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May 8, 2023

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1091

Re: *Safeguarding Advisory Client Assets (File No. S7-04-23)*

Dear Ms. Countryman:

The Investment Company Institute[1] fully agrees with the Commission's goals to protect the integrity of investor assets from risk of loss, misuse, theft, or misappropriation.[2] ICI believes, however, that the Proposal places onerous new responsibilities on custodians and advisers and provides little evidence that the proposed changes will better protect client assets.

For the first time, the Commission would equate an adviser's discretionary trading authority over client assets with having custody of those assets and require advisers, rather than their clients, to enter into a contract with the client's custodian. We oppose these changes because doing so is unnecessary and yet will create a significant number of practical difficulties. For example, equating discretionary trading with custody could cause advisers to be deemed to have custody over thousands of additional client accounts despite no change in the adviser's relationship with the client. Requiring advisers to renegotiate existing custodial contracts for their clients will cause great expense and yet the Commission has failed to ground these consequential changes in

[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor, through advocacy and education efforts focused on regulated funds and certain other professionally managed products. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $29.9 trillion in the United States, serving more than 100 million investors, and an additional $8.1 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

[2] *See* Proposed Rule 223-1 (the "Safeguarding Rule") under the Investment Advisers Act of 1940 ("Advisers Act" and *Safeguarding Advisory Client Assets*, SEC Release No. IA-6240, 86 Fed. Reg. 14672 (Mar. 9, 2023), available at https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf ("Proposal" or "Proposing Release").

thorough evidence and careful study and analysis. Doing so is a prerequisite to fulfill its mandate to act in the public interest and for the protection of investors.

We explain these and other points below and offer recommendations that would protect client assets in a manner that reflects how the custodial markets operate.[3] We stand ready to fully engage with the Commission as it continues to consider how best to protect client assets from risk of loss, misuse, theft, or misappropriation.

Section 1. Executive Summary

The Commission has made – and acknowledged – errors in its approach to custody-related rulemaking in the past but surprisingly does not mention this prior experience. In 1997, the Commission adopted custody-related rule amendments for foreign banks and foreign securities depositories that it then was forced to delay, then suspend compliance dates for, and ultimately replace with new requirements that accounted for the practical realities of safeguarding client assets. In adopting the new requirements in 2000, the Commission rightly acknowledged that:

> New rule 17f-7 and the amendments to rule 17f-5 respond to concerns expressed by global custodians and fund managers that rule 17f-5, as amended in 1997, is not workable. The new rule and rule amendments also address our concerns that, as a result of global custodians' unwillingness to assume delegated responsibilities under rule 17f-5, obligations to evaluate depositories' custodial capabilities may fall to fund boards, which lack the relevant knowledge and expertise to make these evaluations…. In adopting this rule, we recognize that investment in many foreign countries presents custodial risks that cannot be avoided, including the use of local securities depositories. The rule seeks to reduce the risks by requiring that fund advisers (or funds) be fully apprised of these risks when they make the decision to invest in the country on an ongoing basis.[4]

The Commission has the opportunity to avoid a similar outcome now through engagement with advisers, global custodians, independent public accountants and other marketplace participants who can provide the Commission with the information necessary to safeguard client assets in a

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[3] ICI generally agrees with the points made in the Investment Adviser Association letter and particularly with the recommendations made with respect to the proposed recordkeeping requirements and the proposed amendments to Form ADV.

[4] *See Custody of Investment Company Assets Outside the United States*, SEC Release No. IC-24424, 65 Fed. Reg. 25630, 25633 (May 3, 2000) ("Rule 17f-7 Release"), available at https://www.govinfo.gov/content/pkg/FR-2000-05-03/pdf/00-11000.pdf (internal footnotes omitted).

manner that takes into account how the custodial markets operate. The issues with the Proposal are so fundamental that engagement along these lines is imperative.

As an example, the Proposal would require an adviser to obtain from custodians certain reasonable assurances – including that they will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the custodian's negligence. Our members report that most custodians today do not agree to indemnify clients for losses and do not have insurance arrangements in place for risk of loss of the client's assets caused by the qualified custodian's negligence – even with very large institutional clients – and they are concerned that qualified custodians are unlikely to agree to do so.

The Proposal would require that the adviser obtain written reasonable assurance that the use of any securities depository will not excuse any of the qualified custodian's obligations to the client. Qualified custodians are unlikely to agree to provide this assurance and therefore this proposed requirement should be removed from any final rule. In its place, we suggest that the Commission could adopt an approach similar to the one in Rule 17f-7, which requires a fund's custodian to analyze and monitor the custody risks of using the eligible securities depository.

If custodians refuse to make their services in certain markets, or with respect to certain assets, available, advisers, as a corollary, will not be able to make their services available. The logical consequence of this is that investors will be deprived of professional management in those markets and for those asset classes. Without the benefit of professional investment advice, investors have a Hobson's choice: invest on their own or divest from those assets along with bearing any associated losses and adverse tax implications.[5]

The Proposal would impose requirements on custodians who are banks, savings associations, and futures commission merchants ("FCMs"), despite the fact that each of these entities already are subject to regulation administered by their own expert regulators. While the Proposing Release references the variety of existing regulations governing custodial activity, it neglects to provide an adequate rationale as to why such regimes are insufficient. Further, the Commission appears to be seeking to extend indirectly its regulatory jurisdiction over persons that Congress has not authorized it to regulate. As Commissioner Peirce correctly observed, "[t]he Commission does not have authority to regulate custodians directly, but we propose to regulate them indirectly."[6]

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[5] *See* Proposing Release at n. 489. With respect to potential divestiture, potentially at a loss, associated with the requirement for a foreign financial institution to meet the conditions to be a qualified custodian, the Proposal states that "[w]e do not have data on the number of client accounts and the quantity of assets affected."

[6] *See* Statement on Safeguarding Advisory Client Assets Proposal, SEC Commissioner Hester M. Peirce (Feb. 15, 2023) ("Commissioner Peirce Statement"), available at https://www.sec.gov/news/statement/peirce-statement-custody-021523.

The Proposal would define "assets" to mean "funds, securities, or other positions held in a client's account" including financial contracts.[7] A futures or option contract, however, is not an "asset" in the traditional sense of the word; rather, it is a live, bilateral contract or a set of two contracts with a clearinghouse interposed as a party to each opposing contract (*e.g.*, a long/short). There is consequently no practical way for a custodian to "have or otherwise evidence possession or control" of financial contracts themselves based on current market practice.[8] In contrast, client assets maintained in connection with such financial contracts, consisting of funds, securities and other assets delivered as margin, can generally be custodied in the traditional sense.[9] ICI therefore recommends that the Commission not include financial contracts in the definition of "assets." Otherwise, advisory clients would be deprived of opportunities to hedge various portfolio and asset-related risks, and obtain certain investment exposures unavailable through other methods of trading and certain investment exposures at lower transaction costs.[10] Further, the Commission's proposed approach oddly does not acknowledge that these privately negotiated contractual arrangements already are subject to existing regulatory regimes, including the Commodity Exchange Act ("CEA") and Commodity Futures Trading Commission ("CFTC") rules thereunder.

ICI recommends that the Commission, in the first instance, examine and defer to existing regulatory regimes that already adequately protect client assets. There is precedent for this approach – Rule 17f-6 under the Investment Company Act requires a FCM to provide contractual acknowledgment of, and agreement to comply with, certain applicable portions of the CEA and CFTC rules thereunder in the relevant account agreement between the FCM and the client, recognizing the safeguards provided by the CEA and CFTC rules.[11]

If the Commission is able to justifiably determine that protections over and above those provided by currently applicable regulatory regimes are necessary, ICI believes that those protections would be most effectively addressed by requiring advisers, in reliance on their experience and

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[7] Proposed rule 223-1(d)(1) and Proposing Release at 14679. *See also* Proposing Release at n. 14, suggesting that swaps, along with certain other instruments, are covered by the proposed expanded definition of the "assets." Note that where this letter refers to "swaps" trading it also encompasses "security-based swap" trading unless otherwise noted because of a regulatory difference in their treatment.

[8] See also discussion of proposed "possession or control" requirement with respect to derivatives in Section 4.1.

[9] However, see concerns about the proposed cash segregation requirements described in Section 3.2.5.

[10] Similar concerns about the application of the Proposal apply with regard to short sales, to-be-announced transactions ("TBAs"), repurchase agreement and reverse repurchase agreement transactions, and securities lending transactions, none of which is typically able to be custodied in the traditional sense.

[11] *See* Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, SEC Release No. IC-22389, 61 Fed. Reg. 66207 (Dec. 11, 1996) ("Rule 17f-6 Adopting Release"), available at https://www.govinfo.gov/content/pkg/FR-1996-12-17/pdf/96-31891.pdf (noting that "[t]he adopted rule incorporates the safeguards that are provided for fund assets under the CEA and CFTC rules….").

expertise, to adopt appropriate policies, procedures, and controls that are reasonably designed to mitigate the risk of misappropriation of client assets.

