October 17, 2018

VIA ELECTRONIC SUBMISSION

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street NW, Suite 3E-218
Washington, DC 20219
Docket ID OCC-2018-0010

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R-1608; RIN 7100-AF06

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AE67

Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090
File Number S7-14-18

Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington, DC 20581
RIN 3038-AE72

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The Bank of New York Mellon Corporation,[1] Northern Trust Corporation,[2] and State Street Corporation[3] (collectively, the "**Custody Banks**") appreciate the opportunity to comment on the proposed

[1] BNY Mellon is a global investments company with $33.6 trillion in assets under custody and/or administration and $1.8 trillion in assets under management as of June 30, 2018.

[2] Northern Trust is a global financial institution that provides asset servicing, asset management and banking for personal and institutional clients. Northern Trust has $10.7 trillion in assets under custody and/or administration and $1.1 trillion under management as of June 30, 2018.

[3] State Street specializes in the provision of financial services to institutional clients, including investment servicing, investment management, data and analytics, and investment research and trading. With $33.9 trillion

rulemaking, *Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds* ("**Proposed Rule**") issued by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "**Agencies**").[4]

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[5] added a new Section 13 to the Bank Holding Company Act ("**BHC Act**"),[6] commonly known as the Volcker Rule. In December 2013, the Agencies issued a final rule implementing those provisions ("**2013 Final Rule**").[7]

The Custody Banks welcome the Agencies' efforts to clarify, tailor, and simplify the 2013 Final Rule. This letter addresses two issues that are of particular concern to the Custody Banks given our limited trading activities.

Part I of this letter responds to Questions 197, 198, and 199[8] in light of our experience with the limitations in Section 13(f)[9] of the BHC Act and the implementing regulation in the 2013 Final Rule, commonly known as "Super 23A." The 2013 Final Rule should be revised to:

- Read the term "covered transaction" in the context of the entirety of Section 23A of the Federal Reserve Act and Regulation W, including the exemption for intraday credit; and

- Allow short-term extensions of credit in connection with payment, clearing, and settlement services, subject to the quantitative limits in Section 23A of the Federal Reserve Act and Regulation W.

Part II of this letter responds to Questions 3 and 4[10] regarding the proposed compliance program. The Proposed Rule should be further revised to:

- Increase the "significant trading assets and liabilities" category from $10 billion to $20 billion in trading assets and liabilities, as calculated over the previous consecutive four quarters;

---

in assets under custody and administration and $2.7 trillion in assets under management as of June 30, 2018, State Street operates in 30 countries, and in more than 100 geographic markets.

[4] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432 (July 17, 2018).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law 111-203, 124 Stat. 1376 (2010).

[6] 12 U.S.C. § 1851.

[7] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Final Rule, 79 Fed. Reg. 5535 (Jan. 31, 2014).

[8] Proposed Rule, 83 Fed. Reg. at 33487.

[9] 12 U.S.C. § 1851(f).

[10] Proposed Rule, 83 Fed. Reg. at 33441-42.

- Allow a phase-in period of at least 24 months for a banking entity to transition to a higher compliance threshold category; and

- Require agency notice and allow a banking entity to respond to an agency determination assigning a banking entity more extensive compliance requirements under the reservation of authority.

I. Limitations on Relationships with a Covered Fund

A. Background on Custody Services to Funds

Custodians provide a range of services to their institutional investor clients, including making payments and settling securities transactions. Clients may not always be able to ensure they have sufficient cash in their accounts to separately settle all their trades at any given moment given timing differences in the payment and settlement cycle; portfolio managers may trade on the expectation of end of day reconciliation of their buys and sells. A custodian may provide an advance or overdraft to the client to cover this temporary mismatch in funds to prevent payment bottlenecks, avoid breaking trades, and smooth out the settlement cycle. Clients expect these advances as part of basic payment, clearing, and settlement services provided by custodians.

These short-term extensions of credit are no different for covered fund clients than for any other custody clients, and there are a number of safeguards to protect the custodian from credit risk. They are discretionary, and not committed. They are secured by assets in the client's custody account, or sometimes by a purchase lien on specific assets. They are typically intraday, but occasionally may go longer due to settlement timing differences or unanticipated settlement delays or fails. Credit limits typically are based on the amount of assets in the client's custody account, aggregate dollar caps, and policies and procedures regarding risk limits.

