

# Sub-Custodian Risks

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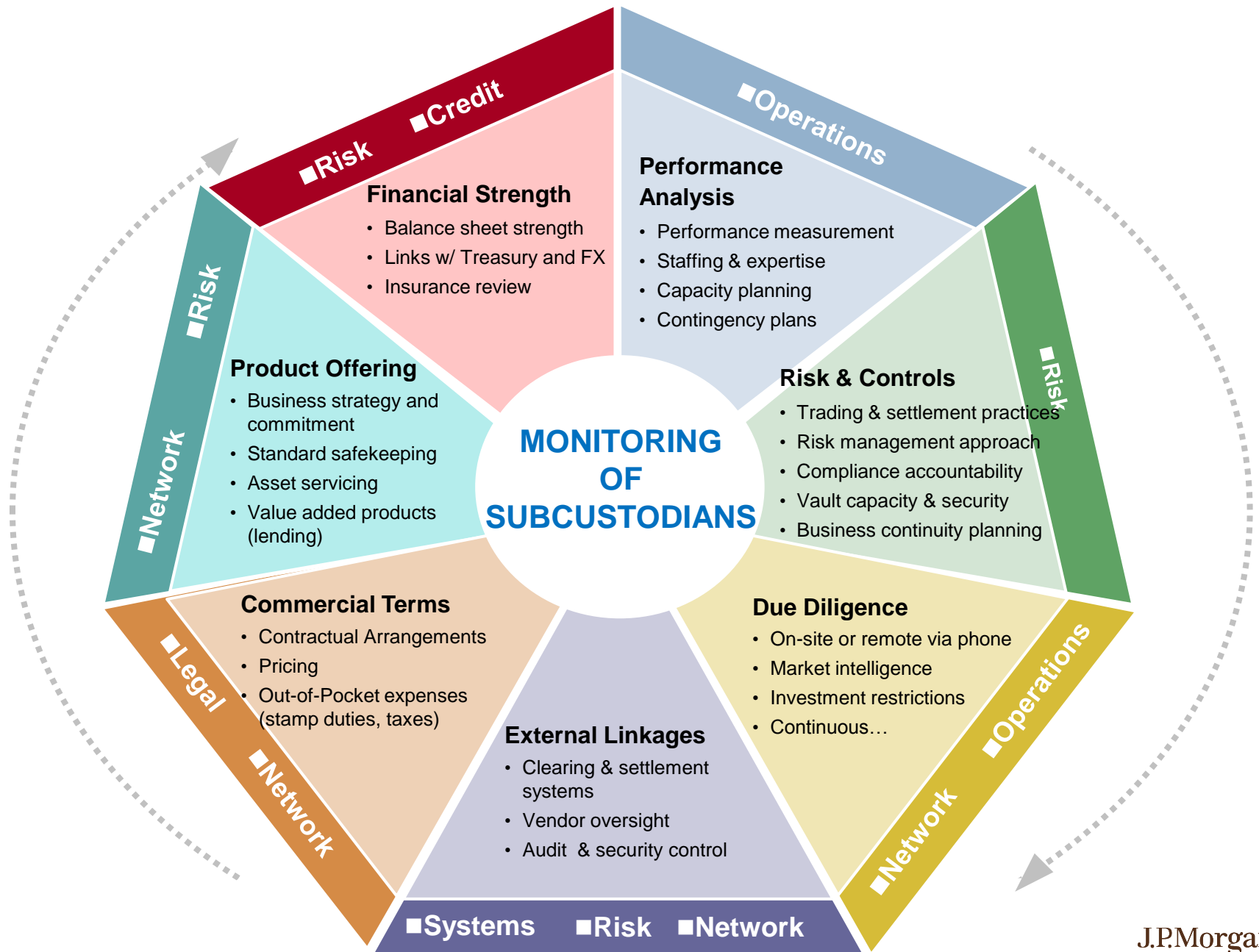
## SEC Rules 15c3-3, 17f-2, 17f-5 and 17f-7

