THE ASSOCIATION OF GLOBAL CUSTODIANS

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Federal Ministry of Finance
Wilhelmstrasse 97
Berlin
Germany
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Re: German Investment Statute Consultation Proceeding – Comments Directed to Matters Affecting Custodian/Depotbank Duties in Servicing Hedge Funds, Funds of Hedge Funds and Real Estate Funds

Dear Sirs and Madams:

This letter is submitted on behalf of the Association of Global Custodians (the "Association") in response to your consultative request of April 20, 2005, for views regarding potential changes to the German Investment Statute to clarify the various roles and responsibilities of investment funds, prime brokers and custodians (also referred to throughout this letter as "depotbanks") in relation to hedge funds and real estate funds. We believe, as more fully set out below, that it is timely to make significant clarifying refinements in the regulatory principles in this area and that those changes should more closely correlate legal responsibilities with functional practicalities, as well as actual contractual relationships extant in market arrangements. As agreed with Dr. Stossberg on June 22, 2005, we will supply a German translation of this letter of comment by July 8, 2005. We appreciate the opportunity to provide you with the Association's views.

The Association is an informal group of nine global banking institutions that provide a variety of cross-border portfolio asset custody and related services to institutional investors active in markets throughout the world. Among other activities,

members of the Association, either directly or through their European branches and affiliates, act as custodians and/or trustees and administrators for various alternative investment funds organized in European jurisdictions, including hedge funds, funds of hedge funds and real estate funds originated in the Federal Republic of Germany, among other jurisdictions. Members of the Association are listed on the letterhead above.

Our comments below are arranged to address the numbered questions identified in the consultative paper in Section B2 – "Hedge Funds: The Role of the Prime Broker" and in Section D – "Real Estate Funds".

I. Question B.2.1: Hedge Funds -- How can the role of the prime broker be defined in the statute?

Based on Association members' experiences serving funds and working with prime brokers, we believe that it would be very useful to the market and practitioners to set out more detailed regulatory guidance in the statute with respect to the roles and responsibilities of various market participants. As explained in our comments below, the generality of the current statute and limited interpretive guidance have created uncertainty about the respective duties and liabilities of funds, custodians and prime brokers, and have led to inefficient allocations of responsibilities for monitoring fund and prime broker compliance. Suitable statutory and regulatory guidance would improve the safe, efficient and regularized assimilation of alternative products such as hedge funds and funds of hedge funds.

Accordingly, in our view, the core functions and responsibilities of the prime broker should be identified in the statute, and supplemental functions, such as those that are flexibly structured for particular funds, should be required to be addressed by contractual agreements between the appropriate parties, notably the prime broker and the relevant hedge fund. Including such definitional provisions in the statute seems likely to reduce uncertainty regarding the respective roles and duties of prime brokers, funds, and depotbanks.

II. Question B.2.3: Hedge Funds -- Which contractual models for the services of a prime broker should be regulated in the statute (sub-custodian model, direct agent model, or other solutions, such as the complete replacement of the custodian by the prime broker)? Which models are customary and proven internationally?

Overall responses.

We believe the sub-custodian appointment model is appropriate and suitable in this context. We also believe that the direct agent model provides useful benefits and protections, assuming the arrangements in fact incorporate the asset safekeeping services and facilities of an independent depotbank.

The sub-custodian appointment approach is common in some jurisdictions (*e.g.*, Ireland). With respect to this approach, it is important to recognize that a depotbank's ability to pre-qualify and select the prime broker in an informed manner in the best interest of the fund is commonly quite limited, as is its ability to oversee, in fact, various services that the prime broker may provide directly to the applicable fund (*e.g.*, facilitating short selling, collateral reporting, etc.). These limitations make sound selection and effective supervision of such services by a depotbank difficult to achieve in practical terms. In view of those types of limitations and the encumbering obligations associated with sub-custodian appointments, statutory and regulatory clarity concerning the nature and appropriate scope of the respective responsibilities and liabilities of prime brokers and depotbanks is critical to effective and predictable service arrangements.

Alternatively, protections associated with a subcustodial arrangement can also be achieved with clarity and assurance contractually through the direct agent approach, thereby providing (i) direct contractual recourse of the fund and its investors to assets and insurance arrangements of the prime broker and (ii) flexibility in structuring the contract with the prime broker. We thus believe that both models – both contractual approaches -- should be available for use in the market assuming in each case that a depotbank performs the needed safekeeping functions.