The Commission rightly proposes to except the accounts of registered investment companies ("funds") from any final rule, an approach ICI supports in light of the existing comprehensive regime designed to safeguard fund assets.[12] This regime has functioned exceptionally well in protecting assets for the benefit of fund investors, and there is no evidence that changes are warranted.[13] The Commission, however, does not propose to except business development companies ("BDCs") or college savings plans from the Safeguarding Rule. ICI recommends that the Commission do so in any final rule given their similarity to funds in structure, operation,[14] and oversight.[15]

While we have done our best to analyze the Proposal and provide constructive comments in the time provided, the volume and pace of the Commission's rulemaking hinders the ability of ICI and its members to undertake the comprehensive analysis that a proposal of this significance merits. Given the scope of the proposed changes, if the Commission determines to move forward with the Proposal, ICI recommends that the Commission allow for a transition period of a

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[12] *See* Section 17(f) of the Investment Company Act of 1940 ("Investment Company Act") and Rules 17f-1 through 17f-7 thereunder, inclusive.

[13] ICI is not aware of any enforcement actions taken by the Commission in respect of the custody of fund assets in recent years. Given this and our concerns with the Proposal, ICI recommends that the Commission not use the Safeguarding Rule as a starting point for any future changes to fund or BDC custody requirements. It is unclear whether the Commission plans on amending fund custody requirements. On the one hand, the Spring 2019 Regulatory Flexibility Analysis indicated that the Commission would be considering amending both adviser and fund custody rules. *See* SEC Agency Rule List – Spring 2019, available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=3235-AM32. On the other hand, the most recent Regulatory Flexibility Analysis did not indicate that the Commission was considering amending fund custody rules. *See* SEC Agency Rule List – Fall 2022, available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202210&RIN=3235-AM32.

[14] Excepting accounts of state-created Section 529 plan trusts for which an adviser is a program manager would be consistent with such plan's treatment under Rule 206(4)-2 under the Advisers Act. *See, e.g., Investment Company Institute,* SEC Staff No-Action Letter (Sept. 5, 2012) (extending no- action relief for advisers to be permitted to treat a 529 plan trust as a pooled investment vehicle under subdivision (b)(4) of Rule 206(4)-2) ("ICI 529 Letter"). The Incoming Letter observed that:

> because 529 plan securities are issued by a state trust and constitute an investment in such trust, they are not investment companies subject to the Investment Company Act of 1940 ("ICA"). This is because Section 2(b) of the ICA expressly provides that "no provision" of the ICA "shall apply to, or be deemed to include, the United States, a State, or any political subdivision of a State . . .." But for this exclusion, because of the way 529 plans are structured and operated, they would qualify as investment companies and be subject to regulation under the ICA.

[15] *See* Section 59 of the Investment Company Act, which applies, among others, Section 17(f) "to a business development company to the same extent as if it were a registered closed-end investment company."

minimum of 36 months for all advisers.[16] The proposed compliance period of one year for larger advisers and 18 months for smaller advisers is completely inadequate given the significant legal, compliance and operational challenges that the Proposal presents, including negotiating (or re-negotiating) thousands of agreements. Moreover, it is essential for the Commission to consider that advisers will be implementing other new requirements simultaneously.

Section 2. The Commission Must Heed Lessons from Previous Custody-Related Rulemaking

The Commission extensively amended Rule 17f-5 (the rule that governs the custody of the assets of registered management investment companies with custodians outside the US) in 1997. The Commission subsequently replaced the rule amendments after insurmountable issues with the new requirements surfaced. The Commission ultimately adopted a new rule, Rule 17f-7 under the Investment Company Act (the rule that regulates funds' use of foreign securities depositories) and its adopting release explains this chronology.

> Rule 17f-5 was adopted in 1984, and extensively revised in 1997 ("1997 Amendments") to reflect significant developments in foreign investment by U.S. funds and the Commission's greater experience with foreign custody arrangements. The 1997 Amendments expanded the types of foreign banks and securities depositories that may serve as custodians of fund assets, and required that the selection of a foreign custodian be based on whether the fund's assets will be subject to reasonable care if maintained with that custodian. In 1998, ***as a result of difficulties experienced by funds, their advisers and bank custodians in applying the standards*** of rule 17f-5 to the use of foreign depositories, representatives of funds asked the Commission to delay the compliance date for the 1997 Amendments. The Commission suspended the compliance date for most of the 1997 Amendments in May 1998. Representatives of funds and bank custodians then submitted a proposal to further amend rule 17f-5 to change the standards by which foreign depositories are evaluated. [17]

Further, the cost-benefit analysis contained in the same release noted:

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[16] We emphasize that by recommending that the Commission extend the compliance period, we are not suggesting that we believe compliance with the proposed requirements, if adopted, would be feasible. Indeed, as we note above, various aspects of the Proposal would pose extraordinary obstacles that may prevent implementation. This recommendation is instead meant to ensure that, if the Commission adopts ICI's recommendations, impacted market participants will have adequate time to implement the necessary policies, procedures, and systems to comply with any final requirements.

[17] Rule 17f-7 Release at 25630 (internal footnotes omitted) (emphasis added).

> New rule 17f-7 and the amendments to rule 17f-5 respond to ***concerns expressed by global custodians and fund managers that rule 17f-5, as amended in 1997, is not workable***. The new rule and rule amendments also address our concerns that, as a result of ***global custodians' unwillingness to assume delegated responsibilities under rule 17f-5,*** obligations to evaluate depositories' custodial capabilities may fall to fund boards, which lack the relevant knowledge and expertise to make these evaluations.[18]

The parallels between the 1997 Amendments and the Proposal are clear, and we urge the Commission to take steps now to preserve investor access to professional management of their assets in foreign markets and with respect to certain asset classes, such as derivative instruments and bank loans. Engagement with advisers, global custodians, independent public accountants and other marketplace participants can equip the Commission with the information necessary to meet its investor protection goals without unnecessarily disrupting the market for advisory services.

Section 3. The Commission Must Better Tailor the Scope of Any New Custody Requirements

Section 3.1. Discretionary Trading Authority Must Be Distinguished from Custody

The Proposal would equate an adviser's discretionary trading authority over assets with having custody of those assets for the first time.[19] We oppose these changes because doing so is unnecessary and yet will create a significant number of practical difficulties. For example, equating discretionary trading with custody could cause advisers to be deemed to have custody over thousands of additional client accounts despite no change in the adviser's relationship with the client. It is also at odds with longstanding Commission statements. Approximately 20 years ago, the Commission made clear that an "adviser has custody when it can control client funds or securities for purposes ***other than authorized trading***."[20] In the same 2003 Custody Adopting Release, the Commission noted that, "[a]n adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client funds or securities for any purpose ***other than authorized trading*** has access to the client's assets."[21] In treating authorized, or discretionary, trading in this manner, the Commission

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[18] *Id*. at 25633 (emphasis added).

[19] *See* proposed rule 223-1(d)(4).

[20] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2176, 68 Fed. Reg. 56691, 56692 (Oct. 1, 2003) ("2003 Custody Adopting Release"), available at https://www.govinfo.gov/content/pkg/FR-2003-10-01/pdf/03-24813.pdf (internal footnotes omitted) (emphasis added).

[21] *Id.* at 56693 (emphasis added).

correctly explained that an arrangement pursuant to which "custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account … minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account."[22] Similarly in the current Proposal, the Commission acknowledges that "there is a more limited risk of loss to a client from authorized trading when a qualified custodian participates in a one-for-one exchange of assets like this."[23] But then, without citing instances of advisers with discretionary trading authority or other evidence that would support such an about face, goes on to determine that authorized trading should be treated as custody.

Expanding the definition of custody to include accounts over which the adviser has discretionary trading authority has the potential to apply Rule 223-1 to a multitude of advisory accounts even though they are already subject to other regulatory regimes administered by expert regulators.[24] It will be both more efficient and effective for the Commission to defer to those regulators. Further, the costs and burdens associated with this expanded definition of custody will put U.S. advisory businesses at a competitive disadvantage compared to foreign advisers – who will not be subject to these costs and burdens – when vying for the management of foreign mandates.

For the foregoing reasons, we vehemently oppose treating discretionary trading authority as custody.[25] If the Commission nonetheless determines that additional protections should accompany discretionary trading, we recommend that, at a minimum, the Commission:

- not treat discretionary trading authority as custody provided that an adviser, in reliance on its experience and expertise, designs policies and procedures under rule 206(4)-7 to mitigate the risk of misappropriation of assets subject to discretionary trading authority; and
- exempt accounts which are subject to a distinct regulatory regime.

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[22] *Id.* at n. 10.

[23] Proposing Release at 14680.

