February 13, 2012

By electronic submission

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Re: Comment Letter on Notice of Proposed Rulemaking Implementing the Volcker Rule - Hedge Funds and Private Equity Funds

Federal Reserve Docket No. R–1432 and RIN 7100 AD 82; FDIC RIN 3064–AD85; OCC Docket ID OCC–2011–14; SEC File No. S7–41–11; CFTC RIN 3038–AD05

Dear Ladies and Gentlemen:

The Bank of New York Mellon Corporation, Northern Trust Corporation, and State Street Corporation (the "**Custodian Banks**") are pleased to have the opportunity to provide comments to the Board of Governors of the Federal Reserve System ("**Federal Reserve**"), the Office of the Comptroller of the Currency ("**OCC**"), the Federal Deposit Insurance Corporation ("**FDIC**"), the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**") (collectively, the "**Agencies**") with respect to the Agencies' notices of proposed rulemaking[1] ("**Proposed Rules**") to implement the new Section 13 of the Bank Holding Company Act of 1956 ("**BHC Act**"), commonly referred to as

[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011); 77 Fed. Reg. _____ (___, 2012).

the Volcker Rule. This letter focuses on the portion of the Volcker Rule relating to investing in and sponsoring hedge funds and private equity funds.

The provision of custodial and trustee services to our institutional clients is a significant component of each of the Custodian Banks' businesses. Collectively, the Custodian Banks had over $50 trillion of assets globally under custody or administration ("**AUCA**") as of December 31, 2011.[2]

Each of the Custodian Banks, either in separate letters submitted in their own name or as participants in trade groups, will provide comments on the Volcker Rule of more general applicability. The Custodian Banks are jointly submitting this comment letter to the Agencies to address four main areas of common concern that are unique to our business models and that will, contrary to Congressional intent, adversely impact our ability to provide custodial and trustee services to pooled investment funds, pension plans, and other institutional investors in the United States and around the world. Such custody services present none of the risks that the Volcker Rule was intended to address. In fact, in his testimony before the Senate Banking Committee, former Federal Reserve Board Chairman Paul Volcker stated that "[c]ustody and safekeeping arrangements for securities and valuables" are among the core commercial banking functions that must remain permissible under the Volcker Rule.[3]

This joint comment letter recommends modifications and clarifications to the Proposed Rules that would mitigate adverse and unintended consequences for the provision of custodial and administrative services by the Custodian Banks. We strongly encourage the Agencies to adopt our recommendations with respect to all four areas of concern identified in this letter because addressing any single topic alone will not fully mitigate these consequences. This joint comment letter addresses the following four topics:

1. Overly Broad Definition of "Covered Fund"

The proposed definition of "covered fund" is overly broad. As drafted, it captures, among others entities, virtually all foreign funds (including those established in well-regulated jurisdictions such as the United Kingdom, European Union, Japan and Canada), all funds that trade futures, swaps or other commodity interests to any extent (including U.S. mutual funds) as well as many other entities that do not exhibit traditional hedge fund or private equity fund

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[2] As of that date, The Bank of New York Mellon Corporation ("**BNY Mellon**") has $25.8 trillion AUCA and is the world's largest global custodian. BNY Mellon operates in 36 countries and over 100 markets. During 2010 and 2011, quarterly *non-U.S.* revenue from BNY Mellon's investment servicing business (of which custody and administration is a part) ranged from 33% to 39%.

As of that date, Northern Trust Corporation ("**Northern Trust**") has $4.3 trillion AUCA. Service fees as a percentage of non-interest income was 79% and *non-U.S.* revenue constituted over 40% of total revenue.

As of that date, State Street Corporation ("**State Street**") has $21.8 trillion AUCA. State Street operates in 29 countries. Service fees as a percentage of non-interest income was 61% and *non-U.S.* revenue constituted over 41% of total revenue.

Please refer to **Annex A** for an overview of the Custodian Banks.

[3] *See Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies* before the S. Comm. on Banking, Housing & Urban Affairs, 111th Cong. 2 (February 2, 2010) (testimony of the Honorable Paul Volcker, Chairman, President's Economic Recovery Advisory Board).

characteristics. Such a sweeping approach is inconsistent with Congressional intent as well as the findings and recommendations of the Financial Stability Oversight Committee ("**FSOC**") in its study on the Volcker Rule ("**FSOC Study**"). Defining "covered fund" so broadly may foreclose a Custodian Bank's ability to provide custodial services to a significant number of clients, whether or not affiliated with the Custodian Bank. The proposed definition also limits the Custodian Banks' global competitiveness and significantly advantages non-U.S. custodial institutions.

The Custodian Banks strongly support industry recommendations that the Agencies define "covered fund" in a way that focuses on the attributes of traditional hedge funds and private equity funds. In addition, the Custodian Banks recommend that the Agencies establish a safe harbor within the definition of "covered fund" for non-U.S. investment funds that are the foreign equivalents of U.S. mutual funds. Specifically, the safe harbor should provide that any issuer that is organized or offered outside the United States would not be a "covered fund" if it is: (i) subject to substantive regulation of its investment objectives and policies by an authority in the jurisdiction in which it is organized or offered; or (ii) subject to contractual or other restrictions that effectively limit its investment objectives, policies and strategies to those objectives, policies and strategies that would be permitted for registered investment companies under the Investment Company Act of 1940 ("**Investment Company Act**").

The Custodian Banks believe these proposed modifications to the "covered fund" definition are within the Agencies' rulemaking authority and are consistent with Congressional intent as well as the recommendations in the FSOC Study. In fact, with respect to the proposed designation of virtually all foreign funds and all commodity pools as "similar funds," the Custodian Banks are merely requesting that the Agencies not exercise their rulemaking discretion to expand the scope of the "covered fund" definition beyond the specific language in the statute itself.

2. Need for Additional Clarity for Directed Custody Arrangements

The Custodian Banks welcome the exclusion of trustees that do not exercise investment discretion, including directed trustees of ERISA plans, from the definition of "trustee" (which is part of the definition of "sponsor") in the Proposed Rules. This exclusion appropriately addresses U.S. arrangements where a Custodian Bank acts as a trustee for a "covered fund" but possesses no investment discretion. However, it may be inadequate to address the broader range of custodial arrangements outside the United States in which a Custodian Bank is required by law or market practice to provide additional fiduciary or administrative services but does *not actually exercise* investment discretion.

The Custodian Banks recommend that the Agencies clarify that a banking entity is not a "trustee" (and hence not a "sponsor") to a covered fund notwithstanding: (i) the banking entity's authority to appoint or terminate an investment adviser to a covered fund if such authority is not exercised; (ii) the actual exercise by the banking entity of its authority to terminate an investment adviser to a covered fund and to appoint another unaffiliated investment adviser if such action is taken to fulfill a demonstrable legal or contractual obligation of the trustee; or (iii) the formal but unexercised power of the banking entity to make investment decisions for a covered fund in circumstances where one or more unaffiliated investment advisers have been appointed to manage funds assets. Without this clarification, common custodial and trustee arrangements in foreign jurisdictions would cause the Custodian

Banks to be "sponsors" of those covered funds such that the Custodian Banks would become subject to the general prohibition on sponsorship and the restrictions in Super 23A.

The Agencies also should clarify in the final rule that any person exercising similar functions to a trustee, regardless of its formal title or position, also would benefit from the exclusion for trustees that do not "exercise investment discretion."[4]

3. Adverse Impact of Super 23A on Custody-Related Transactions with Covered Fund Clients

The Custodian Banks believe that ordinary custodial and administrative services provided to covered fund clients – particularly the provision of intraday or short-term extensions of credit to facilitate securities settlement, contractual settlement, pre-determined income or similar custody-related transactions – should not be considered "covered transactions" for purposes of Section 13(f) of the BHC Act, commonly referred to as "Super 23A." Custody-related transactions, by their nature, do not give rise to the type of "bailout" risk that Super 23A was intended to address and, in any event, other aspects of the Proposed Rules already adequately foreclose such bailout risk. Rather, they are an integral part of custody functions that the Custodian Banks perform for all of our clients, not just covered fund clients.

Subjecting custody-related transactions to Super 23A would substantially limit a Custodian Bank's ability to enter into such transactions with covered fund clients for which the Custodian Bank or any of its affiliates serves as the investment manager, investment adviser or sponsor to the fund. As a result, these covered fund clients could be forced to make alternative arrangements for custodial and administrative services, resulting in broad market disruption and elevated levels of risk in global payment and settlement systems, with no corresponding systemic or firm-specific risk reduction. With respect to covered funds where the Custodian Banks are an arms-length service provider, the Custodian Banks do not believe the market will accept alternative servicing strategies that seek to narrow the services provided in order to comply with Super 23A.

The Custodian Banks recommend that Super 23A be interpreted and implemented in a way that preserves our ability to continue to engage in custody-related transactions with covered fund clients that we advise, manage or sponsor. Specifically, the Agencies should clarify that custody-related transactions are not "covered transactions" for purposes of Super 23A or are not otherwise prohibited by Super 23A. As we discuss in detail below, the Agencies and the Federal Reserve have legal authority to interpret and implement Super 23A in this way.

In addition to providing custody-related credit extensions, the Custodian Banks also act as securities lending agents for our clients, including covered fund clients. The Custodian Banks' role as securities lending agents is a traditional banking activity that, as the OCC itself has stated, is "one of the most important value-added products custodians offer to their

[4] *C.f.* 12 C.F.R. § 225.2(e)(1)(ii)(Relying on the concept of "individuals exercising similar functions" to a trustee).

customers."[5] These agency-based activities pose none of the risks that the Volcker Rule was intended to address. Furthermore, we believe the inclusion of securities lending as a "covered transaction" under Section 23A of the Federal Reserve Act was only intended to encompass credit exposures incurred by banks acting in a principal role as a securities borrower or securities lender and not in an agency capacity.[6] Accordingly, the Agencies should clarify that a Custodian Bank's role as a securities lending agent, including the provision of indemnifications to the lending covered fund client against borrower default, is not prohibited by Super 23A.

4. Conformance Period and Phase-in Compliance

If Super 23A were to apply to custody-related transactions, many covered fund clients could be forced to change custodial structures or operations, engage third parties to provide certain essential custody-related transactions or potentially transfer traditional custody functions to a different service provider. In addition to their disruptive consequences for global payment and settlement systems, effecting these changes will require a significant amount of time for the Custodian Banks and their covered fund clients globally and could not possibly be completed by July 21, 2012.

Accordingly, should the Agencies decide not to mitigate the adverse impact of Super 23A on the provision of custodial and administrative services, they should, at a minimum, allow the Custodian Banks and our covered fund clients to use the two-year statutory conformance period to bring our custodial arrangements and custody-related transactions into compliance with the final rule.

We also encourage the Agencies to announce any determinations regarding compliance schedules or phase-in implementation of the Volcker Rule well in advance of the July 2012 effective date to allow market participants to plan their conformance activities accordingly.

Request for Re-proposal. In light of the significant revisions that must be made to the Proposed Rules to mitigate their adverse and unintended consequences for market participants and the U.S. financial system, we also recommend that the Agencies re-propose their Volcker Rule regulations after a careful consideration of all comments received. A re-proposal will give interested parties, including the Custodian Banks, the opportunity to meaningfully comment on the Agencies' revisions to the Proposed Rules before they are finalized.

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[5] OCC, Comptroller's Handbook: Custody Services (Jan. 2002) ("**OCC Handbook**") at 26.

[6] *See* Federal Reserve Act § 23A(b)(7)(G) (as amended by Dodd-Frank Act § 608) ("'covered transaction' means with respect to an affiliate of a member bank . . . a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.").

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I. Overview: Adverse Impact of the Proposed Rules on Custodian Banks

The Custodian Banks are global leaders in providing traditional custody services to pension funds, government entities, and other institutions, both within the United States and globally. Many of these clients have global operations, offer covered funds in multiple jurisdictions, and offer multiple product types within each jurisdiction. These clients look to their Custodian Bank to meet all of their custody-related needs, regardless of fund structure or jurisdiction of organization, and the inability of a Custodian Bank to do so could jeopardize these client relationships on a global basis and disadvantage it in a competitive, global market.

