

THE ASSOCIATION OF GLOBAL CUSTODIANS

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STATE STREET BANK AND TRUST COMPANY

COUNSEL AND SECRETARIAT TO THE ASSOCIATION:

BAKER & MCKENZIE LLP

EUROPE  
ATT: ARUN SRIVASTAVA  
100 NEW BRIDGE STREET  
LONDON EC4V 6JA, ENGLAND  
INT'L TEL: 44 20 7919 1000

GLOBAL  
ATT: ROBIN TRUESDALE  
815 CONNECTICUT AVENUE, N.W.  
WASHINGTON, D.C. 20006  
TEL: 202 452 7000  
FAX: 202 452 7074

WWW.THEAGC.COM

8 February 2012

*By electronic submission*

Department of the Treasury  
Office of the Comptroller of the Currency  
250 E Street, S.W.  
Washington, D.C. 20219

Board of Governors of the Federal  
Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.  
Washington, D.C. 20551

Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, N.W.  
Washington, D.C. 20429

Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: **Comment Letter on the Notice of Proposed Rulemaking Implementing the Volcker Rule – Foreign Funds Designation and Definition of Trustee (Docket IDs – OCC-2011-14/RIN 1557- AD44; FRB Docket No. R-1432/RIN 7100 AD 82; FDIC RIN: 3064-AD85; SEC Release No. 34-65545/File No. S7-41-11/RIN: 3235-AL07)**

Ladies and Gentlemen:

On behalf of the members of the Association of Global Custodians (the "**Association**")<sup>1</sup>, we submit the following comments concerning aspects of the proposed rules (the "**Proposed Rules**") implementing new Section 13 of the Bank Holding Company Act of 1956 (the "**Volcker Rule**"). The Proposed Rules were included in the notice of proposed rulemaking published by

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<sup>1</sup> The Association of Global Custodians is an informal group of 11 global custodian banks (the "**Members**") that are major providers of securities custody and trade settlement services to institutional investors worldwide. Members are listed on the letterhead above. Established in 1996, the Association primarily seeks to address regulatory and market structure issues that are of common interest to global custody banks. For more information, visit [www.theagc.com](http://www.theagc.com).

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the Office of the Comptroller of the Currency ("**OCC**"), the Board of Governors of the Federal Reserve System ("**Board**"), the Federal Deposit Insurance Corporation ("**FDIC**"), and the Securities and Exchange Commission ("**SEC**") (each an "**Agency**", and collectively the "**Agencies**") in the Federal Register on November 7, 2011 (the "**Notice of Proposed Rulemaking**" or "**NPR**").<sup>2</sup> The Association appreciates the opportunity to provide members' views.

This comment letter relates solely to the Proposed Rules as they pertain to (1) the designation of foreign funds as covered funds and (2) the definition of a trustee as it relates to banking entities providing certain ancillary services to covered funds as well as banking entities with certain fiduciary duties.

### I. Foreign Funds Designation

The core objective of the Volcker Rule is to reduce the exposure of the Deposit Insurance Fund to the risks of hedge funds or private equity funds; however, as drafted, a broad range of non-U.S. based funds that are not normally considered to be hedge funds or private equity funds will be swept into the Proposed Rules.

Although Section 13(h)(2) of the Volcker Rule clearly defines a "hedge fund" and "private equity fund" as (1) an issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act, or (2) such similar funds as the appropriate agencies may determine by rule," the Proposed Rules merge the terms "hedge fund" and "private equity fund" into a single defined term -- "covered fund" -- and add to its definition as a similar fund "any foreign issuer that would be a covered fund were it organized or offered under the laws, or offered to one or more residents, of the United States" (the "**foreign fund definition**"). As defined by the Proposed Rules, "covered fund" is any issuer that would be an investment company, as defined in the Investment Company Act of 1940 (the "1940 Act") but for Sections 3(c)(1) or 3(c)(7) of that act.

Instead of limiting the applicability of the Proposed Rules to non-US equivalents of hedge funds and private equity funds, the definition established in the Proposed Rules appears to treat as a hedge fund or a private equity fund a fund that is offered to the general public in the country of its domicile and subject to regulation in that country as a mutual fund, such as an Undertaking for Collective Investment in Transferable Securities ("**UCITS**") fund. This is because such a foreign fund, while not being offered publicly in the United States *could* have a limited number of investors resident in the U.S. and typically would be exempted from

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<sup>2</sup> 76 Fed. Reg. 68,846 (Nov. 7, 2011).