[24] For example, an investment adviser that has been delegated portfolio management, including discretionary trading authority for an Undertakings for the Collective Investment In Transferable Securities ("UCITS") in the European Union may be deemed to have custody under the proposed rule. Yet the accounts of that adviser already are subject to separate custody requirements under that regulatory regime, and there is no equivalent provision for treating an investment adviser that provides portfolio management services with discretionary trading authority as having custody of those assets. *See, e.g.*, Undertakings for Collective Investment Transferable Securities Directive 2009/65/EC (Jul. 13, 2009), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32009L0065.

[25] Additionally, the Proposal leaves open questions about the treatment of sub-advisers which, depending on the resolution of such questions, would have substantial consequences and effects on these arrangements which have not been analyzed by the Commission in the Proposal.

Section 3.2. Existing Custody-Related Requirements Must be Given More Credence

The Proposal fails to acknowledge the sufficiency of the existing regulatory framework to which custodians are subject. While the Proposing Release references the variety of existing regulations governing custodial activity, it neglects to demonstrate the insufficiency of these regimes.[26]

Section 3.2.1. Written Agreement Requirement

For the first time, the Commission would require advisers, rather than their clients, to enter into a contract with the client's custodian. This element of the Proposal would present a significant number of practical difficulties. For example, requiring advisers to renegotiate existing custodial contracts will cause great expense. In the Commission's view, however, "it is necessary to help protect client assets from the harms the custody rule is designed to address and would help ensure that [clients] receive certain standard custodial protections under the rule."[27]

While the sheer magnitude of the repercussions from this new requirement cannot be overstated, it appears that they clearly are under-appreciated. For example, the Proposal does not adequately consider the interplay between an adviser's fiduciary duty and the proposed requirements, especially when an adviser and a qualified custodian are affiliated entities. Negotiating against, and supervising the compliance of, an affiliated bank, broker-dealer, FCM, or foreign financial institution could be perceived as a conflict of interest and, if Employee Retirement Income Security Act of 1974 ("ERISA") plan assets are involved, could be a prohibited transaction under ERISA requiring exemptive relief. ERISA's prohibited transaction rules restrict transactions with parties in interest and prohibit self-dealing by plan fiduciaries.[28] Failure to comply with these rules, which include a complex framework of prohibited transaction exemptions, carries serious consequences. To avoid these risks, advisers may determine to prohibit the use of the services of affiliates, which could be problematic in a highly concentrated market. For this reason and many others, ICI members, along with representatives of the custodial community, have identified this proposed requirement as especially unworkable.

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[26] *See, e.g.*, Proposing Release at Section III.C.1.c (citing, *inter alia,* U.S. Department of the Treasury, Office of Comptroller of the Currency and Federal Deposit Insurance Corporation regulations, guidance and processes).

[27] Proposing Release at 14691.

[28] Section 406(b) of ERISA prohibits a fiduciary (including an investment manager to a plan) from entering into transactions on behalf of the plan that would benefit the fiduciary or from acting (in any transaction involving the plan) on behalf of a party whose interests are adverse to the interests of the plan or plan participants. More broadly, ERISA's prohibited transaction rules generally prohibit plans from engaging in almost any transaction with a party in interest, which includes just about any person or entity that has any connection to the plan (such as a service provider). To enable plans to operate and obtain necessary services (including asset management), ERISA provides for a complex framework of exemptions from these prohibited transaction rules. The availability of an exemption depends on the specific circumstances and parties involved in a transaction and requires compliance with specified conditions.

We understand that many investment advisers advise accounts on behalf of investors who collectively may utilize dozens, and in some cases one hundred or more, distinct custodial relationships. The Proposing Release fails to appropriately acknowledge the volume of these relationships, and the corollary impact of negotiating the proposed written agreements. While the costs of the proposed approach are clear, the benefits to clients are not: clients hire investment advisers for their investment expertise, not for their ability to negotiate agreements with custodians.

In its economic analysis, the Commission estimates that "each investment adviser and each qualified custodian that enters into an agreement would incur an internal burden of 1 hour each to prepare the written agreement."[29] We understand from members and custodians alike that this estimate dramatically understates the time and expense associated with preparing and negotiating a custodial agreement. Some members have indicated that negotiating these agreements would most likely constitute the single largest – in terms of cost and time expended – legal project ever undertaken by their firm. Furthermore, the time it takes to finalize these agreements is not wholly within the control of the adviser and may stretch over many months.

Given the complexities of implementing such agreements, the proposed rule could also have the unintended effect of consolidating the number of custodians utilized by clients. This could lead the loss of negotiating leverage with custodians as well as increasing the risks associated with having industry assets being held by only a handful of custodians.

Given these costs and burdens, along with the substantive issues outlined below, we recommend that the proposed requirement for a written agreement between the adviser and each client's qualified custodian be eliminated from any final rule. However, if the Commission determines that protections over and above those provided by currently applicable regulatory regimes[30] are necessary, ICI believes that those protections would be most effectively addressed by appropriate policies, procedures, and controls that are reasonably designed, in reliance on the adviser's experience and expertise, to mitigate the risk of misappropriation of client assets. We believe that such measures would more directly address the potential risks that concern the Commission.

Section 3.2.2. Custodial Oversight of Trades is Unnecessary and Inappropriate

The Proposal would require the written contract to specify the adviser's agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations, and

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[29] Proposing Release at 14763.

[30] *See, e.g.*, Comptroller of the Currency Administrator of National Banks, Custody Services: Comptroller's Handbook January 2002), available at https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/custody-services/pub-ch-custody-services.pdf ("OCC Handbook").

permit the adviser and the client to reduce that authority.[31] This proposed requirement can be read to inappropriately put the qualified custodian in the place of monitoring the adviser's trading activities to ensure consistency with the investment management agreement between the adviser and its client. This level of custodial oversight would be unprecedented and entirely unworkable, in addition to being unnecessary. Current custodial systems are built to accommodate high volume throughput using automation or "straight through processing." Custodians rely on high levels of automation to consume thousands of settlement instructions from advisers each day, post the details to their own systems and onward remit them to relevant market participants, including sub-custodians and securities depositories, without manual intervention. Mandating such an oversight regime would require custodians to entirely overhaul their systems, disrupt automated settlement flow, hire significant numbers of new staff and develop new protocols. In short, it would impose on custodians a role which they neither desire nor are qualified to perform. We understand that custodians are concerned that such a requirement could have serious negative repercussions with respect to straight through processing. Yet such a requirement is unnecessary given that investment advisers already maintain trade monitoring protocols, and are subject to a fiduciary duty requiring them to invest in a manner that is consistent with the investment management agreement.[32]

Implementation of this type of arrangement would fundamentally change the timing, reactivity, connectivity and communication patterns that attend trading. Some investment advisers trade actively throughout the trading day, and timing can be an important element of the investment strategy. The imposition of a third-party monitoring and/or approving or denying each trade will invariably lead to delays in the implementation of a strategy, depriving investors of the advisory services for which they contracted. Furthermore, this type of arrangement is nearly certain to result in disagreements between the adviser and the qualified custodian with respect to the applicability of the investment management agreement to particular trades. These disagreements will lead to delays in implementation of the portfolio management strategy and an increase in settlement fails in light of the transition to T+1 settlement, with attendant losses to end investors.

Given the number of portfolio trades executed daily by some advisers, and the apparent proposed requirement for oversight on a trade-by-trade basis, the Commission appears to be asking custodians to take on a truly gargantuan new role. As such, assuming custodians even are willing to assume such a role, our members are concerned that custodians will pass the costs associated

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[31] *See* proposed rule 223-1(A)(1)(i)(D).

[32] *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963). *See also* Compliance Programs of Investment Companies and Investment Advisers, SEC Release Nos. IA-2204; IC-26299, 68 Fed. Reg. 74714, 74716 (Dec. 24, 2003), available at https://www.govinfo.gov/content/pkg/FR-2003-12-24/pdf/03-31544.pdf (noting that "[w]e expect that an adviser's policies and procedures, at a minimum, should address the following issues to the extent that they are relevant to that adviser: Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives . . .").

with this expanded new role onto advisers and their advisory clients. It would be difficult, if not impossible, to accurately assess the potential costs associated with this requirement. Setting aside the expenses associated with systems build-outs and personnel hiring/training, the opportunity costs to advisers and their clients are immeasurable. Custodial delays in approving certain trades, or custodians erroneously blocking certain trades, could cost advisers and their clients unknown amounts. The potential costs of this requirement are likely to meaningfully outweigh any potential benefits. Current law appropriately addresses the SEC's concerns: investment advisers have a fiduciary duty to act in the best interests of their clients and manage portfolios consistent with the terms of their investment management agreements. This, coupled with the Commission's examination and enforcement authority sufficiently protects the integrity of client assets.

In a separate but similar context discussed above, the Commission previously acknowledged "the unwillingness of global custodians to assume responsibilities that may overlap with investment decisions…."[33] A requirement that a custodian be responsible for authorizing each investment transaction as consistent with an investment management agreement would certainly be asking custodians to assume responsibilities that may overlap with investment decisions, and we understand that custodians' unwillingness to assume these responsibilities persists to this day.