In summary, to ensure that sufficient concrete guidance to the market is established via statute, the scope of respective responsibilities of funds, prime brokers and depotbanks should be clearly set forth and should be structured to reflect the scope of powers and functions typical and suitable to the respective parties.

Specific Points of Legal Concern.

In acting as depotbanks and appointing and monitoring prime brokers under the existing statute and the interpretations of the Federal Ministry of Finance ("FMF"), the German Banking Association, and the BVI Rules of conduct for these fund types, Association members have identified various points of legal concern -- notably, the overbroad scope and undue effect of obligations that are triggered or implied in connection with (i) appointment of a prime broker as an agent of the depotbank; (ii) monitoring of fund investment compliance and the investment compliance of target funds, particularly in the case of funds of hedge funds; and (iii) review of pricing methodologies for illiquid investments in underlying funds. In members' experience, these points of concern are aggravated by the current lack of regulatory and interpretive details concerning depotbank responsibilities and functions.

We therefore urge the FMF to structure amendments to the statute so as to provide more detailed guidance and greater clarity. Clarity is particularly needed in: (i) allocating the monitoring and supervision responsibilities with respect to prime broker service activities to the fund, on the one hand, and with respect to the prime broker's custodial functions to the depotbank, on the other; (ii) confirming that the primary responsibility for ensuring fund investment compliance by target funds resides with the fund; and (iii) confirming that the primary responsibility for pricing of the fund investments resides with the fund. These allocations are not likely to conflict with the depotbank's proper and limited scope of oversight.

Prime broker appointment and oversight. The German Investment Act (hereafter, the "Investment Act"), Chapter 4 (Hedge Funds), Section 112 (3), as supplemented by the Guidance Notes of the FMF, May 24, 2004, regarding prime broker activities (hereafter, "Guidance Notes") sets out very general regulatory principles concerning depotbank duties. Those sources effectively dictate that depotbanks engaged in a custodial capacity by the applicable fund incur liability with respect to selection and appointment of prime brokers and in connection with supervising such entities' key activities. These liability risks are typically put into effect where the depotbank appoints the prime broker directly or jointly with the investment manager of a fund and where the arrangements among the fund, the depotbank, and the prime broker cause the depotbank to assume oversight responsibilities or supervisory functions over the prime broker.

In revising the statute, we urge the FMF to recognize the practical and substantial limitations, noted above, that a depotbank - as a custodian - faces when asked to select or monitor a prime broker (or any other third party that services the fund). Compounding those practical problems, the generality of the statutory and interpretive guidance have led to uncertainty about the scope of duties and liabilities incurred by a depotbank. For example, the extent to which a depotbank is obliged to duplicate the records of a prime broker relative to a fund is not clear and could impose both unnecessary costs and recordkeeping risks on the depotbank. On this issue we urge the FMF to adopt the view, as in other jurisdictions, that the depotbank may utilize and rely on the records of its sub-custodial prime broker, subject to appropriate terms for reasonable access. Timely amendments to the statute seem likely to provide needed regulatory clarification and function-appropriate changes in the expected arrangements, responsibilities and liabilities for appointing and supervising prime brokers.

Monitoring fund asset valuations. Additional points that merit clarification relate to monitoring or overseeing the pricing of fund shares for valuation purposes, as well as compliance with investment guidelines or restrictions, in the case of a fund of funds, including a fund of hedge funds. These monitoring duties arise under the foregoing sections of the statutory and interpretive guidance as supplemented by the Investment Act, Chapter 3 (Depositary Bank), Section 27 (1) and the BVI Rules of Conduct (January 15, 2004) Section V, para. 7.

Funds of funds are necessarily complicated by their layered structure. Depotbanks are not positioned as a matter of contract or practice to audit or otherwise verify the pricing calculations and decisions made by the underlying hedge funds themselves, or, more generally, to oversee investment compliance by those underlying hedge funds for which a depotbank is not the appointed execution agent. Although it has become customary for depotbanks not to monitor or verify the calculation of the underlying funds' net asset value by the underlying fund administrators, it would be valuable to have statutory or regulatory confirmation of that custom. In addition, it would be useful to establish that a depotbank's oversight duties in respect of a fund of funds' investment compliance are narrow.