We also operate complementary global asset management businesses, which involve managing client assets in separate accounts or in pooled investment vehicles. Generally, asset management clients also use our custody-related services because our global networks allow us to provide such services across developed and developing markets. We have invested significant amounts of capital to build and maintain this global custody infrastructure.

The Proposed Rules would significantly interfere with the ability of the Custodian Banks to provide traditional custody and related banking services to a broad range of pooled investment funds, many of which fall within the sweeping definition of "covered fund" contained in the Proposed Rules. To the extent these covered fund clients are deemed to be advised, managed or "sponsored" by the Custodian Banks, the Agencies' proposed implementation of Super 23A would wholly prohibit the Custodian Banks from entering into any "covered transactions" with such clients, including intraday and short-term extensions of credit that are integral to the transaction settlement services we provide to custody clients. This would not only impair the Custodian Banks' ability to provide a traditional banking service to our clients, leading to customer attrition, it also would increase payment system risks[7] and harm the competitiveness of U.S. banks, which currently are successful competitors in the global custody banking business.

Accordingly, it is imperative that the Proposed Rules be clarified or modified to mitigate their adverse impact on the provision of custody and related banking services, which present none of the risks that the Volcker Rule was intended to address. We strongly encourage the Agencies to adopt our recommendations with respect to all four areas of concern discussed below as addressing any single topic would not fully mitigate the negative and unintended consequences of the Proposed Rules.

[7] Systemic risks would increase if the Volcker Rule were implemented in a way that forced the Custodian Banks' covered fund clients to seek alternative institutions that lack the experience, capital base, and global infrastructure to provide them with high quality and low risk custody-related services. Systemic risks would also increase if the Custodian Banks were forced to outsource custodial services with respect to covered fund clients that they advise, manage or sponsor.

II. Overly Broad Definition of "Covered Fund"

The scope of the "covered fund" definition determines the breadth and impact of the Volcker Rule's prohibitions and restrictions on a banking entity's fund-related activities. The overly broad definition of "covered fund" in Section __.10(b)(1) of the Proposed Rules captures a wide range of entities that do not exhibit the characteristics of traditional hedge funds and private equity funds. It also captures virtually all foreign funds and all funds that trade futures, swaps or other commodity interests in their investment program regardless of the extent of such trading or the funds' regulatory structure. The Custodian Banks recommend that the definition of "covered fund" be narrowed to give effect to Congressional intent and the findings and recommendations of the FSOC Study.

1. Proposed Definition of "Covered Fund" Is Inconsistent with Congressional Intent and FSOC Recommendations

By adopting a definition of "covered fund" that fails to distinguish between traditional hedge funds and private equity funds, on the one hand, and the broad range of legal entities that solely rely on the exemptions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act, on the other, the Agencies failed to give effect to Congressional intent and the recommendations in the FSOC Study.

The legislative history of the Volcker Rule indicates that Congress expected the Agencies to narrow the definition of "hedge fund" and "private equity fund" to avoid "excessive regulation" and to ensure that the Volcker Rule only applies to traditional hedge funds and private equity funds.[8] Similarly, in addressing commenters' concern "that the statutory definition [of hedge fund and private equity fund] unintentionally includes corporate structures and entities that do not exhibit the characteristics of hedge funds or private equity funds," the FSOC Study recommended that the "Agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases."[9] The FSOC Study also identified a number of characteristics of traditional hedge funds or private equity funds, including those relating to "compensation structure . . . trading/investment strategy . . . use of leverage . . . [and] investor composition."[10] It also

[8] *See* colloquy between Senators Dodd and Boxer, 156 Cong. Rec. S5904 (daily ed. July 15, 2010); colloquy between Representatives Frank and Himes, 156 Cong. Rec. H5226 (daily ed. June 30, 2010) ("**Mr. Himes**. . . . Because the [Volcker Rule] uses the very broad Investment Company Act approach to define private equity and hedge funds, it could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds. I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings. **Mr. Frank**. . . . The point the gentleman makes is absolutely correct. We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do.")(emphasis added).

[9] *See* FSOC Study at 61-62 *and* n. 54.

[10] *See* FSOC Study at 62-63.

recommended that the Agencies limit any similar funds designations to funds that are similar to traditional hedge funds or private equity funds.[11]

Instead of giving effect to the clear intent of Congress and the FSOC's recommendations to narrow the scope of the "hedge fund and private equity fund" definition, the Proposed Rules significantly expand the types of entities that would be "covered funds" by designating two broad groups of legal entities as "similar funds."

(a) Designating All Commodity Pools as "Covered Funds"

Section __.10(b)(1)(ii) of the Proposed Rules includes as a covered fund any "commodity pool, as defined in section 1a(10) of the Commodity Exchange Act." The Commodity Exchange Act broadly defines commodity pool as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests," without regard to the level of trading in such interests. "Commodity interests," in turn, cover a broad range of instruments including contracts of sale of a commodity for future delivery, options on such contracts, security futures, swaps (including options on foreign currencies and non-exempted foreign currency swaps), leverage contracts and foreign exchange contracts on physical commodities.[12] Not all entities falling within the broad definition of commodity pool in the Commodity Exchange Act possess the characteristics of hedge funds or private equity funds. In fact, many domestic and foreign investment funds that do not possess these characteristics engage in some level of trading in commodity interests, including swaps, and would therefore be "covered funds" under the proposed definition. Moreover, the commodity pool aspect of the "covered fund" definition would even capture SEC-registered investment companies that trade "commodity interests." The Volcker Rule was clearly not intended to prohibit banking entities from investing in or sponsoring U.S. mutual funds.

The Custodian Banks request that the Agencies reconsider the necessity of including all commodity pools within the scope of the Volcker Rule. The Agencies should, at a minimum, define "commodity pool" as a traditional hedge fund or private equity fund that is primarily engaged in trading commodity interests.

(b) Designating Virtually All Foreign Funds as "Covered Funds"

Section __.10(b)(1)(iii) of the Proposed Rules includes as a covered fund any issuer organized or offered outside the United States that would be a commodity pool or an investment company but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act "were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States." This aspect of the "covered fund" definition would capture virtually all foreign funds because Sections 3(c)(1) and 3(c)(7) of the Investment Company Act are the primary exemptions that foreign funds rely on to offer their interests to U.S. residents. Specifically, it would capture virtually all publicly offered and substantively regulated non-U.S. funds, including an Undertaking for Collective Investment in Transferable Securities ("**UCITS**"), which is offered to the public and subject to substantive regulation under the

[11] *See* FSOC Study at 62.

[12] *See* Commodity Exchange Act § 1a(10).

European UCITS Directive and the fund's home jurisdiction.[13] UCITS is the EU equivalent of a registered U.S. mutual fund, which was clearly not intended to fall within the Volcker Rule's definition of hedge fund and private equity fund.

The preamble to the Proposed Rules does not explain why the Agencies have determined that so many foreign funds are "similar" to traditional hedge funds or private equity funds. Moreover, nothing in the legislative history of the Volcker Rule suggests that Congress intended or contemplated that substantially all foreign funds would be swept into the Volcker Rule's prohibitions.

The Custodian Banks appreciate the need to prevent certain banking entities from evading the Volcker Rule by investing in or sponsoring non-U.S. funds that are equivalent to traditional U.S. hedge funds and private equity funds. However, the Agencies should not address the risk of evasion by designating as "covered funds" substantially <u>all</u> foreign funds regardless of their characteristics. Instead, the Agencies should consider addressing evasion directly through the supervisory and enforcement processes. In this respect, we note that Section 13(e) of the BHC Act grants the Agencies broad powers to respond to specific instances of evasive behavior.

2. Adverse Consequences of Overly Broad Definition of "Covered Fund"

The Custodian Banks are concerned that many of our domestic and foreign custody and asset management clients would be swept into the overly broad definition of "covered fund" such that our relationships and transactions with such clients would become subject to the Volcker Rule, including the prohibition in Super 23A, the impact of which is further discussed in Section IV. This could force the Custodian Banks to discontinue certain custody services and restructure our global asset management and custody businesses at significant costs to comply with the Volcker Rule. Even then, we could face significant loss of revenue from customer attrition without any improvement to our safety and soundness or to the financial stability of the United States.

The inclusion of virtually all foreign funds in the proposed definition of "covered fund," many of which exhibit no traditional hedge fund or private equity fund characteristics, would present particular problems for the Custodian Banks that service those funds. Examples of foreign funds that could fall within the proposed "covered fund" definition include index, money market, Treasury and other government securities funds, traditional long-only equity funds as well as other funds that maintain conservative investment programs. Many such funds are established under foreign regulatory and common law trust regimes, such as UCITS, Canadian mutual funds, Japanese mutual funds and UK Unit Investment Trusts.

The Custodian Banks are among the leading global providers of asset management and custody services to the many foreign funds that do <u>not</u> share the characteristics of hedge funds or private equity funds but nevertheless fall within the proposed definition of "covered fund." In many instances, the financial institutions that manage such funds represent significant global relationships for the Custodian Banks and the revenues placed at risk by the Proposed Rules

[13] The foreign fund aspect of the proposed definition does not take into account the manner of offering, investment or operational characteristics of foreign funds.

extend far beyond the range of investment products within the scope of covered funds. At the same time, non-U.S. banks that are not subject to similar restrictions will be able to compete with the Custodian Banks for the provision of custodial services on an unlevel playing field.

If large numbers of sponsored or advised foreign funds become subject to the Volcker Rule, the Custodian Banks will need to satisfy the onerous requirements in the asset management exemption[14] and comply with the restrictions in Super 23A in order to continue to provide custody and asset management services to those funds. Because the asset management exemption and Super 23A were not designed with foreign funds in mind, it may not be possible for some foreign funds to satisfy the requirements in those provisions. For example, the asset management exemption requires that a covered fund owned or sponsored by the banking entity not share the same name as the banking entity. This requirement is incompatible with laws in certain jurisdictions that require a fund's name to have a direct connection to its sponsor.[15] Moreover, because this prohibition would not apply to registered investment companies (unless they constitute commodity pools under the Proposed Rules), it should not apply to similar foreign funds. The prohibitions contained in the Agencies' proposed implementation of Super 23A could also force large foreign fund complexes to cease having an affiliated entity serve as fund custodian or engaging in principal trades, both of which are permitted under certain foreign laws.

The individual and aggregate ownership limits contained in the asset management exemption would also be problematic if applied to publicly offered foreign funds. For example, a banking entity would need to closely monitor its investments in such covered funds on a continuous basis because many of them provide daily liquidity to public investors. A banking entity could also be forced to divest its ownership interests in such a covered fund whenever the three percent individual ownership limit is exceeded because of redemption by other investors. In addition, certain foreign regulatory regimes may require a fund manager or adviser to have measurable "skin in the game" that exceeds the three percent limit.[16]

Under the Proposed Rules, *de minimis* investments in covered funds pursuant to the asset management exemption would also be deducted from the Tier 1 capital of the banking entity.[17] An expansive definition of "covered fund" would result in greater capital deductions.

[14] BHC Act § 13(d)(1)(G); Sections __.11 and __.12 of the Proposed Rules.

[15] In certain instances, the Financial Services Authority ("**FSA**") has taken the position under Section 6.9.6 of the Collective Investment Schemes Information Guide that the authorized fund must have a name representative of the authorized investment manager to avoid misleading fund investors. *See* FSA Handbook, Collective Investment Schemes, *available at* http://fsahandbook.info/FSA/html/handbook/COLL/6/9.

[16] *See* Article 9, Initial Capital and Own Funds under DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (requiring alterative investment fund managers to have minimum investments in funds they manage) *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF.

[17] *See* Section __.12(d) of the Proposed Rules.

This would place U.S. banking entities at a competitive disadvantage to certain foreign banking entities[18] by making the former appear to have less capital than the latter.

3. Recommended Definition of "Covered Fund"

The Custodian Banks strongly support industry recommendations that the Agencies define "covered fund" in a way that focuses on the attributes of traditional hedge funds and private equity funds. We generally support the attributes-based approach proposed by the Securities Industry and Financial Markets Association, the American Bankers Association, the Financial Services Roundtable and The Clearing House Association (collectively, the "**Trade Associations**"), including the hedge fund and private equity fund characteristics identified in their joint comment letter on the covered funds portion of the Proposed Rules ("**Trade Associations Joint Funds Letter**"). As discussed below, the Custodian Banks also recommend that the Agencies establish a safe harbor within the definition of "covered fund" for non-U.S. investment funds that are the foreign equivalents of U.S. mutual funds.