We therefore recommend that this proposed requirement be eliminated from any final rule.

Section 3.2.3. Reasonable Assurances Obtained by Adviser

In addition to the written agreement requirement, the Proposal would require an adviser to obtain reasonable assurances that the qualified custodian will:

- exercise due care in accordance with reasonable commercial standards and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss;
- indemnify the client against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct;
- not be excused from its obligations to the client as a result of any sub-custodial or other similar arrangements;
- clearly identify and segregate client assets from the custodian's assets and liabilities; and

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[33] Rule 17f-7 Release at 25634.

- not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.[34]

It is puzzling why the Commission would require an adviser to obtain these assurances, as the universe of who can be a qualified custodian is limited to assure protection of client assets, including only a bank or savings association, registered broker-dealer, FCM, or FFI. Each of these entities already is subject to a robust regulatory regime which is tailored to their operations and overseen by an expert regulator. The Commission rightly recognizes this, stating that,

> [qualified custodians] operate under regular government oversight, are subjected to periodic inspection and examination, have familiarity with providing custodial services, and are in a position to attest to custodial customer holdings and transactions—all critical components of safeguarding client assets under the proposed rule…."[35]

Yet, the Commission does not go on to articulate an adequate rationale for why an entity meeting the standards of a "qualified custodian" is no longer sufficient in and of itself to adequately safeguard client assets. Certain of the proposed reasonable assurances requirements also raise significant concerns in the context of derivatives transactions, as discussed in Appendix A.

Section 3.2.3.1. Indemnification and Insurance

The Proposal would require an adviser to obtain from custodians certain reasonable assurances – including that they will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the custodian's negligence. Our members report that most custodians today do not agree to indemnify clients for losses and do not have insurance arrangements in place for risk of loss of the client's assets caused by the qualified custodian's negligence – even with very large institutional clients – and they are concerned that qualified custodians are unlikely to agree to do so. This element of the Proposal could theoretically inure to the benefit of advisers and their clients in the face of custodial error. However, advisers have expressed concerns about their ability to negotiate with large global custodians, especially when, historically, custodial relationships have been maintained directly with the advisory clients.

If a qualified custodian refuses to agree to such an indemnification standard, the Proposal will result in advisers and their clients being put in a very difficult position. In order to maintain operation of their account, they will be forced to seek out the services of another qualified

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[34] *See* proposed rule 223-1(a)(1)(ii).

[35] Proposing Release at 14682-83 (internal citations omitted).

custodian, which will not have been the client's (or the adviser's) first choice for custodial services, and even then that custodian may or may not agree to the mandated standard. Advisers and their clients will be pushed toward whichever, if any, qualified custodian is willing to agree to such indemnification standard. Should one or more qualified custodians ultimately agree to such a standard, our members are concerned that, in order to be compensated for taking on a greater amount of risk and the expense associated with obtaining the insurance arrangements necessary to support indemnification agreements, qualified custodians are likely to significantly increase the costs associated with custodial services.

The Proposal also would require an adviser to obtain reasonable assurance that a qualified custodian will have insurance arrangements in place that will adequately protect the client.[36] Even more concerning than the associated cost, we understand that there may not be capacity for custodians to obtain such insurance as robust insurance markets have not been developed for all types of assets which would be covered by the Proposal. Compliance with such a requirement therefore may be impossible.

If the Commission determines to include an insurance requirement in any final rule, we recommend that it provide guidance in the adopting release as to what insurance coverage would be deemed to "adequately protect the client" as that phrase is used in the Proposal. More specifically, we recommend that guidance be provided both as to the scope and amount of coverage that would be required for protection to be deemed "adequate." In this regard, we urge the Commission to carefully consider the reasonable likelihood that such coverage will be commercially available, as well as the anticipated cost of obtaining it.[37] Finally, in light of the foregoing, at a minimum, the Commission should allow an investor to waive this requirement. Otherwise, a client may be deprived of access to professional investment advice if its preferred custodian is unable to obtain the required insurance.

Section 3.2.3.2. Sub-Custodial and Securities Depository Arrangements

The Proposal would require that the adviser obtain written reasonable assurance that the existence of any sub-custodial, securities depository or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client.[38] We understand that qualified custodians are interpreting this proposed requirement to effectively

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[36] *See* proposed rule 223-1(a)(1)(ii)(B).

[37] *See generally* Comment Letter of The Association of Global Custodians to File No. S7-15-99 -- Custody of Investment Company Assets Outside the United States/Investment Company Act Release No. 23815 (July 15, 1999) ("AGC Comment Letter"), available at https://www.sec.gov/rules/proposed/s71599/goelzer1.htm (noting that, in respect of a similar proposal to obtain insurance, "[t]o the extent commercial insurance may be available, it would likely be narrowly drawn and prohibitively expensive.").

[38] *See* proposed rule 223-1(a)(1)(ii)(B).

make the qualified custodian a guarantor of the operations of any sub-custodian or securities depository holding client assets. ICI members have expressed concerns that qualified custodians are unlikely to agree to provide this assurance with respect to securities depositories at any price.

The implications of this proposed requirement cannot be overstated. In virtually every market throughout the world, securities depositories function as a central utility and the decision to invest in such a market demands, of necessity, the use of such securities depository.[39] No amount of due diligence or oversight will have any impact on the operations of the local securities depositories, and imposing liability on qualified custodians for their operations would be akin to imposing liability on qualified custodians for the failures of the local telecommunications provider.

In fact, in adopting rule 17f-7, the Commission stated that "[i]n adopting this rule, we recognize that investment in many foreign countries presents custodial risks that cannot be avoided, including the use of local securities depositories."[40] It further stated that "[a] depository may fail, causing losses to investors, despite the diligence of global custodians, funds and advisers."[41] The Commission rightly recognized the practical limitations of custodial arrangements then, and we urge it to do so again here.

Otherwise, as a practical matter, if no qualified custodian is willing to provide written reasonable assurance in accordance with this (or any other) particular requirement, then no qualified custodian will make its services in certain markets available to advisers and their clients, depriving investors of professional management of their assets in those markets. Without the benefit of professional investment advice, investors have a Hobson's choice: invest on their own or divest from those assets along with bearing any associated losses and adverse tax implications.

We therefore recommend that the requirement that the adviser obtain written reasonable assurance that the existence of any securities depository or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client be removed from any final rule. In its place, the Commission could adopt an approach

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[39] *See* AGC Comment Letter (noting that "depositories are a key part of a market's financial infrastructure and . . . the decision to invest in a particular security is inevitably also a decision to use the depository for that security." Also noting that "[a]dvisers and custodians are not normally willing to assume unconditionally the risks associated with governmental or quasi-governmental entities, such as foreign depositories, over which they have little or no influence.").

[40] Rule 17f-7 Release at 25633.

[41] *Id*.

similar to the one in Rule 17f-7, which requires a fund's primary custodian or its agent to analyze and monitor the custody risks of using the eligible securities depository.[42]

Rule 17f-7 requires that a fund's primary custodian furnish the fund or its investment adviser an analysis of the custody risks of using an eligible securities depository before the fund places its assets with the depository. The fund's contract with its primary custodian also must require the custodian to monitor these risks on a continuing basis, and promptly notify the fund or its adviser of any material change.[43]

The Proposal would modify the conditions for a foreign financial institution to be deemed a qualified custodian.[44] As a general matter, ICI supports the Commission's intent to ensure that foreign financial institutions have instituted measures designed to protect investor assets. ICI is concerned, however, that the Proposal does not account for the practical realities in foreign markets, which ultimately will reduce investment opportunities and increase costs for investors.

It will be challenging for an adviser to determine that a foreign financial institution has the "requisite financial strength to provide due care for client assets" because of the lack of consistent availability of the information necessary for advisers to make this determination. Additionally, this determination is subjective and may open advisers up to the risk of second-guessing.

Together, these concerns may substantially reduce the types of advisory services available. The Proposal would require any foreign financial institution to be "[r]equired by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act … and regulations thereunder."[45] The Proposing Release acknowledges the possibility that a country might not have a regulatory framework equivalent to the Bank Secrecy Act requirements, which would result in no foreign financial institution qualifying as a custodian in that country, and that a client may suffer losses after being forced to divest.[46] The Proposing Release then states that the Commission does not have data on the number of client accounts or the quantity of assets that would be affected.[47] The Commission therefore is potentially requiring investors to divest

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[42] We note, however, that any approach based on Rule 17f-7 should appropriately account for the differences between advisory accounts and funds, including differences in the roles and responsibilities of the adviser.

[43] *See, e.g.*, Rule 17f-7 Release.

[44] *See* proposed rule 223-1(d)(10)(iv).

[45] *See* proposed rule 223-1(d)(10)(iv)(C).

[46] *See* Proposing Release at n. 488.

