the safekeeping of these assets held outside the traditional custody network remains the responsibility of the Board of Directors of the Fund or the Management Company.

The Fund should provide the Depositary Bank with a duly signed list of authorised counterparties and make available the relevant information supporting its due diligence process in the selection and ongoing monitoring of those counterparties. The Depositary shall comply with its general obligation of supervision by:

- a) Ensuring that the board of the Fund or its Management Company has adequate procedures in place with respect to the selection and the monitoring of those third parties,
- b) Implementing checks on financial resources, competence and reputation of the counterparty,
- c) Reconciling records (at least on balances) periodically. Differences are identified, investigated and resolved on a timely basis.

Notwithstanding the above, the Depositary Bank would not engage a validation process for counterparties that play a passive and administrative role (e.g. Transfer agent of a target fund or Registrar for a Private Equity investment). The Depositary Bank may decide to be part of the contractual agreement but this is not a prerequisite. However, it should receive from the Board of Directors and related counterparties concerned all the necessary information in order to perform its supervision duties. Finally, the scope and frequency of reviews should be commensurate with the risk attached to the counterparty in charge of the safe-keeping of the assets.

2. Account structure and segregation of assets at the counterparty

It is acknowledged as general principle that third parties should segregate the assets held on behalf of their clients from their own and ensure that the accounts holding the assets of the Fund (including collateral) should be opened in the name of the Fund (or the sub-Fund in case of an umbrella structure) or in the name of the Depositary Bank in favour of the Fund. One would also expect a power of attorney to be granted to the Depositary in order to give it direct access to the assets. The Depositary Bank would be looking to receive an attestation or affirmation letter from the Board of Directors of the Fund or Management Company that, at the level of the counterparty (and where applicable its sub-custodians), there is an effective segregation of assets. Alternatively, the Depositary Bank will send a questionnaire to the counterparty, by which it obtains evidence.

3. Re-hypothecation of assets

Re-hypothecation of assets, where authorised by regulation, should be subject to specific disclosure into the Fund prospectus and the Board of Directors of the Fund or Management Company should ensure that safeguards are in place to ensure that the safety and liquidity of the assets subject to the re-hypothecation are not compromised. It is

important to mention that in case of re-hypothecation, a direct intervention from the Depository on the assets will not be possible.

4. Additional considerations

The contractual documentation and related service level agreements to be signed by the relevant parties should include specific arrangements supporting the provision of all the necessary information (e.g. legal documentation, statements, summary of activity...) to the Depository in order to fulfill its supervisory duties. In the context of the annual certification of the accounts by the independent auditors, assets held by those third parties will not be included on the official custody confirmation but the Depository Bank will make the results of its controls available to the auditors.
