AGC Americas Focus Committee

Submitted electronically

28 June, 2019

Chief Counsel's Office
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219

Re: OCC Advanced Notice of Proposed Rulemaking, *Fiduciary Capacity; Non-Fiduciary Custody Activities*, 84 FR 17967 (April 29, 2019).

Ladies and Gentlemen:

We write on behalf of the Americas Focus Committee of the Association of Global Custodians (the "AGC"),[1] to provide participating members' views concerning the Office of the Comptroller of the Currency's ("OCC") advance notice of proposed rulemaking ("ANPR") on *Fiduciary Capacity and Non-Fiduciary Custody Activities*. The AGC welcomes the opportunity to provide input to the OCC on the ANPR, which covers important components of the regulatory framework for custody and fiduciary activities conducted by national banks and federal savings associations. This regulatory framework has historically enabled banks to offer a wide range of custody and fiduciary products and activities in response to developments and changes in customer demands, industry trends, and state laws.

Given the focus of the AGC, and our members, this letter addresses the non-fiduciary custody activities aspect of the ANPR. In our opinion, the potential rulemaking suggested in the ANPR would impose an undue and conflicting regulatory burden for national banks and federal savings associations engaging in custody and fiduciary activities, and would not reduce uncertainty or materially enhance the safety and soundness of the institutions engaged in the business. The AGC therefore recommends that the OCC reconsider its intent to modify the regulatory framework for custody activities through the introduction of a new regulation. We have provided further details below which outline our reasoning and rationale for coming to this conclusion.

The ANPR states that the custody business of banks is significant, with approximately $41 trillion in assets held by OCC-regulated entities, and that the lack of requirements set out in regulation may pose a risk to those institutions. The ANPR points out that the current OCC regulations that apply to custody when a bank acts as a *fiduciary* (e.g., trustee) require that the bank provide adequate safeguards and controls over fiduciary assets, keep fiduciary account assets separate from bank assets and maintain and segregate certain records related to fiduciary accounts. The ANPR further notes that the OCC does not currently have in place formal regulations to govern custody services provided when a bank is not acting as a fiduciary and asks whether regulations should be considered in light of the growth in the size of non-fiduciary assets. The ANPR also indicates that if the OCC

[1] Established in 1996, the Association of Global Custodians (the "AGC" or "Association") is a group of 12 financial institutions that provide securities safekeeping services and asset-servicing functions to primarily institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory and market structure matters through comment letters, white papers and interaction with legislative and regulatory authorities and financial industry organizations. The member banks are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses.

proposes and adopts non-fiduciary custody regulations, it could apply the same standards to fiduciary custody accounts.

While we recognize the importance and significant size of the custody business, the AGC believes the introduction of further regulatory requirements for national banks and federal savings associations covering non-fiduciary custody activities is unnecessary and could impose significant risk and legal uncertainty. This will ultimately impede rather than support custodians' ability to competitively meet the needs of their clients.

1. Non-Fiduciary Custody Activities Are Subject to Adequate Regulation and Supervisory Oversight.

As identified in the ANPR, national banks are currently subject to numerous regulatory frameworks and legal regimes covering non-fiduciary custody activities, some of which are highlighted below. In our view, these regimes already cover the core concerns raised by the OCC, and a national bank's violation of them can be the basis of an enforcement action. Additionally, the OCC has broad prudential authority to monitor and take supervisory actions against banks from a safety and soundness perspective with respect to both their compliance with these regimes and their conduct of the custody business in general without the need to rely upon a specific and prescriptive set of non-fiduciary custody regulations. In this regard, the OCC has previously issued considerable guidance in the form of Comptroller's Handbooks and Bulletins addressing custody generally, as well as custody for certain types of clients and assets, which clearly lay out the supervisory expectations.

Article 8 of the Uniform Commercial Code ("UCC") imposes specific requirements on securities intermediaries, such as bank custodians, with respect to the safekeeping and servicing of assets held on behalf of their clients. Specifically, UCC section 8-503 provides that to the extent necessary to satisfy its clients' interest in a financial asset "all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary...."[2] This effectively imposes upon custodians a segregation requirement, and the full protection of client assets. Further, UCC section 8-504 expressly requires that custodians promptly obtain and maintain financial assets in sufficient quantities to satisfy the entitlements of its clients and prohibits custodians from pledging or rehypothecating clients' financial assets except to the extent affirmatively agreed by its client. Other sections of Article 8 require the securities intermediary to support the settlement of securities transactions (§8-507), exercise rights relating to financial assets held in custody in accordance with the client's instructions (§8-506), and to obtain income and other distributions owing on the financial assets held for its clients and credit them to its clients' accounts (§8-505). This explicit and uniform protection of customer rights provided in US statutory law is a more effective way to assure those rights than a European-style prescriptive regulation of custodial practices.[3]

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[2] Given this allocation of the ownership of a securities intermediary's financial assets, segregation of client and proprietary assets is not strictly necessary. The AGC recognizes that as a prudential matter such segregation facilitates the verification that sufficient financial assets are available to satisfy client claims, and accordingly as a supervisory matter the OCC can require it, without a regulation.