- U.S. Securities and Exchange Commission (SEC) Rules govern the custody of investment company assets outside the United States under the **Investment Company Act of 1940**.
- **GLOBAL CUSTODIANS** appointed as **Foreign Custody Manager** for certain mutual funds under **Rule 17f-5 for selection and monitoring of eligible foreign custodians** need to
  - Exercise “reasonable care, prudence and diligence,” and consider all factors relevant to safekeeping of foreign assets, including financial strength general reputation and standing, as well as procedures and internal controls
  - Determine that assets will be subject to reasonable care based on local market standards and that there is ability to enforce judgments in the jurisdiction
  - Establish a system to monitor performance of the subcustodian and ascertain the continued appropriateness of maintaining assets there
- **Rule 17f-2 requires proof of non-collusion** between a Global Custodian and a sub-custodian under the same parent entity
- The SEC adopted **Rule 17f-7 to provide a framework** under which an **INVESTMENT COMPANY** can assess the level of protection for its assets **when maintained with a foreign securities depository**
  - Eligibility based on acting as system for central handling of securities in country where incorporated, or is transnational system for central handling of securities, and is regulated by foreign financial regulatory authority
  - Maintains records and provides reports that identify assets of each participant and treats them similarly
  - Is subject to periodic examination by regulatory authorities or independent accountants
  - Performs risk analysis, monitors depositories, and is promptly notified of material changes in the risks
- **BROKER-DEALERS** are subject to the General Rules and Regulations promulgated under the Securities Exchange Act of 1934, including **Rule 15c3-3, which covers customer protection** through “good control locations”
  - Registered broker-dealers that hold securities for the accounts of their customers are required to maintain physical possession or control of all customer fully-paid and excess margin securities
  - Control means that the securities are located in an account in the name of the broker-dealer at a clearing corporation, depository or bank, free of any lien

## Alternative Investment Fund Managers Directive (AIFMD)

<p><b>What</b> is the intention?</p>	<ul style="list-style-type: none"> <li>■ AIFMD is an European Union law that provides a framework for the supervision and oversight of Alternative Investment Funds that have not been previously regulated by UCITS.</li> <li>■ This framework is scheduled to come into National Law from 22nd July 2013 with a 12 month transition period; approach and timetable will vary across member states.</li> <li>■ Publication of the Final Text was delayed until December 19<sup>th</sup>, 2012</li> </ul>
<p><b>Why</b> is it happening?</p>	<ul style="list-style-type: none"> <li>■ The EU Commission has responded to past financial crises and is looking to protect the interests of investors in alternative funds (namely Hedge Funds, Private Equity Funds and Investment Trusts)</li> </ul>
<p><b>How</b> will Fund Managers be impacted?</p>	<ul style="list-style-type: none"> <li>■ Impacted fund managers will need to be authorised by their Regulators in order to market funds in Europe</li> <li>■ Authorised fund managers will be required to appoint a Depositary for each impacted fund</li> <li>■ The Depositary will have similar oversight responsibilities to those currently applicable to authorised open ended funds (unit trusts, oeics, etc.), but there are a number of additional activities (e.g. reconciliation of cash flows which was included in the Final Text on December 19<sup>th</sup>)</li> <li>■ In addition to long assets held in custody, the Depositary will now be required to verify the ownership of all 'other assets' held in the fund (eg derivatives, private equity, real estate)</li> </ul>
<p><b>How</b> will Custodians be impacted?</p>	<ul style="list-style-type: none"> <li>■ Which banks are well placed to provide the Depositary services that will be required – and for which clients will they do it?</li> <li>■ What new service will be required: separate accounts? record keeping ? Verification services?</li> <li>■ Sub custodian agent liability</li> <li>■ How quickly will clients seek authorization?</li> </ul>

# Subcustodian Management — Continuous Monitoring Process



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