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registration under the 1940 Act in reliance on Sections 3(c)(1) or 3(c)(7)<sup>3</sup>. Accordingly, the Proposed Rules could be read as including in the definition of “covered fund” every single non-US fund regardless of how such fund is offered, whether it is regulated, or whether it has few, or many, investors. By designating all foreign funds, whether regulated and/or publicly offered, as covered funds, the regulations greatly expand the scope of funds subject to the Volcker Rule in contravention of Congressional intent to limit the scope of “covered fund” to funds that are “similar” to hedge funds and private equity funds.

By being overly inclusive in defining “covered fund” with respect to foreign funds, the Proposed Rules could create unnecessary inconsistency with the 1940 Act, effectively requiring banking entities to comply with the conditions set forth under subsection (f) of the Volcker Rule regarding “covered transactions” and forcing foreign funds into using only unaffiliated entities as fund custodians while US mutual funds may use affiliated custodians.

The Association recommends the Agencies limit the type of foreign funds that will be treated as similar funds so as to adhere to the statutory limit contained in the Volcker Rule and envisioned by Congressional intent. The Proposed Rules should be modified to provide that only foreign funds that have *all* of the characteristics of a traditional hedge fund or private equity fund will be treated as similar funds, and that no foreign fund will be treated as a “similar fund” if its shares are eligible to be offered to the public outside the US and its operation is subject to investor protection regulation in the country of its domicile.

The Proposed Rules also should avoid requiring, for purposes of the foreign fund designation, that home country regulations must be similar to 1940 Act regulations. This “equivalence” condition will require banking entities to perform analysis and evaluation of adequacy and equivalency of the relevant local country’s regulatory rules, which can be unduly burdensome and expensive given the number of foreign funds, the variety of jurisdictions impacted, and the need to retain experts to review the nature and extent of equivalence.<sup>4</sup>

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<sup>3</sup> Section 3(c)(1) exempts any issuer that is beneficially owned by 100 or fewer persons that does not make a public offering. Section 3(c)(7) exempts any issuer that is beneficially owned exclusively by “qualified purchasers” and does not make a public offering.

<sup>4</sup> We also submit that applying 1940 Act standards to determine whether a foreign fund should be treated as a hedge fund would be inappropriate. The regulators within a given jurisdiction are better placed than the Agencies to assess how a mutual fund organized in that jurisdiction and offered primarily to residents of that jurisdiction should be managed.

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### II. Banking Entities Providing Certain Ancillary Services to Covered Funds and Banking Entities With Certain Fiduciary Duties

The Proposed Rules state that a covered banking entity may not sponsor a covered fund. "Sponsor" is defined as an entity that (a) serves as a general partner, managing member, trustee or commodity pool operator of a covered fund, (b) in any manner selects or controls a majority of the directors, trustees or management of a covered fund or (c) shares with a covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name. The Proposed Rules include an important clarification that for purposes of determining whether an entity is the sponsor of a covered fund, the term "trustee" specifically excludes trustees that do not exercise investment discretion with respect to the assets of a covered fund, such as directed trustees. This clarification recognizes that in the case of funds that are structured as trusts the trustee will often act as custodian and, in some jurisdictions, will necessarily exercise specified and limited oversight over the fund's compliance with applicable regulations and the fund's offering materials, but will not have general responsibility for the fund's investment management. Accordingly, the Proposed Rules provide that a "trustee" includes only those persons who possess authority and discretion to manage and control the assets of the covered fund.

The Association fully supports this interpretation of the definition of "sponsor." However, based on the following commentary we recommend a further sharpening of this clarification to make clear that a banking entity acting as custodian would not be considered a trustee if (a) it provides certain ancillary services, such as securities lending services and/or cash management services, to a covered fund or (ii) it holds the assets of a covered fund with certain residual fiduciary duties but does not exercise investment discretion.

#### A. *Banking Entities Providing Certain Ancillary Services to Covered Funds*

In addition to providing core custody services, such as facilitating trade settlements, collecting income, and providing recordkeeping services, a banking entity acting as custodian frequently provides value-added ancillary services, such as securities lending, to its custody customers. In fact, by delivering value-added securities lending services, custodians act as the customers' lending agent, thereby adding liquidity and efficiency to the markets and supporting trading activities and strategies both in the US as well as internationally. These services are commonly provided by a bank when acting as a directed trustee to an ERISA plan or a group trust or to offshore funds for which it acts a directed trustee.