We believe an attributes-based approach to defining "covered fund" gives effect to Congressional intent and the recommendations in the FSOC Study. We also believe the Agencies have legal authority to adopt such an approach.[19] Specifically, Section 13 of the BHC Act broadly authorizes the Agencies to "adopt rules to carry out this section."[20] This general and broad grant of rulemaking authority allows the Agencies to issue regulations and interpret terms in Section 13 that give effect to the "goals" of the Volcker Rule.[21]

As noted above, a key Congressional goal behind the Volcker Rule is to avoid the "excessive regulation" that would result from a mechanical implementation of the "very broad Investment Company Act approach to defin[ing] private equity and hedge funds."[22] Instead, Congress intended and expected the Agencies to use their rulemaking authority to implement

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[18] For example, instead of relying on the asset management exemption, a foreign banking entity may rely on the offshore exemption in Section __.13(c) of the Proposed Rules to invest in certain covered funds. Under the Proposed Rules, such investments would not be deducted from a banking entity's Tier 1 capital.

[19] The Custodian Banks support the interpretive approach to the definition of "covered fund" set forth in the Trade Associations Joint Funds Letter, which demonstrates that the Agencies have the authority to exclude funds that do not have the characteristics of traditional hedge funds or private equity funds from the definition of "covered funds."

[20] BHC Act § 13(b)(2).

[21] 76 Fed. Reg. at 68,928 ("In implementing the covered funds provisions of section 13 of the BHC Act, the Agencies have proposed to define and interpret several terms used in implementing these provisions and the goals of section 13.").

The Agencies' concern with the goals of the Volcker Rule is also evident in their numerous requests for comment. In fact, approximately one in ten of the 383 questions in the Proposed Rules ask whether a proposed approach, or some alternative, would be consistent with or effective in light of both the "language and purpose of section 13 of the BHC Act." These questions include, among others: Question 5; Question 9; Question 14; Question 15; Question 25; Question 28; Question 46; Question 52; Question 76; Question 84; Question 106; Question 114; Question 115; Question 116; Question 124; Question 131; Question 215; Question 217; Question 218; Question 221; Question 225;226; Question 230; Question 234; Question 237; Question 243; Question 266; Question 283; Question 290; Question 342; Question 345; Question 350; and Question 375.

[22] Colloquy between Representatives Frank and Himes, 156 Cong. Rec. H5226 (daily ed. June 30, 2010).

the Volcker Rule in a way that focuses its prohibitions and restrictions on traditional hedge funds and private equity funds.[23] Section 13(b)(2) of the BHC Act authorizes the Agencies to adopt a definition of "covered fund" that "carri[es] out" this Congressional intention and expectation.[24]

In addition, with respect to the proposed designation of virtually all foreign funds and all commodity pools as "similar funds," the Custodian Banks are merely requesting that the Agencies not exercise their rulemaking discretion to expand the scope of the "covered fund" definition beyond the specific language in the statute itself. Without the proposed regulatory expansion, neither foreign funds nor commodity pools that do not solely rely on the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act would be covered funds under the statutory definition.

4. Proposed Safe Harbor for Foreign Equivalents of U.S. Mutual Funds

The Agencies should establish a safe harbor within the definition of "covered fund" for non-U.S. investment funds that are the foreign equivalents of U.S. mutual funds. A foreign issuer that satisfies either condition in the safe harbor would not be a "covered fund." Specifically, the safe harbor should provide as follows:

> Any issuer that is organized or offered outside the United States would <u>not</u> be a "covered fund" if it is:
>
> (A) subject to substantive regulation of its investment objectives and policies by an authority in the jurisdiction in which it is organized or offered; <u>or</u>
>
> (B) subject to contractual or other restrictions that effectively limit its investment objectives, policies and strategies to those objectives, policies and strategies that would be permitted for registered investment companies under the Investment Company Act of 1940.

This safe harbor is consistent with the goals of the Volcker Rule. The Volcker Rule was not intended to bring SEC-registered mutual funds within the definition of hedge fund and private equity fund. In fact, the statutory definition's focus on the exemptions from the investment company definition ensures that entities that *are* investment companies are outside the scope of the Volcker Rule. By parity of reason, the Volcker Rule should not capture the foreign equivalents of U.S. mutual funds, whose investment strategies do not involve the types of risks that the Volcker Rule was intended to address.

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[23] *Id.*

[24] Our recommended approach to defining "covered fund" is also consistent with the findings and recommendations of the FSOC study, which the Agencies are required to consider in implementing the Volcker Rule. *See* BHC Act § 13(b)(2).

The Agencies have the legal authority to create such a safe harbor because the designation of certain foreign funds as similar funds is discretionary and not mandatory,[25] which means the Agencies could define similar funds as narrowly as they deem appropriate in light of the purposes of the Volcker Rule.

III. Need for Additional Clarity for Directed Custody Arrangements

The Custodian Banks welcome the exclusion from the definition of "trustee" (which is part of the definition of "sponsor") for trustees that do not "exercise investment discretion," including directed trustees of ERISA plans.[26] This exclusion would permit "covered funds" in the United States that have directed trustee arrangements with the Custodian Banks to continue receiving custody and related services from us and our affiliates without being subject to the restrictions in Super 23A, which, on its face, applies to covered funds that are "sponsored," advised or managed by a banking entity. This outcome is consistent with the goals of the Volcker Rule, which was not intended to undermine the ability of the Custodian Banks to provide traditional bank custody services to investment funds.[27]

However, in light of the proposed inclusion of virtually all foreign funds as "covered funds," the Agencies should clarify that the exclusion in Section __.10 (b)(6) of the Proposed Rules would be available in comparable non-U.S. trust arrangements. Specifically, the Agencies should confirm that the exclusion is available where a banking entity does <u>not</u> actually exercise investment discretion and, as a result, is <u>not</u> in any traditional sense a sponsor or promoter of a foreign fund.

Due to the legal structure of funds or the prevailing market practice in certain jurisdictions, a banking entity acting as trustee to a fund in the form of a trust may possess the formal authority to appoint or terminate the trust's investment adviser or manager or direct the investment of the trust's assets. However, such power is not – and is not expected by shareholders or local regulators to be – exercised by the trustee absent extraordinary circumstances. Even when such power is exercised by the trustee, it is only to appoint a successor investment adviser or manager. The existence of such incipient authority, however, creates an interpretive issue under Section __.10 (b)(6) of the Proposed Rules. The Custodian Banks request that the Agencies resolve this interpretative issue by clarifying the text of the final rule.

The Agencies also should clarify in the final rule that any person exercising similar functions to a trustee (such as a fund management company established under Irish law),

[25] BHC Act § 13(h)(2) ("The terms "hedge fund" and "private equity fund" mean . . . such similar funds as the [Agencies] <u>may</u>, by rule, as provided in subsection (b)(2), determine.").

[26] Section __.10(b)(6) of the Proposed Rules.

[27] *See* Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies before the S. Comm. on Banking, Housing & Urban Affairs, 111th Cong. 2 (February 2, 2010) (testimony of the Honorable Paul Volcker, Chairman, President's Economic Recovery Advisory Board).

regardless of its formal title or position, also would benefit from the exclusion for trustees that do not "exercise investment discretion."[28]

1. Overview of Investment Trust Arrangements and Duties of Trustees in Traditional Common Law Jurisdictions

Investment funds use different types of legal structures depending on the jurisdiction in which they are established. In traditional common law jurisdictions, investment funds are often established in trust form. Please refer to **Annex B** for an overview of fund structures and trustee requirements in various foreign jurisdictions.

Typically in a traditional common law jurisdiction a promoter or sponsor and, in some instances, the asset owners who seek to establish a fund in trust form will identify an investment adviser for the fund as well as a trustee. Depending on the jurisdiction, the trust can be a single party trust, in which the investment manager appoints the trustee as the sole party responsible under the trust deed, or a two party trust in which both the promoter and the trustee are parties to the trust deed and are assigned different responsibilities.

In either case, the trustee is subject to the duties and obligations set out in the trust deed and must ensure that the terms of the trust and relevant regulations are observed. The primary role of the trustee is to provide traditional custody, safekeeping and other administrative services for the fund, in much the same way as a directed trustee provides these services for ERISA plans. Among other responsibilities, the trustee must ensure that the underlying assets are appropriately segregated for the benefit of the fund and must properly effect the settlement of transactions directed by the investment adviser.

The trust deed also may grant the trustee the authority to appoint and remove the investment adviser or, in certain circumstances, the formal authority to exercise investment discretion. The decision to appoint or remove an investment adviser is typically made by the asset owners in conjunction with the promoter or sponsor of the fund. To the extent the trustee is involved, its role is typically limited to giving effect to the decision of the promoter, sponsor or asset owners. In certain cases, however, obligations imposed by law or contract also may require the trustee to replace an investment adviser when the trustee determines that retaining the current investment adviser is inconsistent with the interests of the trust's beneficiaries. This is analogous to the obligation of an ERISA directed trustee to overrule a pension fund sponsor in extraordinary circumstances.

Consequently, in these exceptional circumstances, a trustee may be compelled by its legal or contractual responsibilities to remove an investment adviser that has failed to comply with its obligations, materially underperformed its management responsibilities, ceased to have required regulatory qualifications or has become insolvent. Upon removal of the existing investment adviser, if the trustee were itself to assume the role of investment adviser and "exercise investment discretion" as to the selection of assets held by the fund, we acknowledge that the exclusion in Section __.10(b)(6) of the Proposed Rules would not be available.

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[28] *C.f.* 12 C.F.R. § 225.2(e)(1)(ii)(Relying on the concept of "individuals exercising similar functions" to a trustee).

However, we seek confirmation that where a banking entity, acting as trustee of a foreign fund, is authorized to appoint or remove an investment adviser or to directly exercise investment discretion but either does not exercise such discretion or chooses to appoint an unaffiliated investment adviser to exercise discretion in the management of the fund's assets, the exclusion in Section __.10(b)(6) would be available. The clarification we seek is consistent with the Section __.10(b)(6) exclusion, as proposed, which focuses on whether a trustee actually "exercise[s] investment discretion with respect to a covered fund," and not on whether it theoretically has the power to do so. We note that we are only seeking clarification of the Section __.10(b)(6) exclusion in situations where the trustee is not affiliated with and is independent from both the promoter/sponsor and the investment adviser of the fund.

This clarification would provide legal certainty by assuring banking entities that, in the above circumstances, the provision of trustee and related custody services to foreign funds pursuant to applicable non-US regulations and market practices would not cause them to be deemed "sponsors" for purposes of the Volcker Rule.

2. Clarification through Amending Section __.10(b)(6) or Providing Interpretative Guidance

The clarification we seek may be provided by amending the text of Section __.10(b)(6) as follows (suggested amendments indicated in red):

(6) Trustee. (i) For purposes of this subpart, a trustee does not include (a) a trustee that does not exercise investment discretion with respect to a covered fund, including a directed trustee, as that term is used in section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)), (b) a trustee that exercises authority to terminate an investment adviser and to appoint an unaffiliated investment adviser with respect to a covered fund if such action is taken to fulfill a demonstrable legal or contractual obligation of the trustee, or (c) a trustee that possesses the authority to appoint or remove an investment adviser, or to exercise investment discretion itself, if an unaffiliated adviser in fact exercises such discretion.

(ii) Any covered banking entity that directs a person identified in paragraph (b)(6)(i) of this section, or that possesses authority and discretion to manage and control the assets of a covered fund for which such person identified in paragraph (b)(6)(i) of this section serves as trustee, shall be considered a trustee of such covered fund.

Alternatively, the Agencies may provide interpretative guidance regarding the phrase "exercise investment discretion" in the preamble to the final rule. Specifically, the preamble could state that the phrase "exercise investment discretion" in Section __.10(b)(6) of the Proposed Rules does not include: (i) the mere authority of a trustee to appoint or terminate an investment adviser to a covered fund if such authority is not exercised; (ii) the actual exercise of a trustee's authority to terminate an investment adviser to a covered fund and to appoint another unaffiliated investment adviser if such action is taken to fulfill a demonstrable legal or contractual obligation of the trustee; or (iii) the formal but unexercised power of a trustee to make investment decisions for a covered fund in circumstances where one or more unaffiliated investment advisers have been appointed to manage funds assets.