[47] *See* Proposing Release at n. 489.

from an entirely unknown universe of assets, subjecting investors to potential losses and depriving them of investment options.

Rather than impose this new burden on investment advisers, ICI recommends that the Commission eliminate this requirement from any final rule. In its place, the Commission could adopt an approach similar to the one in Rule 17f-5 which has been subjected to public comment and scrutiny by impacted parties, and has served investors in registered investment companies well since its adoption.[48]

Section 3.2.4. Exception for Certain Physical Assets and Privately Offered Securities

The Proposal acknowledges that there may be circumstances where the protections of a qualified custodian are unavailable for certain physical assets and privately offered securities, and excepts these assets from having to be maintained with a qualified custodian.[49] The Proposal would require an adviser to "reasonably determine" that ownership of certain privately offered securities and physical assets cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession or control of such assets.[50]

ICI is concerned that the requirement that an adviser "reasonably determine" that a privately offered security cannot be custodied by a qualified custodian would be subject to a perilous amount of second-guessing. ICI members have expressed concern, with respect to some difficult-to-custody assets, about the implications of the Proposal as applied to a situation where one custodian has devised a way to custody such assets, but others have not. Would the fact that one custodian has purported to devise a way to custody a type of asset that no other custodian has be sufficient evidence that the asset is able to be custodied? What if the adviser has other reasons not to engage such custodian for custody services?[51] What if the custodial costs adversely impact the relative value of holding the asset?

The Proposal acknowledges that "while the rule does not prescribe exactly how advisers should comply with the requirement, many advisers may choose to develop policies and procedures that establish the frequency with which the market for custodial services is reviewed."[52] We recommend that any final rule include a safe harbor, which acknowledges the experience and

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[48] We note, however, that any approach based on Rule 17f-5 should appropriately account for the differences between advisory accounts and funds, including differences in the roles and responsibilities of the adviser.

[49] *See* proposed rule 223-1(b).

[50] *See id*.

[51] *See also* Commissioner Peirce Statement (observing that, "it is unclear how frequently such a determination would have to be made or how far and wide would an adviser have to search for a qualified custodian for these securities?").

[52] Proposing Release at 14751.

discretion of advisers, such that advisers who maintain reasonable policies and procedures that establish the frequency for reviewing the market for custodial services will be deemed to reasonably determine that the protections of a qualified custodian are unavailable for certain physical assets and privately offered securities.

Section 3.2.5. Segregation of Client Assets

The Proposal would require an adviser to obtain written reasonable assurances that a bank or savings association acting as custodian ("bank custodians") will clearly identify and segregate client assets from its assets and liabilities.[53] The Commission, by proposing this, appears to be seeking to extend indirectly its regulatory jurisdiction over persons that Congress has not authorized it to regulate.[54]

As a general matter, ICI supports the Commission's intent to ensure that client assets are clearly identified and appropriately segregated from bank custodian's assets and liabilities. However, we understand that, as applied to cash deposits, this proposed requirement would subvert the entire banking model and decrease the efficient day-to-day operation of the financial markets. If this element of the Proposal is adopted, ICI members are concerned that bank custodians are likely to reduce or even eliminate the offering of key custodial services, while also significantly raising fees associated with custodial services to offset the lost revenue opportunities.

Making such a monumental change also appears to be unnecessary in light of current accounting procedures. ICI understands that standard banking practices involve placing all end of day cash from client accounts into an omnibus account that exists on the balance sheet of the bank. Accounting procedures are in place to ensure that each account is credited with the appropriate amount of cash, but as a practical matter, all cash is combined, daily, on the balance sheet of the bank as a liability of the bank. It is this pool of aggregated cash that funds the bank's operations and serves as the basis for the bank's ability to offer a variety of credit services to its clients, including short-term lines of credit and, more importantly, intra-day liquidity to ensure the timely settlement of securities transactions. Further, ICI understands that a foundational element of the custody banking business model involves earning net interest income by investing residual cash left on the bank's balance sheet, and that such income can comprise a meaningful portion of the custodian's profit margin. Thus, the requirement to "segregate all client assets" is fundamentally

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[53] *See* proposed rule 223-1(a)(1)(ii)(D).

[54] Other recent SEC issuances attempting this regulatory overreach include: *Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies*, SEC Release No. IA-5956 (Feb. 9, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11028.pdf; *Request for Comment on Certain Information Providers Acting as Investment Advisers,* SEC Release No. IA-6050 (June 15, 2022), available at https://www.sec.gov/rules/other/2022/ia-6050.pdf; and *Outsourcing by Investment Advisers*, SEC Release No. IA-6176 (Oct. 26, 2022), available at https://www.sec.gov/rules/proposed/2022/ia-6176.pdf. *See also* Commissioner Peirce Statement.

inconsistent with the custody bank business model and is likely to result in changes in processes and access to credit services that will undermine the stability and efficiency of the trade settlement and other financial market processes.

Relatedly, we understand that this proposed requirement would potentially be inconsistent with certain existing CFTC requirements and existing requirements for broker-dealers, as discussed in more detail in Appendix A. We encourage the Commission to acknowledge the existing CFTC segregation requirements and current requirements for broker-dealers and revise the proposed requirements as discussed in Appendix A. We further encourage the Commission to acknowledge existing bank regulatory requirements[55] and recommend that the proposed requirement for an adviser to obtain reasonable assurance that a bank custodian will identify and segregate cash from its assets and liabilities be eliminated from any final rule.

The net result of these changes would be to greatly increase costs and reduce investor choice, as increased costs and burdens coupled with the lack of available custodial services for certain asset types or in certain markets will cause advisers to reduce the investment opportunities they offer to their clients. We are concerned that just this one aspect of the Proposal will not only deprive investors of beneficial investment opportunities but also have a significant impact on efficiency, competition and capital formation more generally affecting advisers, their service providers, and the markets overall.

Section 3.3. Derivatives-Related Issues Must be Separately Examined and Certain Derivatives and Related Client Assets Must be Excepted

The Proposal raises a number of concerns and questions related to the use of certain derivatives instruments. In general, we believe that the Proposal:

- seeks to impose operationally burdensome regulatory requirements without adequately justifying the need for such requirements;
- misunderstands the nature of certain derivatives positions and their inability to be custodied as contemplated by the Proposing Release; and
- inappropriately attempts to regulate privately negotiated contractual arrangements that are already covered by provisions of the CEA and CFTC rules thereunder.

ICI's recommendations are summarized below, and Appendix A provides additional information on each of these points.

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[55] *See., e.g.,* OCC Handbook, Safekeeping of Custody Assets ("a custodian's accounting records and internal controls should ensure that assets of each custody account are kept separate from the assets of the custodian….").

The Proposal does not explicitly address the custody of financial contracts (such as over-the-counter (or "OTC") swaps, cleared swaps, futures contracts and option contracts). ICI recommends that the Commission not include financial contracts in the definition of "assets." In contrast, client assets maintained in connection with such financial contracts, consisting of funds, securities and other assets delivered to the swap dealer, counterparty, FCM or broker-dealer as margin, can generally be custodied in the traditional sense.[56] If the Commission nevertheless determines to include such financial contracts in the expanded definition of the term "assets," it should acknowledge that an adviser would not be viewed as having "custody" of such financial contracts if the adviser either does not have the authority to transfer the financial contracts or may only do so with the consent of the counterparty. In addition, the Commission should except from the proposed custody requirements margin and collateral posted in connection with OTC financial contracts.

ICI supports including registered FCMs as qualified custodians and agrees that the CFTC regulatory requirements currently applicable to registered FCMs provide appropriate safeguards to protect client assets. However, ICI requests that the Commission make certain clarifying changes as described below.

ICI believes that current CFTC customer funds requirements applicable to registered FCMs are sufficient grounds to eliminate the condition that customer assets held by FCMs be limited to an amount that is incidental to the relevant transaction. ICI supports the statement in the Proposal noting that FCMs holding futures customer funds subject to CFTC Rule 1.20 meet the proposed definition of "qualified custodian;" however, ICI requests that the Commission clarify that FCMs holding customer funds in connection with cleared swaps and foreign futures contracts, which are addressed in separate parts of the CFTC regulations that provide similar and appropriate safeguards, also meet the proposed definition. The Commission should clarify that, if a broker-dealer or FCM complies with applicable customer funds rules, including the FCM customer funds rules relating to foreign futures and cleared swaps, the broker-dealer or FCM will satisfy the proposed "possession or control" requirement.

We recommend that the proposed requirement that the adviser enter into a written agreement with each qualified custodian (including each FCM and broker-dealer) with respect to each advisory client be eliminated from any final rule.

If the Commission determines to require that the adviser obtain reasonable assurances as proposed, as discussed above, our members have identified significant concerns with certain of the proposed required assurances. We recommend that the Commission consider the practicality

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[56] However, see concerns about the proposed cash segregation requirements described in Section 3.2.5.

and operational feasibility of each such proposed term, as discussed above and as discussed in more detail with respect to derivatives transactions in Appendix A.