Under a typical securities lending program, the lending agent (frequently the fund's custodian) will lend the fund's securities to third parties on a fully secured basis. The lending agent typically will lend only to borrowers that have been pre-approved by the customer, but the

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agent may have discretion to negotiate the terms and conditions under which each loan of a security to such a borrower is made. The terms of securities loans are typically negotiated in a way that does not limit the fund's investment manager from engaging in customary trading activities involving those securities or from taking advantage of any corporate action (such as a tender offer) that may arise with respect to a security while it is on loan. The primary forms of collateral used for a securities lending transaction are cash or securities. If cash is being pledged as collateral to a lender, the lending agent (e.g., the custodian) will typically be responsible for investing the cash for the term of the loan. When a covered fund engages in securities lending transactions as a lender, its lending agent would thus have investment discretion over the cash collateral pledged to such covered fund; however, such investment discretion is required to be carried out strictly in accordance with pre-established and pre-approved written cash collateral investment guidelines by the covered fund that provide the framework for managing the interest rate, credit, price and liquidity risks associated with managing cash collateral. Through these disciplines, securities lending services operate ancillary to custody services, supplementing fund performance without materially impacting investment policies or management of the fund. Accordingly, the Association does not believe that the discretion exercised by a directed trustee that provides securities lending agent services to a covered fund should be treated the same as a party having investment discretion with respect to the assets of that covered fund.

Similarly, when providing cash management services, the custodian acts in its capacity as an agent for its customers. Cash management -- another ancillary service that is typically provided by custodians to customers -- involves moving, managing and monitoring cash positions associated with securities transactions whereby customers' excess cash is invested in instruments such as time deposits, reverse repo agreements, commercial paper, money market funds, short-term investment funds, and interest-bearing accounts. Typically, customers would sign off on the counterparties, any maximum exposure to a particular counterparty, the maximum term of any instrument and possibly the maximum average maturity of the portfolio, but the custodian would have authority to select the best available rate offered within those parameters. The cash management service helps to supplement the performance of the fund with respect to cash awaiting investment in a way that, like securities lending, does not impact overall investment policies or management of the fund. Accordingly, the Association believes that the ancillary-service discretion exercised by a directed trustee that provides cash management services to a covered fund should not be treated the same as true investment discretion over the assets of that covered fund.

The Association recommends that the Proposed Rules be modified to clarify that when a banking entity acting as custodian provides ancillary services such as securities lending and cash management to a covered fund subject to limits and conditions established by a general

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partner, managing member, trustee, etc., it will not be considered a "Sponsor" under the Proposed Rules.

### *B. Banking Entities With Certain Fiduciary Duties*

As a consequence of the inclusion of non-US funds as "covered funds" in the Proposed Rules, the Association seeks clarification that the provisions of the Proposed Rules applicable to a "directed trustee" in §\_10.(b)(6) are equally applicable to trustees of non-US trust arrangements in situations where the banking entity serves as trustee of a covered fund with certain residual fiduciary duties as those may relate to the investment adviser but does not exercise investment discretion.

In common law countries, funds are often established in trust form. In a typical fund situation, the sponsor seeking to offer an investment product will identify an investment adviser for the fund, and also a trustee. The trust deed sets out the duties and obligations of the trustee and in some instances the investment adviser, and the trustee must ensure that the terms of the trust and of relevant regulations are complied with. The fundamental responsibility of the trustee is to provide custody, safekeeping and other administrative services for the fund. This is the case in much the same way as a directed trustee serves US ERISA plans.

Applicable law, and/or the trust deed may also give a trustee authority to appoint and remove the investment adviser, or in certain limited circumstances to exercise investment discretion itself. The decision to appoint or remove an investment adviser is in practice typically made by the unitholders in conjunction with the fund sponsor. In instances where the trustee is involved, it is to implement a decision made by the unitholders or sponsor. In rare cases, the investment adviser may be removed by the trustee where, for instance, the investment adviser has materially breached its legal obligations or has become insolvent. The Association is concerned that a banking entity that serves as trustee of a covered fund but has no investment discretion with respect to the fund could be deemed to "sponsor" the fund simply by virtue of its ability to engage in certain fiduciary tasks relating to appointment or removal of an investment adviser.

Accordingly, the Association seeks your confirmation that the trustee as described above qualifies as a "directed trustee" where the trustee: (i) may have inherent authority to appoint or remove an investment adviser of a covered fund -- provided such authority (a) is not exercised or (b) is only exercised in fulfillment of the trustee's fiduciary obligations as described above, and when so exercised the trustee appoints an unaffiliated investment adviser; or (ii) has the theoretical but unexercised power to make investment decisions for a covered fund directly -- provided one or more unaffiliated investment advisers have been appointed to manage the

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assets of the covered fund. In all cases, the clarification sought would apply only where the trustee is independent from the sponsor of the fund and from the investment adviser.

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The Association appreciates the opportunity to provide you with members' foregoing views regarding the Proposed Rules. Association members stand ready to discuss or supplement these comments if that would be useful to you. To initiate follow-up, please contact the undersigned at 312.861-2620 or Rosa Chang, JPMorgan, at 212.552-0358.

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Dan W. Schneider  
Baker & McKenzie LLP  
Counsel to the Association