The Agencies also should clarify in the final rule that any person exercising similar functions to a trustee (such as a fund management company established under Irish law), regardless of its formal title or position, also would benefit from the exclusion for trustees that do not "exercise investment discretion."[29]

IV. Adverse Impact of Super 23A on Custody-Related Transactions with Covered Fund Clients

Section __.16 of the Proposed Rules would prohibit a banking entity from entering into a "covered transaction, as defined in section 23A of the Federal Reserve Act" with a covered fund, or with any covered fund that is controlled by such fund, if the banking entity or any of its affiliates serves as the investment manager, investment adviser, or sponsor to the covered fund or organizes and offers the covered fund pursuant to the asset management exemption in Section 13(d)(1)(G) of the BHC Act.

"Covered transactions" under Section 23A of the Federal Reserve Act include, among other things, "a loan or extension of credit." Accordingly, Section __.16 of the Proposed Rules would, on its face, significantly restrict the ability of the Custodian Banks to extend intraday or short-term credit to covered fund clients in connection with the provision of core custodial and administrative services to such clients, including for the purpose of facilitating securities settlement. This has the potential to significantly disrupt U.S. and global payment and settlement systems in which the Custodian Banks are key participants.

To avoid these consequences, the Agencies should clarify that Super 23A does not prohibit the Custodian Banks from providing custody-related services to our covered fund clients. In particular, Super 23A should be implemented in a way that preserves our ability to extend intraday or short-term credit to a covered fund in connection with the provision of core custodial and administrative services. These types of services have been part of traditional custody banking for decades, are very low risk, and are necessary to facilitate the smooth functioning of global payment and settlement systems.[30]

As we explain further below, there are a number of legal authorities pursuant to which the Agencies could give effect to our recommendation. Specifically, the statutory text of Super 23A suggests the phrase "covered transaction, as defined in section 23A of the Federal Reserve Act," should be interpreted by reference to Section 23A of the Federal Reserve Act as a whole, including its statutory and regulatory exemptions, and not only by reference to the subsection in Section 23A that defines covered transaction. Such an approach would be consistent with the structure and legislative history of Section 23A. The Agencies also have broad authority under Section 13(b) of the BHC Act to "adopt rules to carry out" the Volcker Rule, which was not intended to interfere with the provision of low-risk custodial and administrative services to

[29] *C.f.* 12 C.F.R. § 225.2(e)(1)(ii)(Relying on the concept of "individuals exercising similar functions" to a trustee).

[30] *See* FSOC Study at 58.

covered funds.[31] In addition, we believe that it would be a permissible exercise of the Agencies' discretion under Section 13(d)(1)(J) of the BHC Act to grant relief from Super 23A to the extent it would promote and protect the safety and soundness of the banking entity and the financial stability of the United States. Finally, the Federal Reserve has broad inherent rulemaking authority to "issue such regulations and orders . . . as may be necessary to enable it to administer and carry out the purposes" of the BHC Act, including the provisions of the Volcker Rule contained in Section 13 of that Act.

1. Custodian Banks Routinely Extend Credit to Clients, Primarily on an Intraday Basis, to Facilitate Settlement of Transactions

A core part of the custodial and administrative services that the Custodian Banks provide to their clients, including covered funds clients, is the ability to make and receive payments related to the settlement of securities, derivatives, foreign exchange and other market transactions. The Custodian Banks also facilitate, on behalf of their clients, the receipt of investment-related income and other similar payments. These services are provided on a global basis via a large number of payment and settlement systems.[32] These services are not related to any proprietary trading activity or to any sponsorship or management of investment funds. Nor are they intended to create leverage.

In the ordinary course of providing custodial and administrative services to clients, including covered fund clients, it is not uncommon for the Custodian Banks to extend immediate or provisional credit to a client to facilitate routine transactional activity. These routine extensions of credit typically occur on an intraday basis and are usually closed-out when cash comes into the client's account as a result of anticipated settlement activity or cash management arrangements.

In order to facilitate the client investment process and also improve overall market efficiency, the Custodian Banks provide their clients with certain well-established payment arrangements. These include:

> **Provisional credit** of funds related to transactions that are expected to settle on the settlement date. Example: Custodian Bank expects to settle a Dollar/Yen trade on settlement date; Custodian Bank pays $1M into CLS Bank International[33] on behalf of client at 6:00 a.m. in anticipation of the receipt of funds from the sale of securities by client later the same day.
>
> **Contractual settlement** of securities transactions for client that are expected to settle on the settlement date. Example: Custodian Bank contracts with a client to credit the client's account with settlement proceeds on settlement date on the assumption that

[31] *See Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies* before the S. Comm. on Banking, Housing & Urban Affairs, 111th Cong. 2 (February 2, 2010) (testimony of the Honorable Paul Volcker, Chairman, President's Economic Recovery Advisory Board).

[32] Please refer to **Annex A** for an overview of the services the Custodian Banks provide to clients.

[33] CLS Bank International operates the world's largest multi-currency cash settlement system, which is designed to minimize settlement risk in the foreign exchange market.

Custodian Bank will receive settlement proceeds from counterparty; the credit is provisional and is subject to reversal.

Contractual income payments based on expected receipt of the income payment on the same day. Example: Custodian Bank credits client with a dividend payment expected to be received on the same day from the Depository Trust & Clearing Corporation ("**DTCC**");[34] the credit may occur before receipt of the payment can be verified. These are generally programmed into the Custodian Banks' systems upon receipt of notice of the dividend payment.

In the ordinary course of business, nearly all of these transactions are settled on the expected settlement date. In exceptional circumstances, however, provisional credits may extend beyond one business day. In the experience of the Custodian Banks, the vast majority of transactions successfully settle on the expected settlement date and do not result in any overnight exposures to the client. Failure to complete settlement as intended may result from a number of factors such as an unexpected delay in the receipt of payment from the counterparty or financial market utility or a failure to match the transaction. Depending on the cause and duration of the failure, a Custodian Bank would either finalize the settlement as soon as possible or reverse the provisional credit.

2. Credit Extensions by Custodian Banks to Clients Are Routine and Essential to Payment and Settlement Systems

The provisional credits that the Custodian Banks extend to clients in connection with custodial and administrative services constitute a key lubricant to global payment and settlement systems. These credit extensions are encouraged by bank supervisors as a key way to avoid bottlenecks which could hamper market efficiency and elevate potential systemic risks. In the adopting release for Regulation W, which exempts intraday extensions of credit from the quantitative and qualitative limits in Section 23A of the Federal Reserve Act, the Federal Reserve recognized the purpose and importance of these forms of temporary credit: "Intraday overdrafts and other forms of intraday credit generally are not used as a means of funding or otherwise providing financial support for an affiliate. Rather, these credit extensions typically facilitate the settlement of transactions between an affiliate and its customers when there are mismatches between the timing of funds sent and received during the business day."[35] In our view, a very similar rationale applies in the case of provisional credits that may, on certain limited occasions, give rise to an overnight exposure.

Settlement payments typically are made through established financial market utilities or infrastructures ("**FMI**") that have well-established procedures designed to ensure both safety and efficiency for participants. In addition, the provisional credits that the Custodian Banks extend to clients in connection with custodial and administrative services are protected under the Uniform Commercial Code and comparable protections in other jurisdictions. They

[34] DTCC provides clearing, settlement and information services for a range of financial instruments including equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives.

[35] Federal Reserve, Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,596 (Dec. 12, 2002).

are also commonly protected by security interests and contractual or statutory rights of set off. Most large value payment systems require settlement of payments using real-time gross settlement, meaning payments are settled on a gross basis and banks must have sufficient liquidity in place to make payments as required. Specifically, they cannot wait for the receipt of payment from the other side of the transaction to meet their obligations.

3. Comprehensive Regulation of Payment and Settlement Activities of Custodian Banks

The Custodian Banks must abide by the rules and established protocols of the various payment and settlement systems in which they participate. These include trade confirmation, trade matching and other requirements, designed to verify the specific transactions that require settlement on a given day. A Custodian Bank will only advance funds on behalf of a client when there has been proper trade matching and trade confirmation.

More generally, payment and settlement systems in the U.S. are subject to supervision and oversight of their procedures and risk management framework under applicable Federal Reserve requirements, including the Federal Reserve's Policy on Payment System Risk.[36] They will also be required to comply with regulations issued pursuant to Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**"). Globally, payment and settlement systems are expected to meet the Principles established by the Basel Committee on Payment and Settlement Systems ("**CPSS**") and the Technical Committee of the International Organization of Securities Commissions ("**IOSCO**"). These are designed to manage payment risk and, among other things, prevent the FMI from releasing a payment until it can confirm that the transaction has been matched and settled. The Federal Reserve and CPSS have recognized the greater demand for intraday liquidity in order to promote the public policy objectives of safety and soundness for payments and settlement systems.

The Custodian Banks must also comply with supervisory requirements with respect to payment and settlement risks.[37] In order to manage such risks, the Custodian Banks are required to implement robust risk management tools in accordance with regulatory guidelines. These include:

- Appropriate due diligence as to the rules, procedures and risk management framework of each payment system in which the Custodian Bank participates;

- Appropriate due diligence of subcustodians and their ability to provide clearing and settlement services on behalf of the prime Custodian Bank in local markets;

[36] Federal Reserve, Policy on Payment System Risk (as amended effective Mar. 24, 2011) *available at* http://www.federalreserve.gov/paymentsystems/files/psr_policy.pdf.

[37] *See* Basel Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision (Sept. 2008) (Principle 8: "A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems"); Federal Reserve, Policy on Payment System Risk (as amended effective Mar. 24, 2011) (Intraday Credit Policies).

- Custody of assets along with contractual or common law lien or setoff rights with respect to assets held by the custodian for the client;
- Settlement limits and overdraft limits for each counterparty that restricts provisional and short-term credit exposure to each client; and
- Ability to suspend provisional extensions of credit to a client that appears to be undergoing financial or liquidity distress.

Provisional credits provided by the Custodian Banks to facilitate settlement and other routine transactional activities are not made with the intention of extending credit to the client, nor are they means of funding or otherwise providing financial support to the client.[38]

In its recently issued Notice of Proposed Rulemaking on Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, the Federal Reserve proposed to exempt intraday credit exposures from the proposed single counterparty credit limits.[39] As the Federal Reserve explained, this aspect of its proposal was designed to "help minimize the impact of the rule on the payment and settlement of financial transactions."[40] Covered Companies would, however, be required to put in place an enhanced risk management framework for liquidity risk, including the monitoring of intraday liquidity.[41] We believe this approach may offer a suitable basis upon which to also monitor intraday and short-term extensions of credit provided by the Custodian Banks to covered funds in support of core custodial and administrative services.

Consistent with the above principles and regulatory precedents, the Custodian Banks believe that the most effective way to ensure the safety and soundness of banking entities and to enhance the financial stability of payment and settlement systems globally is <u>not</u> to prohibit banking entities from providing provisional extensions of credit to covered funds, but rather to permit these transactions subject to appropriate safety and soundness standards.

4. Adverse Consequences of Restricting the Ability of Custodian Banks to Extend Custody-related Credit to Covered Fund Clients

If Super 23A were implemented in a way that severely restricted a Custodian Bank's ability to extend custody-related credit to its covered fund clients, such clients would be forced to change existing custodial arrangements, either by engaging third parties to provide certain custody-related transactions or seeking alternative providers of custodial services. The result would be significant client disruption, unnecessary market dislocation, and a pronounced reduction of revenues for Custodian Banks from a traditional banking service with stable and predictable revenues and extremely low credit losses. It would also seriously damage a core

[38] *See* 67 Fed. Reg. at 76,596.

[39] Federal Reserve, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012) (Proposed 12 C.F.R § 252.97).

[40] 77 Fed. Reg. at 622.

[41] 77 Fed. Reg. at 612 ("Intraday liquidity monitoring is an important component of the liquidity risk management process for a covered company engaged in significant payment, settlement, and clearing activities.").

banking activity in which U.S. financial institutions are recognized as global leaders, with a concomitant adverse impact on U.S. employment. These adverse effects would not, in our view, be offset by any corresponding systemic or institution specific risk reduction benefits. To the contrary, firm-specific and systemic risks would most likely rise.