The Federal Reserve recognized the importance of this type of short-term credit in exempting intraday credit extensions from the requirements of Section 23A of the Federal Reserve Act:[11]

> "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."[12]

B. Impact of Super 23A on Payment, Clearing, and Settlement Services

Section 13(f) of the BHC Act generally prohibits a banking entity that serves as an investment manager, investment adviser, or sponsor to a covered from entering into a "covered transaction" with such covered fund. Under the 2013 Final Rule, advances and overdrafts provided as part of normal course payment, clearing, and settlement services are prohibited "covered transactions" under Super

---

[11] 12 U.S.C. § 371c.

[12] Transactions between Member Banks and Their Affiliates; Final Rules and Proposed Rule, 67 Fed. Reg. 76560, 76596 (Dec. 12, 2002).

23A.[13] In practice, this means that a banking entity that sponsors, advises, or manages a covered fund cannot also provide custody services to that fund for fear of potentially engaging in a prohibited credit extension while processing routine, day-to-day transactions.

As a result, these covered fund clients are forced to split traditionally bundled services among multiple providers and choose servicing arrangements that may not represent the first choice of the funds, their boards, and their investors. Since 2013, custodians and investment advisers and managers have severed existing, or declined new, relationships with covered funds to avoid Super 23A compliance issues. For bank-affiliated investment management firms and their covered funds, Super 23A forces the fund to replace its preferred affiliated banking entity as a custodian. For third-party covered funds, Super 23A forces the fund to choose a banking entity for custody services *or* advisory and management services; it cannot use the same banking entity for both.

There is no obvious corresponding policy benefit or risk reduction. Funds will continue to pay other custodians for these services, and the other custodians will continue to provide these advances and overdrafts to facilitate payment, clearing, and settlement. The key disadvantage and new risk that this regulatory prohibition creates is that clients do not get their "first choice" provider. Instead, clients must find secondary replacement providers and split bundled turnkey services (*e.g.*, fund accounting, fund administration, and custody) among multiple providers. From an operational perspective, splitting services among multiple providers decreases transparency, increases the risk of processing errors, and increases the risk of miscommunications. From an efficiency perspective, splitting services increases costs for funds (and by extension investors) and increases the time and resources needed to find adequate replacement providers. Finally, from a business perspective, custodian banks and their affiliated investment managers forego fees from fund clients that are based on servicing relationships rather than proprietary trading. All of these adverse consequences run counter to the statutory policy goals of the safety and soundness of banking entities and the financial stability of the United States.[14]

C. Regulatory Authority to Address the Unintended Outcomes of Super 23A

This outcome was not the intent behind the Volcker Rule. It results from an unduly restrictive reading of the term "covered transaction" in the 2013 Final Rule that is contrary to the plain language of Section 13(f) of the BHC Act.

The Agencies have broad authority to clarify that intraday and short-term extensions of credit in connection with payment, clearing, and settlement services are permitted under Section 13(f). These adjustments would allow custodians to provide normal course payment, clearing, and settlement services to covered fund clients consistent with the statutory language and intent behind the Volcker Rule.[15]

---

[13] *See, e.g.*, 12 C.F.R. § 248.14(a)(1).

[14] *See, e.g.,* 12 U.S.C. § 1851(d)(1)(J)

[15] *See, e.g.*, Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies, Hearing 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), at 50-51, *available at* https://www.gpo.gov/fdsys/pkg/CHRG-111shrg57709/pdf/CHRG-111shrg57709.pdf.

i. Amend the 2013 Final Rule to Incorporate the Exemptions in Section 23A

Under the plain reading of the statute, Section 13(f) incorporates the entirety of Section 23A of the Federal Reserve Act.[16] It does not refer to a specific subsection of Section 23A. In fact, when Congress intended a provision of the Volcker Rule to refer to a specific subsection of the Federal Reserve Act, it did so expressly.[17]

Unfortunately, the regulation implementing Section 13(f) took another view. The 2013 Final Rule defines "covered transaction" solely with respect to the enumerated list of transactions in Section 23A(b)(7).[18] The regulation does not reference the remainder of Section 23A, including exempt transactions in Section 23A(d) or the Federal Reserve's authority to issue further regulations and orders to "administer and carry out the purposes of this section" in Section 23A(f). This failure to construe the term "covered transactions" in light of the entirety of Section 23A has led to the impractical and adverse outcomes described above—including expansion of risk to the financial system rather than reduction.