[3] Although the UCC will not govern custody business entered into by non-U.S. branches of national banks, it is our experience that the jurisdictions in which substantial custody

It is important to note that a general regulation on custody services would not have the usual effect of interpreting and elaborating the requirements of a federal statute administered by the agency adopting the regulation. Because the underlying law is state law (principally Article 8 of the UCC), the regulation would most likely instead attempt to codify "best practices"; a role that is better left to the more flexible current system of Comptroller's Handbook and examination manuals than to regulations.

Given the adequacy of the current regulatory framework the AGC believes it is unnecessary to promulgate a new regulation that imposes additional requirements on national banks' non-fiduciary custody activities.

2. The Implementation of Minimum Safekeeping Standards Would Be Likely to Impose Undue Burdens on National Banks and Federal Savings Association, Restrict Fair and Free Competition in the Market, and Result in More Costly and Less Flexible Service to Clients

The ANPR mentions that the United Kingdom ("UK") and the European Union ("EU") have adopted regulatory regimes setting out minimum safekeeping standards for custodians, and that these regimes have in many respects been strengthened since the financial crisis of 2008. For a variety of reasons, the AGC believes that instituting a similar regime in the U.S. – applicable only to national banks and federal savings associations – would be burdensome and tend to restrict the services available to clients.[4]

As an initial matter, the European safekeeping and segregation regulations – found in the Undertakings Collective Investment in Transferable Securities ("UCITS") and the Alternative Investment Funds Managers Directive ("AIFMD") and in other sources, such as the Financial Conduct Authority ("FCA") Handbook in the UK – are reflective of a much different regime than is present in the U.S. The regulations are applicable to all depositories (not just a segment of the providers in the space), who when providing custodial services for clients do so in a largely fiduciary capacity. In this regard, the European regulations rightly track U.S. fiduciary standards, with express rules governing oversight, control and segregation. These fiduciary style rules should not apply to the U.S. custodial market in the same way, where the custodial relationship is intended to be much narrower than under the depository regime in Europe.

The minimum safekeeping standards, if applied to custodial activities in the U.S. , could prevent national banks and federal savings associations from engaging in typical market activities, or require the impacted institutions to pass through to clients increased costs. For example, it is market practice in the U.S. to treat certain types of assets as "memo postings" or "held away" assets for which custodians do not take responsibility for safekeeping and instead provide a more limited range of reporting and income collection services. Examples include loan participations and

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business is conducted have their own rules, to which the national bank's local branches would be subject. If the OCC were to promulgate rules that governed the custody business of these branches, there would be a significant risk of conflict with local law.

[4] We also note that in many cases where a prescriptive regime has been put in place the regulators tasked with administering them have responsibility for enforcing conduct rules but not for prudential oversight. Accordingly, it is more important for those regulators to have detailed conduct standards in place than it may be for the OCC.

investments in alternative funds, and the reason for the "memo posting" treatment is that it is not practicable for a custodian to enter into the chain of legal title for the asset. Similarly, in cases where securities are registered on the books of a transfer agent, it may not be practicable for a custodian to perform the reconciliations necessary to assure that the position continues to be in place on an ongoing basis given the number of entities that maintain the share records for such issues and the lack of a standard system that would facilitate automated reconciliations. The custodian's obligations for these types of holdings is clearly addressed by contract, and the risks are understood and accepted by the client. In Europe, however, this arrangement would not be available for regulated funds.

Under UCITS, for example, if the asset is of the type that can be held in custody, the custodian is strictly liable for its loss. If it is not, the custodian would be responsible on an ongoing basis for validating the existence and location of the asset. Similarly, for certain currencies and under certain circumstances, it may be desirable for a custodian to place cash in a local market as agent for its client and hold the cash in a manner similar to a security held in custody rather than maintain it as a deposit liability at the custodian itself. In these cases, the custodian would perform periodic reconciliations, much as it would for securities held in custody in the same market. In the UK, however, these types of arrangement are subject to a highly detailed set of rules regarding the maintenance of client money. These rules are extremely burdensome, to the point that some custodians refuse to do cash placements of this kind. The costs associated with these responsibilities are significant, and implementing similar requirements in the U.S. – and applying them to only a portion of custodial providers (namely, national banks and federal savings associations) – would impose an inequitable burden on impacted providers that would have a material impact on the services provided and the cost to clients.

