Meeting between Federal Reserve Board Staff
and Representatives of Bank of New York Mellon, Northern Trust, and State Street
January 4, 2012

Participants: Heather Koenig and Victor Siclari (Bank of New York Mellon); Kelly Dibble and James Roselle (Northern Trust); Joseph Barry, Stefan Gavell, Suzanne Sobel-Case, and Simon Zornova (State Street)

Scott Alvarez, Felton Booker, David Lynch, Jeremy Newell, Christopher Paridon, and Laurie Schaffer (Federal Reserve Board)

Summary: Staff of the Federal Reserve Board met with representatives of Bank of New York Mellon, Northern Trust, and State Street (together, the “Custody Banks”) to discuss the restrictions on proprietary trading and hedge fund and private equity fund activities under section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as the “Volcker Rule”).

Among matters discussed in the meeting were the Custody Banks’s views regarding: overall impressions of the interagency proposal to implement the Volcker Rule; potential competitive impact of the Volcker Rule and the proposal, including the proposed provisions related to activities occurring “solely outside of the United States”; application of the so-called “Super 23A provisions” of the Volcker Rule; potential issues under foreign law related to the statutory prohibition on namesharing between a banking entity and a covered fund organized and offered by the banking entity; the proposed definitions of “directed trustee” and “covered fund”; and the statutory effective date and proposed implementation of the conformance period provided by the statute.

A copy of the handout provided by the Custody banks is attached.
1) Overly broad definition of “covered fund”

The proposed definition of “covered fund” is overly broad, capturing all non-US funds, all funds using futures, and 3(c)(1)/(7) funds with no hedge fund or private equity fund characteristics. The broad inclusion of non-US funds, that in most cases more closely resemble registered U.S. mutual funds rather than unregistered hedge/private equity funds, will present particular problems for custody banks that service these funds. The proposal should be narrowed to capture only traditional hedge fund and private equity funds, and to limit its extraterritorial scope.

2) Adverse impact of “Super 23A” restriction

The custody banks believe that normal settlement services for covered funds, to the extent they may be deemed to be provisional credit or liquidity for securities settlement, contractual settlement, pre-determined income or similar custody-related transactions, should not be considered “covered transactions” for purposes of the “Super 23A” provision of the Volcker Rule. Should such services be considered “covered transactions” under the Volcker Rule, the custody banks would not be able to provide normal custody for covered funds. As a result, sponsors and advisers of “covered funds” could be required to seek new providers of these services, creating market disruption and higher risk to payment systems, with no corresponding systemic or institution specific risk reduction benefits. The proposal should be modified to exclude core custody-related activities from the “Super 23A” restriction, as custody-related transactions, by their very nature, do not raise a risk of undue credit support for sponsored and advised funds.

3) Need for additional clarity for directed custody arrangements

The proposal’s directed trustee exception appropriately addresses U.S. arrangements where a custody bank may be a trustee for a “covered fund” but has no investment discretion. The exception, however, may be inadequate to address the broader range of custodial arrangements outside the U.S. in which a custodian may be required to provide additional fiduciary or administrative services, but does not exercise investment discretion. The proposal should clarify that custodians are outside of the scope of the definition of “sponsor” in cases where they serve in a directed, fiduciary, or administrative role and an unaffiliated third party directs the funds actual investments.

4) Effective date

The proposal appears to suggest that no new transactions subject to the “Super 23A” provision will be permitted after the statutory effective date of July 21, 2012. To the extent “Super 23A” applies to custody-related transactions, this could force sponsors or advisers of “covered funds” to change custodians, or shift some traditional custody functions to a different service provider. Such changes require long transition times, sometimes in excess of a year, and would be impossible to adopt prior to July 2012. The proposal should be revised to clarify that custody-related “Super 23A” transactions, if not fully excluded, would continue to be permitted throughout the conformance period.