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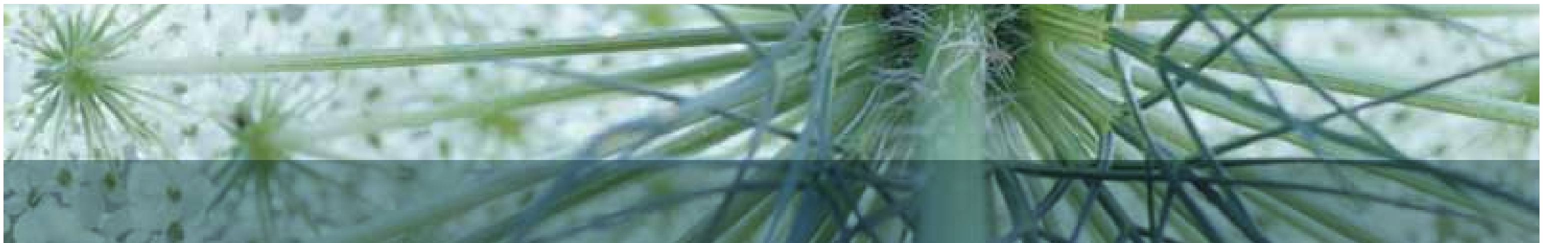

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Filling the Void:
Transparency and the Rise of Custodian Banks

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These are uncertain times for the world economy.

As we enter 2012, it is evident that the growing size of sovereign debt and accelerating Asian inflation is reshaping the global marketplace. Whether it is the impact of mixed U.S. employment and housing statistics, or fallout from bank stress tests, the market is skittish and looking to financial institutions for asset safe-havens and investment reassurance.

As a result of the financial events of the past four years, the international financial community is now having to deal with much stricter regulations. Largely due to lack of transparency, the Great Recession of 2007/2008 opened the doors for a more restrictive regulatory landscape. Major challenges now include balancing counterparty exposure with a high degree of transparency amid a rapidly changing political-economic framework.

However, in every market cycle there are unique opportunities — not only for investments but also innovation. Such is the case of prime custody. With investment banks and fund managers in crisis, the universe of companies providing key services to hedge funds has dramatically shifted, and a door has opened. Hedge funds gained a new appreciation for counterparty risk and financial strength and started to look at another group of service providers - custodian banks.

The Two Custody Models

In a practical sense, following the crash in 2008, US-based hedge funds sought to use a custodian to safe keep and service their unencumbered cash and securities. Through a Federal Deposit Insurance Corporation (FDIC) member bank custodian, hedge funds had the reassurance that un-invested cash balances in certain transaction accounts are 100% FDIC insured until December 2012. Also, by using custodian banks, clients found added comfort in knowing that securities would be kept off of the custodian's balance sheet and would not be rehypothecated. These two key points led hedge funds to seek out custodial banks as their safe haven.

As a result, the US custody model evolved and expanded. Services traditionally reserved for the prime brokerage sector, such as cash management, global clearing capabilities and collateral management became essential components of a service partnership. Middle office services also grew with increasing demand for servicers to offer fail management and claims management products, that are able to coordinate the resolution of failing trades and related claims between the client and counterparty.

As US hedge funds increasingly move towards self-financing through direct lending, custodian banks enable their clients to lend as well as borrow against their portfolios. Where the market allows, custodian banks are also able to interface with respective depositories to allow them to capture and maintain this activity. This is one of several channels to self-financing offered to hedge funds; others include repo and reverse repo processing.

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The second model is the budding European interpretation of prime custody. In Europe, hedge funds primarily use custodian banks to provide collateral management services on initial and variation margin. However, European based hedge funds are increasingly demonstrating interest in custody services for their unencumbered assets as well.

European hedge funds are also moving towards a self-financing model. In this instance, emphasis is on using reverse repo processing to off-set short sales. Repo processing allows hedge funds to trade general collateral repos without requiring intraday, trade-for-trade settlement. This removes constraints on collateral notification and allocation, which helps to ensure market liquidity across clearing banks.

Asset Protection

Today, the two custody models — the established US model and emergent European model — are constantly evolving to meet growing demand for asset protection through increased transparency. Most recently, the US model advanced to accommodate partnerships with primes. Much sought after by the hedge fund community, this type of partnership enables prime brokers to maintain their current relationship with their hedge funds, while providing the fund with the ability to hold assets with a third party custodian. Interest is now expanding to the European shores as well.

The partnership with a prime service model appeals to many hedge funds because it allows them to stay in control of their assets at all times through a direct relationship with their custodian. Unencumbered assets are held away from the primes, but primes continue to provide hedge funds with a consolidated view of holdings at both the prime broker and custodian. The custodian bank can also segregate hedge fund securities to act as collateral for leverage with a third party prime broker.

For many EU-based hedge funds, today's relationship with custodial banks remains either indirect or non-existent. Prime brokers maintain a direct relationship with the custodian and enjoy direct control over unencumbered assets. This service model is being challenged. Driven by the need for greater asset protection and control, hedge funds are pushing prime brokers towards service models similar to those found in the US.

Navigating Regulatory and Legislative Developments

The push for asset protection is not only prevalent in the market sector; it is a central point of interest for governing bodies. This uptake of interest at the Federal level in the US, and the subsequent flux of new regulation in Europe, are shaping global prime custody models of the future perhaps more than any other contributing factor.