The European requirements regarding segregation in the regimes cited above and the Central Securities Depository Regulation, on the other hand, reflect the view that under EU or UK law clients are likely to have a greater degree of protection if their assets are segregated throughout the chain of custody, down to and including at the Central Securities Depository ("CSD"). The UCC, on the other hand, takes a different approach, under which each custody client has a pro rata interest in all of the custodian's holdings of the relevant financial asset, whether that asset is segregated at a sub-custodian or CSD in an account in the name of the client or is held in an omnibus position.[5]

To that end, it is important to note that the impact of prescriptive-regulations issued by the OCC in this space would not apply directly to state chartered banks, and that we would therefore expect that the cost of complying with these regulations would be likely to have a disproportionate impact on national banks and federal savings associations – putting them unnecessarily at a competitive disadvantage. This would be especially the case if the regulations substantially increase the risk and cost for the impacted custodians or require material changes to their operating model, service offerings, internal policies and procedures, and contracts.[6]

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[5] See UCC §8-403(b).

[6] Consideration should also be given to the cumulative impact of the proposed regulations with other regulatory initiatives that appear likely to contribute to an unequal market environment, including the changes to Section 402 of the Economic Growth, Regulatory Relief and Consumer Protections Act of 2018, which allowed "custodial banking organizations" certain relief not available to all custodians operating in the market.

3. The Introduction of a New Set of Prescriptive Regulations Would Be Likely To Negatively Impact a National Bank's Ability to Adapt to the Introduction of New Types of Financial Assets and Evolve Its Service Model in Accordance with Market Developments

The AGC also believes that the introduction of a new prescriptive regulation would **hinder standard custody practices and stifle industry innovation.** The ANPR itself pointed to the evolution of custodial services and the impact of new technologies on those services; developments that a prescriptive regulation based on the market practices of today would inhibit rather than promote.

Banks providing non-fiduciary custodial services require flexibility in order to evolve to meet client needs and address changing technologies. If the OCC imposes a new regulation that is not principles-based, the ability of national bank custodians to meet client needs and compete would be impaired. Furthermore, prescriptive new requirements would substantially slow down and add cost to many standard custody practices, including the contractual negotiations for non-fiduciary custody services and the administration of such agreements. These contracts are comprehensive and heavily negotiated today, and the process would become increasingly lengthy, burdensome, and costly.

The current developments relating to digital assets (of which digital currencies are the most widely-known example) and the use of distributive ledger technologies are a good example of emerging asset classes where it is not clear what the role of a custodian will or should be. These structures might or might not involve the holding of a traditional financial asset at the end of the chain, but will involve the issue of some kind of token by an entity that may or may not be the same entity as the one that holds custody of the underlying financial asset. These new developments raise a number of questions, as yet unresolved: whether this product will evolve so that the token and associated key become a financial asset itself; whether the issuer of the token is considered to be an intermediary custodian of the underlying financial asset (if there is one); what the contractual relationship might be between the custodian of the underlying asset and the custodian for the investor to whom a token is issued; and what practices will constitute or be equivalent to "segregation". Prescriptive regulations would address the products as they currently exist and therefore will invariably be ill-suited to their further development.

The ANPR suggests that it may be appropriate to apply regulatory standards to a number of services that are ancillary to non-fiduciary custody services, and lists a number of possibilities, including fund accounting, fund administration (which we take as excluding transfer agency, which is already the subject of an OCC regulation), and foreign exchange ("FX"). Promulgating banking regulations to cover these services would be a major variance from traditional practice. Fund accounting and fund administration, for example, are, to our knowledge, not treated as a regulated product by banking regulators anywhere in the world and in fact can be provided in most (if not all) jurisdictions by entities that are not regulated. While FX trading is subject to some level of regulation, it is important to recognize that custody banks generally offer FX as a service, with the bank acting as principal, and not as an execution service. This would be a major regulatory change and, in our view, given the sophistication of our clients and their freedom to put their own FX trading relationships in place, does not offer significant benefit from a prudential oversight or an investor protection standpoint.

It is important to bear in mind that the custody business conducted by the AGC members (which includes the majority of the $21 trillion in assets held by OCC regulated entities) is done for very large institutional clients who are both sophisticated in their understanding of the risks associated with custody services and able to negotiate terms with their custody providers that properly address those risks and allows for a level of service that meets their needs in a manner that falls within their

risk tolerance. It is our experience that these agreements are frequently actively negotiated in a manner that addresses client concerns regarding standard of care, risk allocation, and the specific service obligations of the custodian. Additionally, we note that, to the best knowledge of our members, no non-fiduciary custody client of an AGC member has incurred a significant loss, not addressed by the contract terms that could have been avoided through a new regulatory regime.

Conclusion

The AGC appreciates the opportunity to provide comments on the OCC's ANPR on fiduciary capacity and non-fiduciary custody activities. We recommend that the OCC reconsiders its intent to modify the regulatory framework for non-fiduciary custody activities. We believe the current regulatory framework for custodial activity of national banks and federal savings associations is adequate to ensure the safety and soundness of the institutions engaged in the business, and the introduction of new regulation could hinder standard custody practices, impose competitive disadvantages for national banks, and stifle industry innovation.

We look forward to discussing our input and comments and would be happy to provide any additional information that might be helpful.

Sincerely,

Theodore Rothschild
Chair, Americas Focus Committee
Association of Global Custodians