Look-through requirements for funds of funds. As a by-product of the statutory and interpretive uncertainty, depotbanks may be perceived as having an obligation to monitor target funds' investment compliance, including in situations where necessary supporting information is not readily available from prime brokers and other parties

involved in relevant fund arrangements or transactions. Examples of such situations include the following:

- The fund is permitted to acquire foreign target funds as fund assets only if the target funds' assets are held in custody by a custodian bank or "another comparable institution";

- The fund is permitted to purchase no more than two target funds that are managed by the same underlying fund manager;

- The fund is not permitted to purchase target funds that invest in other funds;

- The fund is required to monitor the target funds continuously to ensure investment strategy compliance and to that end must obtain generally recognized risk ratios at regular intervals.

It is apparent that the tiered structure of any fund of funds makes compliance oversight in the foregoing situations very difficult. In critical respects, the depotbank as a remote third party is neither well-situated nor disposed by experience to perform such oversight; and this is true even when information about target fund activities and transactions is accessible to depotbanks. In short, it would be useful to clarify depotbank responsibilities in such situations in ways that more closely correlate duties and liabilities with the typical base of experience and expertise of a custodian.

III. Question B.2.4: Hedge Funds -- What types of liability should be written into the statute in the event of harm to the investor in connection with each of the various types of contracts?

With respect to the engagement of prime brokers under either contractual model, prime brokers should be liable under the statute to the hedge fund and the depotbank for any breach of the contractual terms and the prime broker should be liable for losses, damages, costs, and expenses arising as a direct or indirect result of the prime broker's negligence, fraud, willful misconduct or bad faith, consistent with the liability imposed upon any other service provider to the hedge fund for breach of its responsibilities to the hedge fund. To the extent that the depotbank and the hedge fund jointly appoint a prime broker, the nature and scope of liability of the depotbank should take into account the limitations described in response to Questions B.2.3 above and should be confined to matters relating to custody oversight functions.

IV. Question B.2.5: Hedge Funds -- What should be the statutory regulations for the transfer of securities to the prime broker as surety when required in the course of business?

It would seem in the interest of funds and investors to establish standards for prime brokers to (i) maintain certain capital or rating requirements and (ii) provide to the depotbank online record access to hedge fund assets in the prime broker's possession. Such standards would be consistent with current regulatory requirements for prime brokers in Ireland.

In addition, it would seem appropriate to mandate that contractual arrangements between prime brokers and hedge funds include the following assurances, among others: (i) maintenance of adequate insurance or other indemnification arrangements for the protection and replacement of assets held on behalf of the hedge fund; (ii) the exercise of care with respect to hedge fund assets at a standard that is consistent with the standard imposed upon the depotbank; (iii) the maintenance of adequate records and suitable reporting to the hedge fund and the depotbank; and (iv) appropriate limitations on the ability of the prime broker to re-hypothecate hedge fund assets. Such assurances, which are typically called for in hedge fund service agreements, work to protect investors and strengthen the integrity of the products.

V. Question D.II.8: Real Estate Funds -- Should the selling of real property at prices below those assessed in the expert opinion be permitted?

It is our view that matters of this sort, including the sale of real property at prices below those of an assessed valuation or a determination as to the adequacy of an independent appraisal, are matters of corporate governance properly consigned to the fund's governors and its appointed independent experts. Despite that general principle, depotbanks that serve German real estate funds have been required in practice to assess the adequacy and accuracy of independent real estate asset valuations provided by independent real estate appraisers. This set of responsibilities appears to be derived from Investment Act, Ch 3, Section 27 (2) as supplemented by the BVI Rules of Conduct Section V, Para. 7. However, neither the safekeeping role nor the administrative capabilities of depotbanks give them special expertise in making such assessments, and this form of oversight responsibility (including any determination relative to a sale at less than an independently appraised value) is appropriately lodged with the capital investment company and its independent experts rather than with the fund's custodian.

Accordingly, in our view, where a real estate fund has obtained a new independent appraisal demonstrating the decline in value and has documented the reasons for such decline and the projected future cost savings to the fund or other similar benefit as a result of the sale, the capital investment company has a basis for permitting such a sale as in the best interest of investors. The FMF should structure amendments to the statute that would place the responsibility for decisions such as these with the capital investment company and appropriate appointed experts rather than the depotbank.

VI. Question D.IV.10: Real Estate Funds -- How can the corporate governance of Open-End Real Estate Funds be improved – particularly with the current background of charges of corruption within the real estate business being publicly discussed? Are additional internal or external control mechanisms necessary? How can the wording of these regulations regarding conflict of interest in Article 9 InvG be more specific?