> Recent regulatory developments in the US underline the need for strong networks of support banks and institutional investors, who will endorse the terms in the tri-party account control agreements and honor those agreements during a control event.

In the US, the SEC recently publicized its positions on `Assets Held Away' from prime brokers. Current SEC concern surrounds broker liquidity and whether the broker will actually be able to access funds on demand. This balancing act stems from the fear that banks may need to disregard brokers' instructions to move assets if a client goes into default. Such regulatory developments underline the need for strong networks of support banks and institutional investors, who will endorse the terms in tri-party account control agreements and honor those agreements during a control event.

Predominately, global custodian banks are responding to regulatory concerns in two ways. First, they are encouraging standard tri-party Segregated Account Control Agreements (SACAs) by jurisdiction. Second, they dedicate teams to monitor and process all terms and conditions for each SACA by client, thereby closely monitoring activities while strengthening the relationship.

In another example, to help reduce the systemic risk associated with over-the-counter (OTC) derivatives transactions, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") would require many swaps to be submitted for clearing to a Commodity Futures Trading Commission (CFTC) or SEC regulated clearing organization.

These requirements, designed to bolster protections for customers posting collateral on their swap transactions, mandate that the counterparty to an uncleared swap transaction has the right to have its collateral held in a segregated account at a custodian held for the benefit of the counterparty. If the counterparty does not choose this option, the dealer must report quarterly collateral to ensure it is in compliance with the agreement made by both parties.

On the other side of the pond, the effects of Dodd-Frank mandates are compounded by the 2011 passing of the European Alternative Investment Fund Managers Directive (AIFMD)[1]. The AIFMD will, for the first time, impose European-wide regulatory standards on alternative investment managers. In particular, provisions involving depository liability will critically impact global custodians and the sub-custodian networks they leverage.

Currently, global custodians generally do not assume liability for sub-custodians. However, Article 21 of the AIFMD dictates certain activities for which the global custodians must take responsibility. Global custodians would be required to hold "financial instruments" in custody if they can be registered or physically delivered. For other assets the global custodians must verify and record ownership of the asset with the fund. Critically, the AIFMD may limit global custodians who do not have direct connectivity to markets.

The full impact of the AIFMD is not yet known and the Directive contains many semantics that have yet to be translated and further defined. To that effect, in mid-July 2011, the European Securities and Markets Authority (ESMA) published a set of provisional proposals[2] pertinent to the AIFMD, seeking feedback from external stakeholders, before the formal submission is released by ESMA to the European Union Commission in November. The final consultation is intended to offer technical advice to the Commission on possible implementing measures of the AIFMD, specifically in relation to the depositary duties and depositary's liability regime. Subsequently, at the end of August 2011, ESMA issued a second draft consultation[3], requesting comments on possible implementing measures of the AIFMD in relation to supervision and third countries — or those countries that distribute non-European domiciled funds within the European Union. BNY Mellon, as a global custodian, was among those who participated in a larger industry effort to provide commentary in both instances as to the impact of the AIFMD, which was formally presented to ESMA for consideration in early September. BNY Mellon will continue to closely follow-up the evolution of this important piece of regulation and, where relevant, engage with the appropriate EU authorities to make sure that the final regulation, as to be voted by the Commission, presents a balanced approach.

> The demands posed in today's global market issue a singular challenge: Transparency.

Corresponding depositary rules for the safe-keeping of UCITS depositaries complement those proposed by the AIFMD. At the end of January 2011, the European Banking Federation (EBF) began lobbying[4] for the depositary custody duty to be limited to instruments that can be held by a Central Securities Depository — either directly or through a chain of intermediaries. With respect to other assets, like derivatives instruments, units and shares of funds and all financial instruments issued in the nominee form, cash deposits made with external entities and all financial instruments that are used as collateral, the EBF advocates the UCITS depositary's duties to be limited to asset monitoring. Effectively, the EBF's proposal could further limit depositary liability and the rights of UCITS holders against the depositary. These directives hold a unique challenge for the burgeoning European prime custody model, and for custodian banks, like BNY Mellon, that are sustaining this momentum by staying close to regulatory changes and keeping clients abreast of new regulation while the industry remains in a state of flux.

Conclusion

In many senses, the true test of a great financial services firm can be measured by its ability to turn market lows into revenue opportunities — both for itself and its clients. The demands posed in today's global market issue a singular challenge: Transparency. In filling this void, custodial banks in both the US and Europe face unique challenges as they look to address regulatory requirements, investor demands and diversification of risk. Alternative investment managers are looking to custody banks as financial intermediaries who can deliver a seamless offering that will safeguard their clients' assets and meet their needs in a changing market environment. This is in direct response to hedge funds that are increasingly seeking to diversify counterparty risk while continuing to deal directly with their prime brokers.

[1] Directive 2011/61/EU of The European Parliament and of The Council on June 8, 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and regulations (EC) no 1060/2009 and (EU) No. 1095/2010.

[2] ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive — July 2011 — ESMA 2011/209.

[3] ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive in relation to supervision and third countries — August 2011 — ESMA/2011/270.

[4] Response to Commission Consultation Paper on the UCITS Depositary Function and on UCITS Managers' Remuneration – January 2011.

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