Restricting the Custodian Banks' ability to extend intraday or short-term credit to covered fund clients in connection with core custodial and administrative services would adversely affect market liquidity and increase payment and settlement system risks. It has been acknowledged by bank supervisors in the United States and globally that delay in payments until later in the day or the release of payments only upon receipt of the contra payment increases both credit risk and operational risk for individual institutions and for payment systems.[42] Requiring the Custodian Banks to operate on behalf of covered funds without the ability to extend intraday or short-term credit would also necessitate fundamental changes in current practices which will heighten transaction risks, increase costs and disrupt market efficiencies.

Yet another adverse consequence is that sweep arrangements with covered fund clients would have to be modified to provide for earlier cutoffs and/or earlier redemptions in order to ensure that covered funds have sufficient liquidity in their accounts to fund any pending transaction. In response, covered fund clients will either change to a non-U.S. custodian that is not subject to the Volcker Rule or keep more funds on deposit with the U.S. Custodian Bank, which will increase the size of the bank's balance sheet and its operating costs. Neither outcome will be favorable for the U.S. banking entity nor for the U.S. financial system; and neither will have any countervailing benefits.

5. Section __.16 of the Proposed Rules Must Be Clarified to Avoid Disruptive and Systemic Consequences

Section __.16 of the Proposed Rules not only fails to incorporate the important exemptions contained in Section 23A and Regulation W that have accommodated the provision of custody-related credit extensions,[43] it would also wholly prohibit a banking entity

[42] *See* Bank of England, *Intraday Liquidity: Risk and Regulation*, Financial Stability Paper No. 11 (Jun. 2011) at 6 ("for the payment system to operate smoothly, banks need to be willing and able to make payments in a timely manner throughout the entire business day. Doing so reduces operational risk in the system. But it also reduces individual settlement banks' exposure to liquidity risk."). *See also* Federal Reserve, Consultation Paper on Intraday Liquidity Management and Payment System Risk Policy, 71 Fed. Reg. 35,679 (Nov. 2006) at 35,680 ("From an operational risk perspective, delaying the sending of large payments until late in the day increases the potential magnitude of liquidity dislocation and risk in the financial industry.") *Id.* at 35,680-81 ("A related long-standing concern of the Federal Reserve has been that depository institutions' intraday liquidity management strategies may lead them to delay sending Fedwire payments until they receive payments in order to manage their use of daylight overdrafts at the Reserve Banks. If this practice became widespread, it could lead to a form of "gridlock" in the payments system with multiple depository institutions waiting for each other to send payments in order to obtain intraday funds and limit their daylight overdrafts.").

[43] Regulation W exempts intraday extensions of credit by a bank to an affiliate from the quantitative limits and collateral requirements in Section 23A provided the bank establishes and maintains policies and procedures reasonably designed to manage the credit exposure arising from its intraday extensions of credit to affiliates in a safe and sound manner. Although overnight overdrafts are not similarly exempt, a bank is still permitted to enter into such transactions provided they satisfy the quantitative and qualitative requirements in Section 23A or qualify for another exemption, such as the exemption for covered transactions that are fully secured by obligations of the United States or its agencies. *See* 12 C.F.R. §§ 223.42(c) *and* 223.42(*l*).

from engaging in any "covered transactions" with a covered fund that it sponsors, advises or manages. This apparent prohibition on all "covered transactions" would severely limit the ability of the Custodian Banks to continue to extend custody-related credit to these covered funds. As explained below, we believe the Agencies have legal authority to, and should, clarify that Section __.16 will not prohibit a Custodian Bank from extending credit to a covered fund in the ordinary course of business in connection with the provision of core custodial and administrative services to the covered fund. In this respect, the market functionality that the Custodian Banks wish to continue providing to covered funds as part of traditional custodial services is no different from the functionality that the Custodian Banks provide generally as a matter of course to their overall client base.

The Custodian Banks recognize that the Agencies may have legitimate concerns that a custody-related exemption from Super 23A should not be so broad as to permit banking entities to abuse the exemption and evade the Volcker Rule. The Custodian Banks note that Section 13(e) of the BHC Act provides the Agencies with broad powers to respond to specific instances of evasive behavior or "abuse of any permitted activity" on the basis of their reasonable belief. Moreover, the following additional safeguards exist through the Agencies' supervisory process to prevent potential abuse of a narrowly tailored custody-related exemption from Super 23A:

- A banking entity providing custody-related credit must comply with applicable safety and soundness requirements and must have appropriate risk management procedures to monitor intraday exposures and to obtain payment on any longer exposures as soon as reasonably practicable;
- Provisional credit made available to covered funds must be on terms no more favorable to the covered fund than credit made available to non-covered funds that are managed by the same investment manager or have similar investment characteristics, consistent with the requirements in Section __.16(b) of the Proposed Rules; and
- Section __.17 of the Proposed Rules would apply to all such extensions of credit.[44]

6. Custodian Banks' Role as Securities Lending Agents Should Not Be Adversely Affected by Super 23A

In addition to the custody-related credit extensions described above, the Custodian Banks also perform an important market function in acting as securities lending agents for our clients, including covered fund clients. The Custodian Banks' role as securities lending agents is recognized by regulators as a traditional banking activity[45] that we have engaged in for many

[44] Section __.17 of the Proposed Rules prohibits any activity that would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

[45] OCC Handbook at 27 ("Custodian banks have traditionally been the primary lending agent or intermediary, bringing borrowers and lenders together for a fee."). *See* 17 C.F.R. § 247.722 (Exemption from the definition of broker in the Securities Exchange Act of 1934 for banks engaging in certain securities-lending transactions). *See also* 76 Fed. Reg. 68,862 ("securities lending transactions do not appear to be the type of transaction intended to be covered by the statutory definition of trading account [in the Volcker Rule]").

decades.[46] According to the OCC, "[s]ecurities lending has evolved into one of the most important value-added products custodians offer to their customers."[47] The Agencies should clarify that the Custodian Banks' role as securities lending agents, including the provision of indemnifications to the lending covered fund client against borrower default, is not prohibited by Super 23A.

A Custodian Bank, acting as a securities lending agent, would generally arrange a securities lending transaction between its client and a third party borrower.[48] Significantly, these securities lending transactions do not involve the borrowing or lending of securities, or any exposure as principal, between a Custodian Bank and a covered fund client. Rather, they generally involve a covered fund client lending its securities to a third party borrower (typically a broker-dealer) in return for collateral[49] that exceeds the value of the securities lent.[50] Accordingly, the mere fact that the Dodd-Frank Act expands the definition of "covered transaction" in Section 23A of the Federal Reserve Act to include "a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate" should not subject a Custodian Bank's role as a securities lending agent to Super 23A.[51]

The securities lending agency agreement between a Custodian Bank and its client would typically require the Custodian Bank to indemnify its client against the risk of loss if the third-party borrower defaults on the loan and the collateral posted was insufficient to replace the securities lent. These types of indemnifications are common industry practice and the Custodian Banks provide them to virtually all of their clients, not just covered fund clients. Clearly, such indemnifications have nothing to do with guaranteeing the performance of a covered fund or bailing out the covered fund. Accordingly, they do not pose the types of risks that the Volcker Rule was intended to address. Moreover, a Custodian Bank's credit exposure on such indemnifications is to the defaulting third-party borrower, not to the covered fund lender.[52] The Agencies should therefore clarify in the final rule that indemnifications provided by Custodian Banks in connection with the provision of securities lending agency services is not prohibited by Super 23A.

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[46] OCC Handbook at 27 ("In the 1970s, U.S. custodian banks first began lending securities to brokers on behalf of their clients.").

[47] OCC Handbook at 26.

[48] In addition, a Custodian Bank would typically provide settlement services for the securities lending transaction as well as safekeeping and/or investment management services for the collateral.

[49] The primary forms of collateral used for a securities lending transaction are cash, securities, or a standby letter of credit.

[50] Collateral margins may vary by market, and by type of collateral provided. In the United States, if cash or U.S. securities are provided as collateral, 102 percent of the value of the securities loaned is generally required. If non-U.S. securities are provided, 105 percent is typically required. *See* OCC Handbook at 33.

[51] *See* 12 U.S.C. § 371c(b)(7)(F). Under Super 23A, a banking entity is deemed to be the member bank and the covered fund is deemed to be an affiliate of the member bank. BHC Act § 13(f)(1).

[52] To the extent that such indemnifications give rise to credit exposure, the Federal Reserve's proposed rules under Section 165 of the Dodd-Frank Act provides a suitable framework for monitoring the overall level of exposure. *See* Federal Reserve, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012).

7. Agencies' Rulemaking Authority and Interpretative Discretion to Address Unintended Consequences of Super 23A

We urge the Agencies to use their broad interpretative discretion and rulemaking authority, as discussed below, to "clarify" or "interpret" Super 23A in a way that preserves the ability of the Custodian Banks to provide custody-related credit extensions to covered fund clients.

(a) Interpreting the Term "Covered Transaction" by Reference to Section 23A in its Entirety

In interpreting and implementing Super 23A, the Agencies should attach significance to the fact the Section 13(f) of the BHC Act refers to "covered transaction, as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c)" and <u>not</u> covered transaction as defined in Section 23A(b)(7) of the Federal Reserve Act. The reference to Section 23A in its entirety suggests that the term "covered transaction" should be construed in light of Section 23A as a whole, including the exemptions in subsection (d) and in Regulation W,[53] and not only by reference to the definitional provision in Section 23A(b)(7). In fact, when Congress intended a provision in the Volcker Rule to refer to a subsection in the Federal Reserve Act, as opposed to an entire section, it did so expressly.[54]

Accordingly, absent express direction to the contrary in the statutory text or legislative history, the Agencies should interpret the phrase "covered transaction, as defined in section 23A" as referring to "covered transactions" that do <u>not</u> qualify for any exemptions in Section 23A(d) or Regulation W. Such an approach comports with both the structure of Section 23A and its legislative history.

The scope of Section 23A cannot be understood from considering any subsection in isolation.[55] Although Section 23A(b)(7) contains a long list of "covered transactions," subsection (d) contains an equally long list of transactions that are wholly exempt from the requirements in Section 23A, provided they are consistent with safe and sound banking practices, which is a general standard that banks must comply with regardless of Section 23A. Using its rulemaking authority in Section 23A(f), the Federal Reserve has added to this list important exemptions such as the one relating to intraday extensions of credit.

Although Subsection (d) of Section 23A effectively exempts transactions listed therein from all the restrictions in Section 23A, under the Proposed Rules' version of Super 23A, such exempt transactions are wholly prohibited. Neither the text nor legislative history of the

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[53] The regulatory exemptions in Regulation W are promulgated pursuant to the Federal Reserve's rulemaking authority under Section 23A(f) of the Federal Reserve Act.

[54] *See e.g.*, BHC Act § 13(h)(1)(D) ("exercise discount or borrowing privileges pursuant to section 19(b)(7) of the Federal Reserve Act").

[55] Structurally, Section 23A is organized into the following subsections: subsection (a) contains the quantitative limits on the amount of covered transactions a bank could enter into with its affiliates; subsection (b) contains definitions of key terms; subsection (c) contains the collateral requirements for certain covered transactions; subsection (d) exempts a long list of transactions from the requirements in Section 23A; subsection (e) relates to the treatment of financial subsidiaries and subsection (f) deals with rulemaking and additional exemptions by regulation.

Volcker Rule suggests that Congress intended this outcome. The more reasonable approach would be to interpret "covered transaction" in Super 23A to mean a covered transaction that both falls within the Section 23A(b)(7) definition and does not qualify for an exemption contained in subsection (d) or Regulation W.