Section 3.4. Preserving Investor Choice

The Proposing Release makes clear that crypto assets would be included in the definition of "assets."[57] We understand that the Proposal may cause a significant contraction in the available venues for trading, and a reduction in the number of entities able to custody, digital assets, resulting in less competition, greater concentration risk and the potential for an increase in fees. The proposed requirement that an adviser receive reasonable assurance that a custodian has insurance that will adequately protect the client is inconsistent with the current state of the marketplace, for which we understand there is limited insurance available.

We are concerned that the Commission is seeking to indirectly prohibit investment advisers from investing in specific asset types – in this case digital assets – via the proposed custodial requirements.[58] We believe that it ultimately will be detrimental for retail investors to be shut out of future investment opportunities based on the custodial infrastructure that exists today, and that the Commission should reconsider its willingness to allowing greater investor access to potentially beneficial investment opportunities.[59]

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[57] *See* Proposing Release at Section II.A.1.

[58] We concur with Commissioner Uyeda, who noted that "[t]his approach to custody appears to mask a policy decision to block access to crypto as an asset class. It deviates from the Commission's long-standing position of neutrality on the merits of investments." *Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets*, SEC Commissioner Mark T. Uyeda (Feb. 15, 2023), available at https://www.sec.gov/news/statement/uyeda-statement-custody-021523. Further, as a practical matter, the ability of a bank custodian to custody crypto assets is restricted by staff guidance. *See* SEC Staff Accounting Bulletin No. 121 (Apr. 11, 2022), available at https://www.sec.gov/oca/staff-accounting-bulletin-121 (requiring on balance sheet treatment of any such assets and a resulting capital charge).

[59] In a previous rulemaking, the Commission has made clear its goal to preserve and promote investor choice and access to products and services. *See, e.g., Regulation Best Interest: The Broker-Dealer Standard of Conduct*, SEC Release No. 34-86031, 84 Fed. Reg. 33318, 33323 and 33389 (Jul. 12, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf (noting "the Commission's important goals of enhancing retail investor protection and decision making, while preserving, to the extent possible, retail investor access (in terms of choice and cost) to differing types of investment services and products" and further noting that the "Commission's goal is to promote access and choice to investors…").

Section 4. Deficient Cost-Benefit Analysis

Responsible regulation requires a regulator to have a minimum level of understanding of the potential implications of its proposed requirements.[60] In this instance, the Commission failed to meet this essential standard. The Proposal's cost-benefit analysis is severely wanting. It does not adequately consider relevant factors or incorporate realistic estimates of economic impacts. The Proposal cavalierly notes that important custody and advisory services may no longer be available as a result of the Proposal's requirements, including with respect to foreign financial institutions,[61] without adequately acknowledging the harm to investors and the overall markets that would result.[62]

Section 4.1. Possession or Control

In the context of defining an entity that can serve as qualified custodian, the Proposal would define "possession or control" to mean:

> holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.[63]

The Proposal asserts that "[t]he proposed definition of 'possession or control' in proposed rule 223-1 is designed to be consistent with the laws, rules, or regulations administered by the

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[60] *See generally* Joint Association Letter to Chair Gensler re: *Importance of Appropriate Length of Comment Periods* (Apr. 5, 2022), available at https://www.ici.org/system/files/2022-04/22-ici-letter-to-sec-chair-gensler.pdf (noting that "[r]ulemakings must provide sufficient factual detail on the legal basis, rationale, and supporting evidence for regulatory provisions such that interested parties are 'fairly apprised' of content, the reasoning of the agency implementing them, and the manner in which such regulations foreseeably may affect their interests") (citations omitted). *See also* Letter from Citadel Securities regarding Order Competition Rule, et al. (Mar. 31, 2023), available at https://www.citadelsecurities.com/wp-content/uploads/sites/2/2023/04/Citadel-Securities-Cover-Letter-Final.pdf (observing that the "Commission cannot just throw up its hands and fail to "make [the] tough choices" needed to properly estimate the economic impacts of its proposals") (internal citations omitted).

[61] *See* discussion above at Section 3.2.3.2.

[62] *See, e.g.,* Proposing Release at 14757 (stating that, "[i]t is possible that the costs borne by advisers may be large enough to cause some advisers to stop providing advice with respect to certain assets," and "to the extent qualified custodians are unable to pass these costs along to advisers and their clients, an increase in compliance costs could cause some qualified custodians to exit the market.").

[63] *See* proposed rule 223-1(d)(8).

qualified custodian's functional or primary financial regulator for purposes of its custodial activities."[64] However, the proposed definition falls short of its intended design.

The proposed definition of "possession or control" would impose significant frictions on transactions in many types of assets that, today, are processed with relative ease. It even would make transacting in certain assets virtually impossible. Further, the requirements of the proposed definition of "possession or control" may put qualified custodians in the impossible position of complying with one regulatory regime while simultaneously violating another. In particular, we understand that Rule 760 of Regulation R limits the ability of a custodial bank to accept orders to effect transactions in securities for custodial accounts, and, to the extent that the Proposal would mandate that the custodian be part of the order-taking process, this requirement seems to be at direct odds with Regulation R's limits.[65]

The Proposal's definition of possession or control would require, among other things, that the qualified custodian "participate in any change in beneficial ownership of assets." This would be a significant departure from current custodial practices, which is likely to interfere with the processing of transactions. By way of example, this proposed requirement would impose significant operational and practical burdens on the custody of OTC derivatives and other bilateral contractual obligations.[66] As discussed below and in Appendix A, it is our view that such derivative instruments that are evidenced by a financial contract (*e.g.,* futures, options on futures, cleared swaps, OTC swaps and other financial contracts themselves that are not able to be custodied in the traditional sense) should be excluded from the definition of "assets" under any final rule. However, assuming that the Commission determines to move forward as proposed, we understand that qualified custodians, in reviewing the Proposal, are taking the reasoned view that the only way for a qualified custodian to have "possession or control" of a bilateral contractual obligation would be for the qualified custodian to be made a third party to such contractual obligation. By their nature, bilateral contractual obligations are agreements between the two parties (buyer and seller) and do not include third parties as part of the negotiation or agreement process. Qualified custodians have indicated that they would have serious issues with being included as party to such agreements. The intermediation of qualified custodians in bilateral contractual obligations in certain types of asset classes has the potential to subject qualified custodians to a variety of regulatory regimes from which their operations are currently designed to be exempted.[67]

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[64] Proposing Release at 14687.

[65] *See* 17 CFR §247.760.

[66] We further understand that other asset classes, including syndicated loans, commercial and residential mortgage loans and real estate, would be subject to similar impediments.

[67] *See, e.g.,* 17 CFR §247.760.

Even setting aside the potential regulatory implications, the practical implications of including a qualified custodian as a party to each contractual obligation are significant. By way of example, a derivatives transaction is typically negotiated between the buyer and the seller, without interposition by a third party. To the extent that a qualified custodian must be made party to a derivatives transaction by virtue of being added to the contractual arrangement, such qualified custodian will have a vested interest in negotiating and securing terms that are consistent with its own requirements, processes and business needs, without regard to the preferences or timing concerns of the negotiating parties. As a purely practical matter, primary transacting parties with a profit motivation are likely to resist a qualified custodian imposing contractual terms, or delaying the completion of, a derivatives transaction. Qualified custodians will have challenges involving their personnel in the negotiation of every derivatives transaction conducted by their custodial clients. Qualified custodians will rightly question what their obligations are in connection with such agreements, and may not have the necessary expertise to evaluate agreements in respect of every derivatives transaction.[68] These and similar concerns exist across a number of different asset classes, and have the potentially to meaningfully delay transactions between principals, resulting in potential losses.[69]

This element of the Proposal is likely to meaningfully impair the efficient operation of markets and limit capital formation. To the extent that qualified custodians are unwilling or unable to take possession or control of certain types of assets, the availability of that asset class as a viable investment strategy will be jeopardized, likely resulting in higher costs for advisers and their clients, and/or fewer investment options for investors.

We recommend that the Commission revise the definition of "possession or control" to be consistent with existing regulatory requirements applicable to custodians, including, with respect to broker-dealers and FCMs custodying margin, existing applicable customer funds rules (see Appendix A).

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[68] In the adopting release for Rule 17f-6 under the Investment Company Act, which governs the custody of fund assets with FCMs, the Commission stated that Rule 17f-6 was proposed "to respond to certain criticisms" regarding the requirement under certain no-action relief that funds place assets relating to commodity transactions in a special account with a third party custodian bank. *See* Rule 17f-6 Adopting Release. The Commission noted that "[c]ommenters have indicated that third party accounts create systemic liquidity risks by diverting FCM capital, which would otherwise be available for use in the marketplace, to effect fund transaction. Commenters have also stated that third party arrangements are unnecessary because they are unlikely to provide any special protection to fund assets in FCM bankruptcy proceedings." *Id.* at 66208. Finally, the Commission stated, "third party accounts may be redundant in view of the safeguards for customer assets afforded by the CEA and CFTC rules." *Id.* While Rule 17f-6 applies in the context of funds and the Proposal does not, we believe that the Commission's rationale for no longer requiring tri-party arrangements for custody in the Rule 17f-6 context is also relevant here. Requiring custodians to enter as third parties into derivatives arrangements that would otherwise be effected as bilateral contracts would impose significant operational burdens that the Commission has not demonstrated are justified.