The 2013 Final Rule should be revised to incorporate the exemptions in Section 23A(d) of the Federal Reserve Act and Regulation W, as Congress intended in Section 13(f) of the BHC Act. This natural reading of the statute would address the issue of intraday credit extended to facilitate normal course payment, clearing, and settlement services provided by custodians to covered funds.

ii. Amend the 2013 Final Rule to Allow Short-Term Extensions of Credit in Connection with Payment, Clearing, and Settlement Services Consistent with Section 23A of the Federal Reserve Act and Regulation W

The 2013 Final Rule should be revised to permit short-term credit extensions in connection with payment, clearing, and settlement services, subject to the quantitative limits of Section 23A and Regulation W. Without this related revision, custodians still could not provide normal course payment, clearing, and settlement services to covered funds for fear of a "cliff effect" in case intraday credit extends overnight.[19]

The Agencies have at least two sources of authority to revise Super 23A to permit such short-term extensions of credit. First, the Agencies have broad and general authority to issue such a revision to

[16] 12 U.S.C. § 1851(f)(1). "No banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to paragraph (d)(1)(G), and no affiliate of such entity, may enter into a transaction with the fund, or with any other hedge fund or private equity fund that is controlled by such fund, *that would be a covered transaction, as defined in section 371c of this title.*"

[17] *See, e.g.*, 12 U.S.C. § 1851(h)(1)(D)(ii) (defining the term "banking entity" and specifying that such institution does not "exercise discount or borrowing privileges pursuant to section 461(b)(7) of this title."). 12 U.S.C. § 461(b) is Section 19 of the Federal Reserve Act.

[18] *See, e.g.*, 12 C.F.R. § 248.14(a)(1).

[19] A separate exclusion for short-term credit extensions in connection with payment, clearing, and settlement services is not necessary in the context of Section 23A of the Federal Reserve Act because Section 23A *permits* such short-term extensions of credit. Super 23A, by contrast, flatly *prohibits* all such short-term extensions of credit, regardless of the protective constraints on the transaction.

further the goals of the statute.[20] Second, the Agencies have specific authority to permit an activity that "would protect the safety and soundness of the banking entity and the financial stability of the United States."[21] This related exclusion for short-term extensions of credit would be consistent with existing safety and soundness rationales to exclude intraday exposures in Section 23A: to facilitate settlement transactions when there are temporary cash flow mismatches between funds sent and received.[22] These normal course short-term extensions of credit allow the efficient and safe operations of markets and their participants in the United States and around the world.[23]

iii. The Benefits of a Change Outweigh the Costs

The benefits of these changes would be real. As the Agencies recognize in the Proposed Rule, these "changes would increase banking entities' ability to engage in custody, clearing, and other transactions with their covered funds and benefit banking entities that are currently unable to engage in otherwise profitable or efficient activities with covered funds they sponsor or advise. Moreover, this could enhance operational efficiency and reduce costs incurred by covered funds, which are currently unable to rely on their affiliated (and in some cases, an unaffiliated) banking entity for custody, clearing, and other transactions."[24] Finally, this change would further the statutory goal of promoting and protecting the safety and soundness of the banking entity and the financial stability of the United States by reversing lost revenue and increased operational risk, which are just some of the adverse consequences the current interpretation of this provision has on banking entities relative to covered funds.[25]

The costs of these changes, if any, would be speculative. Transactions between a banking entity and covered funds would continue to be subject to the limitations in Section 23A of the Federal Reserve Act and Regulation W, as well as other restrictions on relationships between banking entities and covered funds.[26]

---

[20] *See* 12 U.S.C. § 1851(b)(2).

[21] *See* 12 U.S.C. § 1851(d)(1)(J).

[22] *See* 67 Fed. Reg. at 76596.

[23] Should the Agencies seek to do so, the revised rule could limit the exclusion for short-term credit to an "extension of credit that arises in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions." This is the language previously proposed by the Federal Reserve in connection with the exemption for intraday credit in Section 23A. *See* Application of Sections 23A and 23B of the Federal Reserve Act to Derivative Transactions with Affiliates and Intraday Extensions of Credit to Affiliates; Interim Rule, 66 Fed. Reg. 24186, 24200 & 24215 (May 11, 2001) (proposed 12 C.F.R. § 223.16(k)) (proposing to exempt only intraday credit extensions "arising in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions . . . ."). The Federal Reserve ultimately did not adopt this limitation and extended the exemption to *all* intraday credit. 12 C.F.R. § 223.42(l).