Legislative history also indicates that when Congress reorganized the structure of Section 23A it attached little, if any, legal significance in placing "covered transactions" and "exemptions" into different subsections or in excluding a transaction from the definition of covered transaction or listing it as an exemption.[56] In 1982, Congress amended the Federal Reserve Act so that in structure Section 23A became similar to the way it reads today, with separate subsections for definitions and exemptions.[57] Prior to 1982, Section 23A did not contain a definitions section, nor did it define or even use the word "covered transaction." Instead, the transactions to which Section 23A applied and those to which it did not apply were grouped together in the same statutory text, which did not contain section numbers. According to the Senate Banking Committee report, one of the major objectives of the 1982 amendment was to "reorganize[ ] and clarif[y] the statute to facilitate compliance and enforcement."[58]

Simply by organizing it better, Congress did not intend to upset the manner in which Section 23A covered transactions were to be understood – *i.e.*, not as the larger set of transactions listed in Section 23A(b)(7) but rather the smaller universe of non-exempt covered transactions. This smaller set of non-exempt transactions is what Congress really intended to be covered by Section 23A. The phrase "covered transaction, as defined in section 23A of the Federal Reserve Act" should logically be interpreted in the same way.

(b) Authority to "Adopt Rules to Carry Out" Section 13 of the BHC Act

The Agencies possess rulemaking authority with respect to the Volcker Rule and have exercised their authority to pursue the goals of Section 13 of the BHC Act. The Agencies should do the same with respect to Super 23A to address its adverse impact on the ability of Custodian Banks to provide custody services to covered funds. Such services are not the type of activity that the Volcker Rule or the Dodd-Frank Act was intended to prohibit or restrict. On the contrary, the Dodd-Frank Act expressly recognizes that "[t]he proper functioning of the

[56] For example, a carve out from "loan or advance or extension of credit" for the "giving of immediate credit to a *bank* upon uncollected items received in the ordinary course of business" in the pre-1982 version of Section 23A became a broader exemption for "giving immediate credit to an *affiliate* for uncollected items received in the ordinary course of business" in subsection (d)(3) after Section 23A was reorganized.

[57] According to the Senate Banking Committee report, the 1982 amendment was largely based on the Federal Reserve's recommendations in a 1981 report to the Committee. In its report, the Federal Reserve complained that Section 23A was "a very difficult statute to interpret" partly because it was "poorly drafted" and that made compliance and enforcement difficult. According to the Fed: "the statute cannot be analyzed effectively without first substantially reorganizing it into a more logical structure." The Federal Reserve further noted that "[t]ransactions . . . covered by Section 23A [were] spread rather haphazardly over several paragraphs of the statute" and "exemptions [were] scattered over various parts of the statute." *See* Federal Reserve, A Discussion of Amendments to Section 23A of the Federal Reserve Act Proposed by the Board of Governors of the Federal Reserve System (Sept. 1981).

[58] S. Rep. No. 536, 97th Cong., 2d Sess. 30-31 (1982).

financial markets is dependent upon safe and efficient arrangements for the clearing and settlement of payment, securities, and other financial transactions."[59]

In enacting Section 13 of the BHC Act, Congress required the Agencies to "adopt rules to carry out this section," which rules are to "assur[e], to the extent possible," that implementation of the Volcker Rule will "protect the safety and soundness of banking entities and nonbank financial companies supervised by the Board."[60] The Agencies have interpreted this provision as authorizing them to issue rules and construe terms in the statute that give effect to the "goals" of the Volcker Rule. For example, in the preamble to the Proposed Rules, the Agencies observed that: "In implementing the covered funds provisions of section 13 of the BHC Act, the Agencies have proposed to define and <u>interpret</u> several terms used in implementing these provisions and <u>the goals of section 13</u>."[61]

Relying on their broad interpretative and rulemaking authority, the Agencies have proposed rules that give effect to the goals and intent behind Section 13. For example, although Section 13 expressly defines "banking entity" to include "<u>any</u> affiliate or subsidiary of any such entity,"[62] the Agencies used their interpretative discretion to introduce important exceptions to this broad definition.[63] The Agencies justified their "clarification" of the statute as to "avoid application of section 13 of the BHC Act in a way that appears <u>unintended by the statute</u>."[64] The Agencies did not rely on Section 13(d)(1)(J) to implement this "clarification." Instead, the Agencies appear to be relying on their broad authority to "carry out" Section 13, which involves implementing the Volcker Rule in a way that is consistent with its "goals."

In the Proposed Rules, the Agencies also used their interpretative discretion to "clarify" an aspect of Super 23A itself. Specifically, Section__.16(a)(2) of the Proposed Rules permits a banking entity to acquire an ownership interest in a covered fund in accordance with other exemptions in the Proposed Rules, even though Super 23A, on its face, would have prohibited this "covered transaction." Again, the Agencies justified their "clarification" of the statute by reference to Congressional intent: "There is no evidence that Congress intended

[59] Dodd-Frank Act § 802 (Findings and purposes of Title VIII of the Dodd-Frank, also known as the Payment, Clearing, and Settlement Supervision Act of 2010).

[60] BHC Act § 13(b)(2)(A) *and* (B)(ii).

[61] 76 Fed. Reg. at 68,928 (emphasis added).

[62] BHC Act § 13(f)(1).

[63] Section __.2(e) of the Proposed Rules.

[64] 76 Fed. Reg. at 68,855 ("[I]n order to avoid application of section 13 of the BHC Act in a way that appears unintended by the statute and would create internal inconsistencies in the statutory scheme, the proposed rule also clarifies that the term 'banking entity' does not include any affiliate or subsidiary of a banking entity, if that affiliate or subsidiary is (i) a covered fund, or (ii) any entity controlled by such a covered fund."); *id.* at 68,856 ("If such a covered fund were considered a "banking entity" for purposes of the proposed rule, the fund itself would become subject to all of the restrictions and limitations of section 13 of the BHC Act and the proposed rule, which <u>would be inconsistent with the purpose and intent of the statute</u>.")(emphasis added).

section 13(f)(1) of the BHC Act to override the other provisions of section 13 with regard to the acquisition or retention of ownership interests specifically permitted by the section."[65]

The above examples provide evidence of the Agencies' authority and willingness to adopt a purpose-oriented and policy-driven approach to interpreting and implementing Section 13 of the BHC Act in a way that is consistent with the "goals of Section 13." The Agencies should adopt a similar approach with respect to Super 23A to mitigate its adverse impact on the provision of custody-related services.

(c) Exemptive Authority under Section 13(d)(1)(J) of the BHC Act

The Agencies should interpret Section 13(d)(1)(J) of the BHC Act as authorizing them to grant exemptions not only from the ownership and sponsorship restrictions in Section 13(a) but also from the Super 23A restrictions in Section 13(f).

Section 13(d)(1)(J) of the BHC Act authorizes the Agencies to permit a banking entity to engage in "[s]uch other activity as the [Agencies] determine . . . would promote and protect the safety and soundness of the banking entity and the financial stability of the United States." Section 13(d)(1) imposes certain overriding limitations on banking entities engaged in the permitted activities contained in Subsections 13(d)(1)(A) through (J). Section 13(d)(1) begins:

> "Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the [Agencies] may determine, the following activities (in this section referred to as 'permitted activities') are permitted . . . ."

Other than the limitations contained in Section 13(d)(2) and any additional restrictions that the Agencies may determine, Section 13(d)(1) does not expressly limit the scope of the Agencies' exemptive authority. Significantly, Section 13(d)(1) does not expressly state that the Agencies lack authority to grant relief from the Super 23A restrictions in Section 13(f) of the BHC Act. As a result, Section 13(d)(1)(J) of the BHC Act is ambiguous on the question of whether it covers the restrictions in Section 13(a) as well as the Super 23A restrictions in Section 13(f).

In light of its ambiguous language, the Custodian Banks believe it would be reasonable for the Agencies to construe the opening phrase in Section 13(d)(1) as <u>not</u> restricting the scope of their exemptive authority under 13(d)(1)(J). In fact, such an interpretation would "carry out" the purposes of the Volcker Rule by allowing the Agencies to grant appropriate exemptions from Super 23A in ways that promotes and protects the safety and soundness of banking entities and the financial stability of the United States.

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[65] Arguably, Section 23A also authorizes the Federal Reserve to make this clarification because the definition of "covered transaction" in Section 23A(b)(7)(C) contains an explicit exemption for "such purchase of real and personal property as may be specifically exempted by the Board by order or regulation." However, the Agencies justified their "clarification" in terms of Congressional intent and not in terms of the Federal Reserve's authority under Section 23A. In addition, the "authority" portion of the Federal Reserve's Proposed Regulation VV implementing the Volcker Rule does not list Section 23A(b)(7)(C).

An exemption from Super 23A that preserves the ability of the Custodian Banks to extend intraday and short-term credit and to engage in other "covered transactions" in connection with the provision of custodial and administrative services would be consistent with these safety and soundness and financial stability objectives.

(d) Volcker Rule Preserves the Federal Reserve's Inherent Rulemaking Authority under the BHC Act

The Federal Reserve, as the regulator with primary responsibility to interpret, implement and administer the BHC Act, has "inherent" rulemaking authority with respect to the entire statute, including the provisions of the Volcker Rule contained in Section 13. Specifically, Section 5(b) of the BHC Act permits the Federal Reserve to "issue such regulations and orders . . . as may be necessary to enable it to administer and carry out the purposes of this Act and prevent evasions thereof."[66] This inherent rulemaking authority is expressly preserved by the Volcker Rule, which states: "*Authority of federal agencies and state regulatory authorities.*—Nothing in this section shall be construed to limit the inherent authority of any Federal agency or State regulatory authority under otherwise applicable provisions of law."[67]

As the Volcker Rule is part of the BHC Act and the Federal Reserve is authorized under Section 5(b) of that statute to issue rules to "carry out" its purposes, we believe the Federal Reserve can, and should, promulgate rules that mitigate the unintended consequences of Section 13(f).[68] Nothing in Section 13 of the BHC Act suggests that the *sole* rulemaking authority with respect to the Volcker Rule resides in Section 13(b)(2), which simply directs the Agencies to "adopt rules to carry out this section." Moreover, the fact that the Federal Reserve is also the regulator with primary responsibility to interpret and implement Section 23A of the Federal Reserve Act places it in a unique position to issue rules relating to Super 23A.[69]

(e) Section 5(b) of the Bank Holding Company Act Grants Broad Rulemaking Authority to the Federal Reserve

The Court of Appeals for the District of Columbia described Section 5(b) of the BHC Act as "a general grant of power to issue regulations and orders so as to carry out the purposes of the Act"[70] while the Sixth Circuit referred to it as a "broad, general grant[ ] of authority."[71]

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[66] 12 U.S.C. 1844(b).

[67] BHC Act § 13(g)(3).

[68] In addition to inserting Section 13 in the BHC Act, Title VI of the Dodd-Frank Act (Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010) also amended Section 5(b) to expressly authorize the Federal Reserve to issue rules relating to capital requirements for bank holding companies. Significantly, Congress did not alter Section 5(b)'s general grant of rulemaking authority to the Federal Reserve. *See* Dodd-Frank Act § 616.

[69] Although Section 5(b) of the BHC Act vests rulemaking authority in the Federal Reserve, we believe that it is relevant to the Agencies'' coordinated rulemaking authority under Super 23A, since Super 23A is part of Section 13 of the BHC Act.

[70] *Ind. Comm. Bankers* v. *Bd. of Governors*, 195 F.3d 28, 31 (D.C. Cir. 1999) (emphasis added).

[71] *In re Bankers Trust Co.*, 61 F.3d 465, 470 (6th Cir. 1995) (emphasis added).

The Federal Reserve has relied on this authority to issue a number of important rules, including Regulation Y,[72] a comprehensive set of rules that is arguably the centerpiece of the federal regulatory regime for bank holding companies.[73] Significantly, as the following examples demonstrate, the Federal Reserve has relied on Section 5(b) and other rulemaking authorities that employ similarly broad language to carry out the purposes of a statute and to give effect to congressional intent.