[69] For example, the execution of foreign currency forwards would be impacted.

Section 4.2. Written Agreement with Independent Public Accountant

The Proposal would require that an independent public accountant verify any purchase, sale or other transfer of beneficial ownership of privately offered securities.[70]

ICI is concerned that the proposed requirement will significantly increase the costs associated with retaining, and strain the capabilities of, independent public accountants. Depending on the asset type, verification of transactions in privately offered securities by an independent public accountant can be a process that involves more work and time than the Commission acknowledges. As noted in the Proposal, verifying a privately offered security held by an adviser on behalf of its client might require an independent public accountant to contact the issuer of the security or its agent to verify the existence of the asset, or to review documents such as private placement memoranda and the issuer's Regulation D filings.[71] These verification processes can take extended periods of time, and, to the extent that they rely on a third party's cooperation (who will generally not be under any obligation to respond), may ultimately prove to be futile.

Verification of such transactions may require the accountant to be physically present at the adviser's location, such as in the case of an adviser that frequently trades privately offered securities. ICI is concerned that this requirement, or even the potential, for significant physical presence is likely to lead to significantly increased costs. We understand that, given this level of involvement, it may be difficult for an adviser to engage an independent public accountant. With the proposed increase in responsibilities to be performed by independent public accountants, the Proposal may actually result in client accounts having less access to the most sought-after independent public accountants.

Further, ICI is concerned that requiring an independent public accountant to verify the existence and ownership of each such asset during a surprise examination or financial statement audit will significantly increase the costs and burden associated with such audit without a commensurate benefit. This would be a meaningful and unnecessary change from current auditing practices pursuant to which a sampling approach is often utilized. The Proposal fails to acknowledge the difficulties associated with verification of the existence and ownership of certain types of

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[70] *See* proposed rule 223-1(a)(4).

[71] *See* Proposing Release at Section II.C.4.

securities, and fails to sufficiently consider the costs associated with this proposed requirement.[72] We therefore recommend that the proposed requirement be eliminated from any final rule.

Section 5. The Commission Should Except Funds, BDCs and College Savings Plans

The Commission rightly proposes to except the accounts of funds from any final rule, an approach ICI supports in light of the existing comprehensive regime designed to safeguard fund assets. This regime has functioned exceptionally well in protecting assets for the benefit of fund investors, and there is no evidence that changes are warranted. The Commission, however, does not propose to except BDCs or college savings plans from the Safeguarding Rule. ICI recommends that the Commission do so in any final rule given their similarity to funds in structure, operation, and oversight.

The Commission should include within the exception in Rule 223-1(b)(1) shares of any other registered investment company (including shares of closed-end investment companies, shares of closed-end investment companies operated as "interval funds" under Rule 23c-3 under the Investment Company Act and unit investment trusts) and BDCs held at a transfer agent. Such holdings should be treated in the same manner as registered open-end investment companies under this exception where a transfer agent "fulfill[s] all of the obligations assigned to a qualified custodian under the rule."[73] Similarly, the Commission should include within the exception in Rule 223-1(b)(1) interests in college savings plans.[74]

Section 6. Transition Period and Compliance Date

The Commission proposes to provide a compliance date of one year for larger advisers and 18 months for smaller advisers. We believe that this timeframe is completely unrealistic and wholly inadequate given the significant legal, compliance and operational challenges that would be presented by the Proposal. Compliance will be further complicated because the same firms will

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[72] Similar to the above discussion regarding difficulties associated with verification of transactions, we understand that the verification of the existence and ownership of certain assets, such as holdings in private investment vehicles and bank loans can be dependent on cooperation of third-party counterparties, which is entirely out of the control of the independent public accountant, custodian, adviser, or their client. Such counterparties are under no legal or contractual obligation to respond to inquiries by independent public accountants, and frequently take extended periods to respond, if they respond at all. We understand that a requirement to verify the existence and ownership of each privately offered security or physical asset would significantly slow down (sometimes by months), and add meaningful expense to, a surprise examination or financial statement audit.

[73] *See* Proposing Release at Section I.A.

[74] *See* discussion of ICI 529 Letter, *infra* note 14.

be implementing other new or changed rules simultaneously.[75] As noted above in our comments, the Commission has many other proposals pending, or planned, that will impact various systems and resources. It is incumbent on the Commission to carry out its mission responsibly, which includes mitigating the very serious issues and risks that the specter of so many new requirements likely being required to be implemented at the same time raise.

Given the scope of the proposed changes, if the Commission determines to move forward with the Proposal, ICI recommends that the Commission allow for a transition period of a minimum of 36 months for all advisers.[76] Although we appreciate the Commission's proposal to give smaller advisers a longer transition period, given the scale and scope of the Proposal's changes, larger advisers are likely to need as much time as smaller advisers to restructure their operations and make the appropriate arrangements to come into compliance.

Careful analysis of empirical data and the costs and benefits of potential policy actions, along with impacts on investors, efficiency, competition, and capital formation, must serve as the foundation for this, and any, rulemaking. Unfortunately, the Proposal is deficient in these areas.

We encourage the Commission to engage with ICI and its members, advisers generally, global custodians, independent public accountants and other marketplace participants as it continues to consider how best to protect advisory client assets from theft, loss or misappropriation. In the meantime, if you have any questions with respect to this comment letter, please contact me or Erica Evans, Assistant General Counsel (with respect to derivatives-related issues).

Sincerely,

/s/ Dorothy M. Donohue

Dorothy M. Donohue
Deputy General Counsel

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[75] Advisers and custodians have systems in place to monitor for a number of factors. The Commission overlooks the fact that these systems are generally tied into numerous other ancillary systems for downstream reporting and monitoring. Enhancements to any one system need to be evaluated for any significant impacts to any other system that is connected to it. Therefore, programming and testing efforts are far more complex and time consuming than contemplated by the Commission. Our members consistently cite one-time compliance costs (*e.g.*, legal costs, preparation of new policies and procedures, creation of internal controls and ongoing testing, and staff training), increased technology expenditures, increased use of third-party vendors, development of appropriate oversight programs, and increased staffing needs as the primary drivers of the overall cost of implementing a new or revised process in response to a new regulatory mandate. Additionally, the Commission ignores the opportunity costs associated with advisers' efforts to comply with the proposed amendments, including the diversion of resources that may otherwise be focused on, for example, bolstering portfolio and risk management capabilities, enhancing oversight of existing legal and compliance, and accounting obligations, improving customer service, and product innovation.

[76] *See* footnote 16 above.

cc: The Honorable Gary Gensler
The Honorable Hester M. Peirce
The Honorable Caroline A. Crenshaw
The Honorable Mark T. Uyeda
The Honorable Jaime Lizárraga

William A. Birdthistle, Director
Sarah ten Siethoff, Deputy Director
Division of Investment Management

Appendix A

Considerations Regarding Safeguarding Requirements for Investments in Derivatives

ICI has significant concerns about the impact of the Proposal on the ability of advisers to engage in certain types of derivatives transactions on behalf of their clients. The Proposal's ill-suited, one-size-fits-all approach to custody raises substantial issues in the context of such derivative instruments. ICI encourages the Commission to take into account regulatory regimes that already exist to protect client assets in these circumstances and to carefully consider the operational feasibility of any final rule with respect to derivatives transactions. This appendix sets forth ICI's derivatives-related comments.

Section 1. Proposed Definition of "Assets"

The Proposal would define "assets" to mean "funds, securities, or other positions held in a client's account."[77] The Proposing Release states that this definition would include "financial contracts held for investment purposes, collateral posted in connection with a swap contract on behalf of the client, and other assets that may not be clearly funds or securities covered by the current rule."[78] However, the proposed requirements for a qualified custodian, including an FCM or broker-dealer, or adviser to properly maintain custody do not make sense in the context of such financial contracts, and ICI is concerned that scoping in the financial contracts themselves would significantly limit an advisers' ability to utilize such transactions in client accounts, to the detriment of clients that may lose opportunities to hedge various portfolio and asset-related risks, obtain certain investment exposures unavailable through other methods of trading and obtain certain investment exposures at lower transaction costs.

A futures contract, option contract or swap is not an "asset" in the traditional sense of the word; rather, it is a live, bilateral contract or a set of two contracts with a clearinghouse interposed as a party to each opposing contract (e.g., a long/short). An OTC swap transaction is evidenced by a confirmation between the two parties to the transaction, while a futures contract, an option on a futures contract or a cleared swaps contract is generally evidenced solely in a statement delivered to the buy-side counterparty. There is consequently no practical way for an FCM or other qualified custodian to "have or otherwise evidence possession or control" of financial contracts

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[77] Proposed rule 223-1(d)(1).