Although the Corporate Governance Codex was introduced in Germany in 2002 (the "Codex"), adherence to the Codex is not currently prescribed by law. In our view, adherence is very important for investment funds and the protection of investors. Indeed, as some members have observed in Germany, investors are willing to pay a premium for funds that demonstrate corporate governance in accordance with the Codex.

We understand that discussions at the BVI regarding corporate governance and the Codex have resulted in the formulation of 'Wohlverhaltensrichlinie' for BVI members. These guidelines require:

- A positive correlation between the increase of net asset value of a fund traded on a stock exchange and its demonstrated level of corporate governance;

- Investment companies and funds must act in the interests of investors only and properly execute voting rights so as to advance investors' interest;

- The investment fund must exercise voting rights for investors in a manner intended to promote the steady increase in the net asset value of the fund;

- The investment fund must adopt measures designed to prevent conflict of interests within the fund's governing body and affiliates (including the parent company);

- The investment fund should not hold a position on the supervisory board of any portfolio company; such positions should be held by an independent party.

In addition to promoting effective governance through prudent and appropriate guidelines such as those suggested by the BVI, governance can benefit by requiring (i) the adoption of written compliance procedures by the fund that are designed to prevent violations of the Codex, (ii) an annual review of such policies and procedures for adequacy and effectiveness, and (iii) the designation of a compliance officer for the fund to carryout such policies and procedures.

Supplementally, the composition of the board of the capital investment company can affect sound decision making and avoid the appearance of conflicts. For example, a certain percentage of board members can, and we believe should, be required to be independent of the fund, the investment manager, and any affiliate.

Although sound corporate governance is important to investor protection and should enhance the viability of the fund industry in Germany, we believe that the responsibility for ensuring such governance should not reside with the depotbank. As described in our responses relating to hedge funds above, such an oversight role is beyond the control and typical expertise of the depotbank.

VII. Question D.VII.1: Real Estate Funds -- Should the role of the custodian bank with regard to special real estate assets continue in its present form?

Under the Investment Act, Section 36, Para. (1), the value of a fund is to be determined by the custodian bank in cooperation with the capital investment company, or by the capital investment company by itself. Effectively, the custodian bank is required to perform plausibility checks on the valuations of the underlying real estate assets. As previously discussed in response to Question D.II.8, the present role of assessing the adequacy and accuracy of independent real estate asset valuations is not properly delegated to the depotbank. In our view -- particularly given uncertain guidance regarding any role of the depotbank in conducting plausibility checks -- such evaluations are best undertaken by the fund's governing body and investment advisor, as each must by the nature of the fund possess such expertise.

In this regard, we note the position taken with respect to real estate funds in Luxembourg. There, the appointment and qualification of an independent appraiser is subject to approval by the regulator; and the accuracy and adequacy of initial and subsequent independent appraisals are ultimately evaluated by the fund's governing body. Appropriately, the role of the custodian is limited to alerting the fund's governing body in the event that the most recent independent appraised value of a property deviates from any previous appraised value of which the custodian is aware. Following an evaluation of such appraisal by the fund and an agreement as to its methodology and conclusions, the appraisal may be accepted without further inquiry. We believe this position, taken in Luxembourg, not only serves the best interests of the investors, but also properly recognizes the traditional role and limited expertise of the custodian bank.

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Conclusion. In practice, to manage the broad range of duties currently imposed on depotbanks despite the narrow scope of a depotbank's powers and processing role, some Association members attempt to obtain relevant written assurances from the funds or fund managers and the respective service providers. They also attempt to see that special disclosures and disclaimers are inserted in the fund's offering documentation to describe the relative roles, responsibilities and liabilities of the various parties. These efforts are not universal, however, and under the current statute and interpretations the responsibility (and potential liability) nonetheless may rest or be construed as resting on the depotbank. We believe that these results entail liability risks for depotbanks that are not commensurate with their role and powers. As a result, we believe that statutory changes should more closely track the actual contractual relationships among and functions of the respective market participants and should focus the various duties on the appropriate parties. Such adjustments in the regulatory scheme would improve the allocation of duties and liabilities and would strengthen the integrity of service agreements.

Thank you for the opportunity to convey the views of Association members. Please contact Susan Neel Morrison at 617.772.2198 for additional information.

Sincerely,

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