Recently, the Federal Reserve relied on Section 5(b) to interpret and implement Section 165(e) of the Dodd-Frank Act, which requires the Federal Reserve to prohibit systemically important nonbank financial companies and large bank holding companies (“**covered companies**”) from “having credit exposure to any unaffiliated company that exceeds 25 percent of [their] capital stock and surplus.” Notwithstanding the statute’s use of the terms “any unaffiliated company,” the Federal Reserve included “sovereign entities” – defined as central government (including the U.S. government), agency, department, ministry, or central bank – in its proposed credit exposure requirements to limit the vulnerability of a covered company to default by a sovereign state. Significantly, the Federal Reserve regarded its “general safety and soundness authority” under Section 5(b) of the BHC Act, among other statutory provisions, as authorizing it to implement Section 165(e) of the Dodd-Frank Act in this way.[74]

The broad grant of authority embodied in the words “as may be necessary . . . to administer and carry out the purposes of this Act” also appears in other statutes administered by the Federal Reserve, including Section 23A of the Federal Reserve Act. Using language that is virtually identical to Section 5(b) of the BHC Act, Section 23A(f) of the Federal Reserve Act authorizes the Federal Reserve to “issue such further regulations and orders . . . as may be necessary to administer and carry out the purposes of this section and to prevent evasions thereof.”[75] Relying on this “broad authority to issue regulations to administer [Section 23A],” the Federal Reserve adopted Regulation W to comprehensively implement Sections 23A and 23B of the Federal Reserve Act.[76]

Significantly, the Federal Reserve has used its Section 23A(f) authority to interpret and implement Section 23A in a way that gives effect to congressional intent. For example, the

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[72] Sec. 225.1(a) (“This part 1 (Regulation Y) is issued by the Board of Governors of the Federal Reserve System (Board) under section 5(b) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1844(b)) (BHC Act) . . . .”)

[73] Other recent rulemakings that rely on Section 5(b) of BHC Act include: Proposed 12 C.F.R. Part 240 (Regulation to permit banking organizations under the Federal Reserve’s supervision to engage in off-exchange transactions in foreign currency with retail customers); and Proposed 12 C.F.R. 236 (Incentive-Based Compensation Arrangements).

[74] 77 Fed. Reg. at 615 (“The Board believes that the authority in the Dodd-Frank Act and the Board’s general safety and soundness authority in associated banking laws are sufficient to encompass sovereign governments in the definition of counterparty in this manner.” (citing Section 5(b) of the BHC Act)).

[75] 12 U.S.C. 371c(f)(1)(“The Board may issue such further regulations and orders, including definitions consistent with this section, as may be necessary to administer and carry out the purposes of this section and to prevent evasions thereof.”).

[76] Federal Reserve, Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560 (Dec. 12, 2002).

Federal Reserve relied on Section 23A(f) to restrict the availability of the "sister-bank exemption"[77] in Section 23A to insured depository institutions despite the fact the statute, on its face, makes the exemption available between all sister banks, regardless of whether they are insured by the FDIC.[78] When it first proposed to restrict the scope of the sister-bank exemption in this manner, commenters argued that the proposal is inconsistent with the statutory language and that the Federal Reserve lacked rulemaking authority to impose such a restriction.[79] Responding to these comments, the Federal Reserve stated in the preamble to its adopting release for Regulation W that the "restriction is consistent with the legislative <u>intent</u> behind the exemption" and that Section 23A(f) "provides the [Federal Reserve] with authority to issue definitions consistent with the section <u>as may be necessary to carry out the purposes of the section</u> and to prevent evasions thereof."[80] In other words, the Federal Reserve regarded the language in Section 23A(f) as broadly authorizing it to give effect not only the letter of a statute but, more importantly, to its legislative purpose.

In adopting Regulation W pursuant to its broad rulemaking powers under Section 23A(f)(1), the Federal Reserve chose to implement Section 23A in a way that would not impose undue restrictions on Custodian Banks with respect to their settlement activities. Specifically, notwithstanding the express statutory language in the Gramm-Leach-Bliley Act directing the Federal Reserve to "<u>address as covered transactions</u> credit exposure arising out of . . . intraday extensions of credit" by banks to their affiliates,[81] the Federal Reserve decided to use its broad rulemaking authority to place intraday extensions of credit beyond the quantitative and qualitative limitations in Regulation W.[82] Significantly, the Federal Reserve justified its approach by referring to the importance of intraday credit extensions to the settlement of transactions.[83]

[77] Section 23A(d)(1) of the Federal Reserve Act, commonly referred to as the sister-bank exemption, exempts from the requirements of Section 23A any transaction between a member bank and a "bank" if the member bank controls 80 percent or more of the voting securities of the bank, the bank controls 80 percent or more of the voting securities of the member bank, or a company controls 80 percent or more of the voting securities of both the member bank and the bank.

[78] Section 23A(b)(5) (Defining the term "bank" to include "a State bank, national bank, banking association, and trust company.").

[79] 67 Fed. Reg. at 76,589 ("The protestants argued that restricting the sister-bank exemption to insured depository institutions is inconsistent with the statutory language and the primary purpose behind the exemption, which focused not on the insured status of the sister depository institutions but on the regulated status of the institutions. In addition, several of these commenters expressed the view that the Board does not have rulemaking authority to restrict the sister-bank exemption to insured depository institutions.").

[80] *Id.*

[81] Gramm-Leach-Bliley Act § 121(b)(3).

[82] Regulation W exempts all intraday credit extensions by a member bank to an affiliate from the quantitative and collateral requirements of section 23A if the member bank (i) maintains policies and procedures for the management of intraday credit exposure and (ii) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms.

[83] 67 Fed. Reg. 76,596.

(f) The Agencies Should Clarify that Custody-related Transactions Are Not "Covered Transactions" or Are Not Otherwise Prohibited by Super 23A

The above precedents show that the Federal Reserve is willing to use its broad authority under Section 5(b) of the BHC Act and similarly worded provisions in other statutes to give effect not only to the express terms of a statute, but more importantly, to carry out its purpose. The Agencies should similarly interpret or implement Section 13(f) in a way that "carr[ies] out the purposes of this Act."

The legislative history of the Volcker Rule clearly suggests that the purpose of Section 13(f) is to prohibit relationships that provide banking entities with the incentives and mechanisms for effecting bailouts of covered funds that they advise, manage or sponsor.[84] The custody and settlement services that the Custodian Banks provide to their covered fund customers do not give rise to these incentives. As noted above, the Federal Reserve has long-recognized the importance of intraday and overnight extensions of credit to the smooth functioning of the global payment and settlement processes and have expressly stated that they are not "a means of funding or otherwise providing financial support." [85]

Accordingly, the Agencies should exercise their rulemaking authority to mitigate the adverse impact of Super 23A on the provision of custody-related services. Specifically, the Agencies should clarify that custody-related transactions are not "covered transactions" for purposes of Super 23A or are not otherwise prohibited by Super 23A.

V. Conformance Period and Phase-in Compliance

The Custodian Banks appreciate the general two-year conformance period adopted by the Federal Reserve pursuant to Section 13(c) of the BHC Act.[86] The statutory conformance period is necessary for banking entities to bring their activities into conformance with the restrictions and prohibitions in the Volcker Rule.

Should the Agencies decide not to mitigate the adverse impact of Super 23A on the provision of custodial and administrative services, they should, at a minimum, allow the Custodian Banks and our covered fund clients to use the two-year statutory conformance period to bring our custodial arrangements and custody-related transactions into compliance with the final rule. This would allow us to comply with the Volcker Rule in an orderly fashion that minimizes disruption to the U.S. financial system.

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[84] Colloquy between Senators Merkley (D-OR) and Levin (D-MI), 156 CONG. REC. S5894, S5898 (daily ed. July 15, 2010) ("Indeed, a large part of protecting firms from bailing out their affiliated funds is by limiting the lending, asset purchases and sales, derivatives trading, and other relationships that a banking entity or nonbank financial company supervised by the Board may maintain with the hedge funds and private equity funds it advises. The relationships that a banking entity maintains with and services it furnishes to its advised funds can provide reasons why and the means through which a firm will bail out an advised fund, be it through a direct loan, an asset acquisition, or through writing a derivative.")(emphasis added).

[85] 67 Fed. Reg. 76,596.

[86] Federal Reserve, Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 12 CFR 225.180-182.

If the final rule does not exclude custody-related transactions from Super 23A, the Custodian Banks and our covered fund clients will require a significant amount of time to bring our "covered transactions" into compliance. It is impossible for the Custodian Banks and our covered fund clients to make all the necessary changes – which may include changing custodial structures or arrangements, engaging third parties to provide essential custody-related transactions or transferring custodial functions to a different service provider – by July 21, 2012.

For example, the process of converting an existing client to a successor custodian is a process that takes significant planning and resources and presents significantly increased operational risk. Consequently, it is critical that the negative impact of potentially losing substantial custodial relationships due to the breadth of the Proposed Rules not be compounded by a timeframe that places additional operational strain and costs upon the Custodian Banks. In addition, the decision to appoint a successor custodian is not solely within the control of the Custodian Banks but requires the cooperation of other service providers to the funds and the acceptance of the appointment by the successor custodian. Such arrangements will require significant time and planning.

The Custodian Banks are also concerned with language in the preamble to the Proposed Rules suggesting that the statutory conformance period would not permit a banking entity to engage in any new activity or make any new investment in a covered fund without complying with the Volcker Rule and implementing regulations.[87] There is a risk that each extension of credit to existing custodial clients would be viewed as a new activity and therefore not benefit from the two-year conformance period. In practice, most investment managers or sponsors establish new funds on a regular basis and require that a Custodian Bank service all of its funds in a particular jurisdiction. Accordingly, the Custodian Banks request clarification that establishing and transacting with new funds in connection with existing custodial relationships are permitted during the two-year statutory conformance period.

In this respect, we observe that nothing in the statutory text of the Volcker Rule suggests that the two-year conformance period is only intended for existing activities. Section 13(c) simply states: "A banking entity . . . shall bring its activities and investments into compliance with the requirements of this section not later than 2 years after the date on which the requirements become effective pursuant to this section."[88]

We also encourage the Agencies to announce any determinations regarding compliance schedules or phase-in implementation of the Volcker Rule well in advance of the July 2012 effective date to allow market participants to plan their conformance activities accordingly.

Request for Re-proposal. In light of the significant revisions that must be made to the Proposed Rules to mitigate their adverse and unintended consequences for market participants and the U.S. financial system, we also recommend that the Agencies re-propose their Volcker Rule regulations after a careful consideration of all comments received. A re-proposal will

[87] 76 Fed. Reg. at 68,923.

[88] BHC Act § 13(c).

give interested parties, including the Custodian Banks, the opportunity to meaningfully comment on the Agencies' revisions to the Proposed Rules before they are finalized.

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The Custodian Banks appreciate the opportunity to provide the Agencies with the foregoing comments and recommendations regarding the Proposed Rules. Either individually or as a group, we would be pleased to have the opportunity to discuss this matter further with staff members of the Agencies, and will follow-up accordingly. In addition, please feel free to contact any of the following with any questions:

The Bank of New York Mellon Corporation
Victor R. Siclari, Senior Managing Counsel
(412) 234-5736

Northern Trust Corporation
James Roselle, Associate General Counsel
(312) 444-7565

State Street Corporation
Simon Zornoza, Senior Vice President and Senior Regulatory Counsel
(617) 664-1541

Respectfully submitted,

Jane Sherburne	Kelly R. Welsh	David C. Phelan
General Counsel & Sr. Executive Vice President	Executive Vice President and General Counsel	General Counsel and Executive Vice President
The Bank of New York Mellon Corporation	Northern Trust Corporation	State Street Corporation

cc: Mary Miller, Assistant Secretary for Financial Markets, Department of the Treasury

Overview of the Custodian Banks

Annex A

Note: Dollars in billions as of, and for, quarter ended 30 September 2011

Bank of New York Mellon		
Assets	$	322.2
Risk - Weighed Assets	$	106.3
Tier 1 Capital	$	14.9
Off Balance Sheet Exposures[1]	$	286.7
Assets under Management	$	1,198.0
Assets under Custody	$	25,900.0
Revenue[2]	$	14.9
Market Capitalization	$	22.5

Northern Trust		
Assets	$	96.1
Risk - Weighed Assets	$	57.5
Tier 1 Capital	$	7.0
Off Balance Sheet Exposures[1]	$	110.7
Assets under Management	$	644.2
Assets under Custody	$	4,172.1
Revenue[2]	$	3.8
Market Capitalization	$	8.4

State Street		
Assets	$	208.8
Risk - Weighed Assets	$	75.6
Tier 1 Capital	$	13.5
Off Balance Sheet Exposures[1]	$	373.0
Assets under Management	$	1,887.0
Assets under Custody*	$	21,510.0
Revenue[2]	$	9.3
Market Capitalization	$	15.8

[1] Off-Balance sheet includes: Unused commitments, financial and performance standby LOCs and foreign office guarantees, commercial and similar LOCs, securities lending per Y9
[2] Revenue is total of last 4 quarters
* AUCA Assets under Custody and Administration

Business Profile

- A custodial bank serves as a financial intermediary to the broader financial system.
- Custodians act on behalf of their investor customers by facilitating the movement of securities and cash through post-market infrastructure.
- In this capacity core custody bank services include safekeeping, securities settlement, asset servicing and banking.