[24] Proposed Rule, 83 Fed. Reg. 33548.

[25] *See* 12 U.S.C. § 1851(d)(1)(J).

[26] Proposed Rule, 83 Fed. Reg. at 33547-48.

The CFTC's Division of Swap Dealer and Intermediary Oversight ("**DSIO**") reached a similar conclusion in Staff Letter 17-18.[27] The Futures Commission Merchant ("**FCM**") in that letter represented that relief from the limitations of Super 23A "would prevent significant disruption of its FCM operations and client relationships."[28] Further, the FCM represented that, without no-action relief, covered fund clients for which affiliates of the FCM undertakes fund services "would need to transfer their accounts to other unaffiliated FCMs, which likely could result in a loss to the covered funds of tested clearing processes and systems, a loss of operational and risk management efficiencies, and potential exposure to higher credit risks."[29] And finally, the FCM asserted that, without the relief, "covered funds would be precluded from using FCMs affiliated with investment managers of covered funds thereby narrowing the choice of those fiduciaries in meeting their optimal execution obligations for FCM services."[30] The DSIO agreed, granting no-action relief for futures, options, and swaps clearing services provided by a registered FCM to covered funds for which affiliates of the FCM were engaged in the fund services identified in Super 23A.[31]

The CFTC proposes to extend this relief from the requirements of Super 23A to all FCMs performing futures, options, and swaps clearing services because "[p]roviding such clearing services to customers of affiliates does not appear to be the type of relationship that was intended to be limited under section 13(f) of the BHCA."[32] The other Agencies do not object to this position.[33] To assure consistent and comparable treatment, similar relief should be provided for short-term extensions of credit provided by banking entities in connection with payment, clearing, and settlement services to all covered funds.[34]

II. Compliance Program

The Custody Banks welcome the Agencies' efforts to tailor the compliance regime. We agree that streamlining the compliance program for banking entities with moderate trading assets and liabilities ("**TAL**") is appropriate because the scale and nature of these banking entities' activities and investments do not justify the additional costs of the more significant and complex compliance program.

The Custody Banks recommend, however, that the threshold for entities with "significant" TAL be increased from $10 billion to $20 billion in TAL, as calculated over the previous consecutive four quarters. We believe that the $20 billion threshold will continue to capture the banking entities with the most significant trading activities while allowing banking entities with more limited trading activities a wider TAL range to manage their businesses without triggering a "cliff effect" of new compliance requirements. The wider TAL range would account for potential fluctuations from customer-driven

---

27 CFTC Staff Letter 17-18 (March 29, 2017).

28 *Id.* at 3.

29 *Id.*

30 *Id.*

31 *See id.*

32 Proposed Rule, 83 Fed. Reg. at 33487.

33 *Id.*

34 *See* 12 U.S.C. § 1851(b)(2)(B)(ii).

trades, quarter-end activity, and market and foreign exchange volatility. Finally, the wider TAL range would allow moderate, organic growth over time.

Given the different compliance obligations in the different categories and potential fluctuations between categories, we recommend a phase-in period of at least 24 months for a banking entity to transition to a higher threshold category. For a banking entity that moves into a lower TAL category, that entity should be permitted to move into the compliance program for the lower category immediately.

Finally, the Agencies should provide for notice and response procedures similar to those in Section __.20(g)(2)(ii) of the Proposed Rule for agency determinations assigning a banking entity more extensive compliance requirements under the reservation of authority.[35] A banking entity should have the opportunity to respond to an Agency's discretionary increase in compliance requirements.

* * *

The Custody Banks appreciate the opportunity to comment on the Proposed Rule. If you have any questions, please contact Eli K. Peterson at (202) 624-7925; Dale K. Nichols at (312) 444-3835; or Stefan M. Gavell at (617) 664-8673.

Respectfully submitted,

Eli K. Peterson

Managing Director
Head of Regulatory Policy and Government Affairs

The Bank of New York Mellon Corporation

Dale K. Nichols

Senior Vice President
Deputy General Counsel

Northern Trust Corporation

Stefan M. Gavell

Executive Vice President
Head of Regulatory, Industry, and Government Affairs

State Street Corporation

[35] Proposed Rule, §__.20(h).