Balance Sheet

- Custody banks have liquid, customer-liability-driven balance sheets; assets are primarily liquid investment securities.
- The nature of custodial services leads to stable deposits, as demonstrated through deposit attrition analysis.
- Credit is provided on a secured basis or with high quality obligors, resulting in limited credit risk.
- Off balance sheet exposures to financial institution counterparties are mainly limited to short-term funding commitments and/or highly collateralized customer transactions.
- Securities held in custody remain under customer control and present no on-balance sheet or off-balance sheet exposure to custody banks.

Revenue and Income

- Income is predominantly annuity-like fee-based revenue which is resilient throughout the economic cycle.
- Credit is extended primarily to support custodial customer relationships and high net worth individuals.
- Trading revenue is primarily customer flow driven.

<u>Annex B</u>: Overview of Fund Structures and Trustee Requirements in Various Foreign Jurisdictions

By way of illustration and background, we set forth below a brief summary of fund structures and trustee requirements in certain foreign jurisdictions. This information has been collected from experts in these jurisdictions but do not purport to represent the entirety of possible arrangements.

Ireland

In Ireland, unit trusts are established at the behest of a promoter. Investors view the trust as an investment product offered by the promoter. The trust is established under the terms of an Irish trust deed entered into by a promoter (typically acting through an affiliated manager) and the trustee formed in accordance with the Unit Trust Act 1990. The roles and responsibilities of the promoter/manager and trustee are laid out in the trust deed itself, and the promoter/manager will appoint both the administrator and the investment adviser. Irish unit trusts are regulated by the Central Bank of Ireland and units are typically distributed in a public offering.

The obligations of the trustee are to (i) hold the assets of the fund in safekeeping, (ii) ensure that the issue and redemption of shares/units to investors, calculation of net asset value per share and application of the fund's income are carried out in accordance with the fund's constitutive documentation and relevant regulations, and (iii) enquire into the conduct of the fund during each financial year and report thereon to investors.

In most trust deeds, the trustee has the ability to replace the promoter/manager upon the insolvency of the promoter/manager or following a resolution of the unit holders to remove the promoter/manager, and to the extent the trustee is involved it is typically to effect the decision of the unit holders. In a limited number of instances, the trustee has the power to replace the promoter/manager if, in the trustee's reasonable opinion, the promoter/manager is incapable of performing or fails to perform its duties. However, as a practical matter, the trustee is not likely to remove the promoter/manager without direction from the unit holders.

The trustee does not have authority to make investment decisions for the trust and takes no active role in the appointment or termination of the investment adviser. As also indicated above, it is the promoter/manager who is responsible for appointing and terminating the appointment of the investment adviser (often an affiliate of the promoter/manager) as well as all other service providers. If the promoter/manager were to fail to act to remove an investment adviser that itself has failed to perform its responsibilities, the trustee may put pressure on the promoter/manager to exercise its power to remove the investment adviser or, ultimately, at the direction of the unit holders, remove the promoter/manager. Generally, a Custodian Bank acting as trustee would likely resign rather than directly take on any advisory responsibilities.

Cayman

In the Cayman Islands, unit trusts are typically established at the direction of investors or an investment adviser, and one or both of these entities select the trustee to provide an administrative role for their structures. The investment adviser is generally viewed as the promoter/sponsor of the fund and investors make the decision to invest in a fund structure managed by that particular investment adviser. The trustee plays no role in developing, determining or marketing the investment strategy or the unit trust structure, and is typically selected based on its ability to provide a comprehensive administrative and custody service solution to the trust.

The trust is formed in accordance with Cayman Islands common law, and is established under the terms of a trust deed entered into by the trustee. The trust can also be established as a two-party trust, in which case both the trustee and the investment adviser form the trust by entering into the trust deed. Once units are issued, the trust operates like an open-ended mutual fund with periodic subscriptions and redemptions.

The obligations of the trustee are set forth in the trust deed, which typically reflects the principle that the trustee does not have any responsibility for the investment management of the trust assets. The trust deed will clearly specify that the investment adviser has this responsibility, and will specify that the unitholders need to approve changes to the investment guidelines or any replacement of the investment adviser.

The trustee is responsible for administering the assets and providing custody services, and will follow the instructions of the investment adviser and the unitholders as necessary. As the legal holder of the assets, the trustee contracts with the investment adviser and other service providers and counterparties, but at the direction of the unitholder. As a consequence, in some circumstances the trustee has the technical power to remove the investment adviser, but the trust deed typically only allows the trustee to exercise this power with the prior approval of the unitholder. While there may be a residual obligation to terminate an investment adviser whom the trustee knows to be engaged in fraud or misconduct, as a practical matter the trustee would still seek to have the unitholders approve any action to terminate or replace the investment adviser. Generally, a Custodian Bank acting as trustee would likely resign rather than directly take on any advisory responsibilities.

Canada

In Canada, investment funds formed as trusts are typically established by a promoter, who will provide administrative services, direct the business operations and affairs of the investment fund and appoint the investment adviser and trustee. Investment funds are typically viewed as investment products sponsored by the investment manager. The regulator for a Canadian investment fund is the securities regulatory body in each province and territory of Canada where the trust is offered.

A Canadian investment fund formed as a trust is established under the terms of a trust agreement between the promoter and the trustee in accordance with common law and is subject to applicable securities and tax legislation. The roles and responsibilities of the promoter, in its capacity as manager, and of the trustee, are set out in the trust agreement. Key legal responsibilities of the trustee are to hold trust assets, perform trust functions as trustee unless permitted to delegate, avoid conflicts of interest and benefitting from trust property and treat beneficiaries with an even hand. Where the trustee is a trust company, it will also provide custodial services.

The trustee does not have authority to make investment decisions for the fund and does not appoint or terminate the promoter or investment adviser unless required to do so by the trust agreement. In the trust agreement, the promoter will generally expressly reserve and retain the exclusive power to manage and direct the investment of the fund assets and to manage and direct the business and affairs of the fund. The promoter can appoint itself or another entity as the investment adviser under an agreement that is separate and distinct from the trust agreement. The promoter can be removed by the unit holders of the fund who will also then appoint the replacement promoter. If no replacement promoter is appointed, the trust agreement will provide for the termination of the fund.

In a very limited number of instances and based upon Canadian taxation law where the promoter of an investment fund is a non-resident, a trust company may be requested to take on a more expanded role as trustee so that the investment fund can be seen as a Canadian resident trust. In those situations, the trustee would be required to appoint the investment adviser and promoter. In these cases, the trustee has the power to replace the promoter/investment adviser. However, as a practical matter, the trustee is not likely to remove the promoter/investment manager without direction from the unit holders and would generally look to the trust agreement to see whether there are circumstances where the trustee is "required" to remove the manager. If the agreement is silent, in order to fulfill its trustee responsibilities to act in the best interests of the beneficiaries, the trustee may feel that it is compelled to remove the promoter/investment adviser in certain circumstances, e.g., the insolvency of the promoter/investment adviser. Generally, a Custodian Bank acting as trustee would likely resign rather than directly take on any advisory responsibilities.

Hong Kong

In Hong Kong, unit trusts are formed at the behest of the promoter/sponsor, who also acts as the investment adviser and identifies the trustee. The trust is viewed as an investment product sponsored by the promoter. Hong Kong unit trusts are regulated by the Securities and Futures Commission in accordance with the Commission's rules relating to the authorization of unit trusts, which are incorporated in the Code on Unit Trusts and Mutual Funds. Hong Kong unit trusts are established under a trust deed entered into by the promoter/investment adviser, and the roles and responsibilities of the trustee and the investment adviser are set out in the trust deed.

The trustee is subject to duties under the general law in Hong Kong, the relevant trust deed and the code on unit trusts. A trustee has a duty to administer the trust in accordance with the terms of the trust deed. The primary obligations of the trustee are to take into custody or under its control all the property of the trust and hold it in trust for the holders in accordance with the terms of the trust deed, maintain a register of holders, carry out the instructions of the manager in respect of investments unless they are in conflict with the provisions of the trust deed or code on unit trusts, take reasonable care to ensure the terms of the trust deed are being adhered to, and issue an annual report to the holders that the investment adviser has in all material respects managed the fund in accordance with the trust deed.

The investment adviser of a Hong Kong unit trust is responsible for making all the investment decisions. It is a fiduciary which undertakes to invest the trust property in the interest of the beneficiaries of the trust by virtue of the trust deed. By contrast, the trustee it is neither able to nor expected to carry out any investment activities for the trust.

By law, the investment adviser must be subject to removal by trustee in certain specified events, including, for instance, if the investment adviser goes into liquidation or has a receiver appointed over its assets or if half of the unit holder request the dismissal of the investment adviser. In addition, by law, the trustee, in fulfilling its duties is required to have a limited right to remove an adviser where the adviser has materially breached the terms of the trust deed and does not remedy it. However, as a practical matter, the trustee is not likely to exercise that power to remove the investment adviser. The trustee will discuss with the adviser any material breach with a view to find a mutually acceptable solution. In the unlikely scenario where the investment adviser retires or is removed by the trustee, the trustee would need to appoint a new investment adviser as soon as possible, but such appointment is subject to the approval of the Commission. Generally, a Custodian Bank acting as trustee would likely resign rather than directly take on any advisory responsibilities.

Singapore

In Singapore, unit trusts authorized by the Monetary Authority of Singapore are formed at the behest of the promoter/sponsor, who also acts as the manager/investment adviser and identifies the trustee. The trust is viewed as an investment product sponsored by the promoter. Authorized Singapore unit trusts are regulated by the Monetary Authority in accordance with the Securities and Futures Act and related regulations and the Code on Collective Investment Schemes. Singapore unit trusts are established under a trust deed entered into by the promoter/manager/investment adviser and the trustee, and the roles and responsibilities of the trustee and the promoter/manager/investment adviser are set out in the trust deed.

The trustee is subject to duties under the general law in Singapore, the relevant trust deed and the securities and futures Act and code on collective investment schemes. A trustee has the duty to administer the trust in accordance with the terms of the trust deed. The primary obligations of the trustee are to take into custody or under its control all the property of the trust and hold it in trust for the participants, keep and maintain, or cause to be maintained, a register of the participants in the scheme and where the trustees become aware that the promoter/manager/investment adviser for the scheme has contravened any legal or regulatory requirement applicable to it in relation to the scheme, the trustee must inform relevant regulatory authorities of the contravention no later than 3 business days after the trustee becomes aware of the contravention.

The promoter/manager/investment adviser of an authorized Singapore unit trust must be a capital market license holder and is a fiduciary undertaking the investment of the trust property in the interest of the participants. The promoter/manager/investment adviser is responsible for making all of the investment decisions in accordance with investment guidelines set out in the relevant trust deed.

By law, the Monetary Authority may in certain instances direct the trustee of certain authorized unit trusts to remove the promoter/manager/investment adviser and appoint a replacement, e.g., in certain instances where the promoter/manager/investment adviser fails to comply with certain applicable laws. By law, the trust deed of an authorized Singapore unit trust will set out the provisions on the retirement and removal of the promoter/manager/investment adviser. It is commonly provided in the trust deed that the trustee will have the power of remove the promoter/manager/investment adviser if the trustee is of the opinion that a change is desirable in the interests of the participants to address the trustee's overall duties towards the participants. However, as a practical matter, the trustee is not likely to exercise that power to remove the promoter/manager/investment adviser. The trustee will discuss with the promoter/manager/investment adviser any material breach with a view to find a mutually acceptable solution. In the unlikely scenario where the investment adviser retires or is removed by the trustee, the trustee would need to appoint a new promoter/manager/investment adviser as soon as possible, but such appointment is subject to the approval of the Monetary Authority. Generally, a Custodian Bank acting as trustee would likely resign rather than directly take on any advisory responsibilities.