[78] Proposing Release at 14679. *See also* Proposing Release at n. 14, suggesting that swaps, along with certain other instruments, are covered by the proposed expanded definition of the "assets." Note that where this letter refers to "swaps" trading it also encompasses "security-based swap" trading unless otherwise noted because of a regulatory difference in their treatment.

themselves based on current market practice.[79] In contrast, client assets maintained in connection with such financial contracts, consisting of funds, securities and other assets delivered as margin, can generally be custodied in the traditional sense.[80] We believe that the "assets" of the client relating to a financial contract are more accurately represented by a receivable equal to the amount of unsettled gains on the transaction and any client assets posted as margin in connection with the transaction. Accordingly, any final rule should:

(i) define the term "assets" to exclude the financial contracts themselves;

(ii) define financial contracts in a manner that includes OTC swaps, cleared swaps, futures contracts, options on futures contracts, and other similar financial contracts; and

(iii) provide that an adviser may have "custody," thereby triggering the requirements of the Proposal, only of client assets maintained as margin or collateral in connection with such financial contracts.[81]

Section 2. Proposed Definition of "Custody"

The Proposal, like the current custody rule, would apply only with respect to client "assets" of which an adviser has "custody." The general principle of the Proposal's definition of "custody" seems to be to apply the rule when an adviser has the ability or authority to effect a change in beneficial ownership of a client's assets. Although an adviser may have the authority to transfer *margin* associated with a financial contract, an adviser generally does not have the ability or authority to effect a change in the beneficial ownership of a client's *financial contracts*. Further, an OTC swap is generally transferable only with consent of the counterparty. A futures contract, option on a futures contract or a cleared swap contract is generally non-transferrable under applicable clearinghouse rules, and an adviser generally must enter into offsetting transactions on the relevant exchange to exit a contract on behalf of a client.

The Proposing Release does not explicitly address this issue in the context of financial contracts but does state that "if a stock certificate is non-transferable (*i.e.,* it cannot be used to effect a change in beneficial ownership of client's investment), an adviser would not be subject to the

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[79] See also discussion of proposed "possession or control" requirement with respect to derivatives in Section 4.1 of the letter above.

[80] However, see concerns about the proposed cash segregation requirements described in Section 3.2.5.

[81] ICI also notes that similar concerns regarding the definition of "assets" and other comments in this appendix apply with regard to short sales, TBAs, repurchase agreement and reverse repurchase agreement transactions, and securities lending transactions, none of which is typically able to be custodied in the traditional sense.

rule as a result of holding it."[82] We agree. The Commission should extend this logic to financial contracts. ICI requests that the Commission clarify that, even if such financial contracts fall within the definition of "assets" in any final rule, an adviser would not be viewed as having custody of such contracts if the adviser may only transfer such financial contracts with the consent of the counterparty, if at all (*i.e.*, the adviser would not be able to unilaterally transfer the financial contract). As discussed above, financial contracts themselves cannot be custodied in the traditional sense. Viewing the adviser as having custody of financial contracts for which an adviser has no authority or ability to effect a change in beneficial ownership, and thereby requiring technical compliance with the proposed requirements with respect to such financial contracts themselves, does not make sense as it would have no protective benefit to advisory clients. Moreover, such a requirement could effectively end futures, options and swap trading by advisory clients by making such transactions impracticable. We do not believe that this was the Commission's intended result, and we urge the Commission to clarify that an adviser would not be considered to have "custody" of such financial contracts. Our proposed approach would recognize that transacting in these types of financial contracts for client accounts is substantively different than transactions in equities, bonds and other assets, and that the limitation on transfer only with counterparty consent and/or the complete absence of the ability to transfer a financial contract would more than adequately protect clients.

Section 3. Proposed Qualified Custodian Requirements

Section 3.1. Definition of "Qualified Custodian" With Respect to Custody of Margin Posted to Support Futures, Options on Futures, and Cleared Swaps

The proposed requirements for the custody of margin posted to support futures, options on futures, and cleared swaps raise significant concerns in the context of both the proposed definition of "qualified custodian" and the "possession or control" requirement.

The Proposal would define the term "qualified custodian" to include "[an FCM] registered under section 4f(a) of the [CEA], holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon."[83] The Proposal states the Commission's view that CEA Section 4d(a)(2) and "regulations promulgated thereunder, including, among others" CFTC regulations, 1.20, 1.22 and 1.25 ("FCM customer funds rules") "holistically serve the same purpose" as the proposed standard of "possession or control."[84] ICI supports including registered FCMs as qualified custodians and agrees that the

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[82] Proposing Release at n. 64.

[83] Proposing Release at 14783.

[84] Proposing Release at 14688.

existing CFTC regulatory requirements applicable to registered FCMs appropriately safeguard client assets posted as margin for futures and options on futures and cleared derivatives. Registered FCMs therefore should be able to serve as qualified custodians without meeting additional conditions.

The Proposal asks whether the 2013 CFTC regulatory enhancements to its FCM customer fund requirements are sufficient grounds to eliminate the condition in the current custody rule that customer assets held by FCMs be limited to an amount that is incidental to the relevant transactions.[85] In 2013, the CFTC adopted a number of comprehensive enhancements to its FCM customer protection rules covering its customer protection regime, risk management requirements for FCMs, liquidity requirements for FCMs, the examination process of FCMs by both their self-regulatory organizations and public accountants that annually audit the FCM and provision of disclosures to customers concerning futures trading and FCMs that hold customer funds.[86] These regulatory revisions augmented the existing CFTC regulations and self-regulatory organization customer protection rules applicable to FCMs that already were fairly robust and extended beyond CFTC regulations 1.20, 1.22 and 1.25. ICI believes that the substantive FCM customer fund requirements provide sufficient protections to justify eliminating the condition in the current custody rule, and that the Commission should defer to the CFTC as the primary regulator of FCMs for how best to protect customers. Based on the above, ICI sees no reason to impose more stringent limits on the amount of assets that an advised client may posted with an FCM when it is trading on its own account compared to when the adviser is trading on behalf of the client.

The Proposing Release states that FCMs that hold futures customer funds subject to CFTC Rule 1.20 would meet the definition of "qualified custodian" under the Proposal;[87] however, the Proposing Release does not address the CFTC FCM rules applicable to customer funds held by FCMs in connection with cleared swaps and foreign futures, which are addressed in separate parts of the CFTC regulations.[88] FCMs that hold foreign futures customer funds and cleared swaps customer funds in accordance with these CFTC rules are subject to long-standing regulatory requirements that provide sufficient and appropriate safeguards. ICI requests that the Commission clarify that FCMs holding customer funds subject to the relevant CFTC Part 22

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[85] See Proposing Release at n. 112 and accompanying text.

[86] *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations*, 78 Fed. Reg. 68505 (Nov. 14, 2013), available at https://www.govinfo.gov/content/pkg/FR-2013-11-14/pdf/2013-26665.pdf.

[87] Proposing Release at n. 89.

[88] *See* CFTC Rules 22.2, 22.4, and 22.6 (cleared swap customer funds protections) and 30.7 (foreign futures and foreign options secured amount protections)

rules and CFTC Rule 30.7 also would meet the definition of "qualified custodian" under any final rule.

Section 3.2. "Possession or Control" With Respect to Custody of Margin Posted

In connection with discussing the possession or control requirement, the Proposal notes that "broker-dealers are required promptly to obtain and maintain in their physical possession or control all of their customers' fully paid and excess margin securities."[89] As noted above, the Proposal posits that CEA Section 4d(a)(2) and the FCM customer funds rules "holistically serve the same purpose" as the proposed standard of having "possession or control." However, the Proposal also states that the "functional regulators have not defined possession or control in the custody context in a manner identical to our proposed rule,"[90] which can be read to suggest that, in the Commission's view, the current broker-dealer and FCM customer protection regimes may not sufficiently address the proposed possession or control requirement.[91] The Commission's imposition of additional requirements on broker-dealers and FCMs would not provide additional customer protection, would cause confusion and tension in the industry as FCMs could be subject to conflicting regimes, and would impose substantial costs and burdens on FCMs, which would likely be passed on to advisers and clients. The Commission therefore should clarify that, if a broker-dealer or FCM complies with the applicable customer funds rules, the broker-dealer or FCM will satisfy the Proposal's "possession or control" requirement. In addition, the Commission similarly should clarify that CFTC rules relating to foreign futures and cleared swaps also satisfy the Proposal's "possession or control" requirement with respect to foreign futures and cleared swaps. Alternatively, the Commission could adopt a standard for possession or control similar to that in Rule 17f-6 under the Investment Company Act, which simply requires the FCM to provide contractual acknowledgment of, and agreement to comply with, the FCM customer funds rules in the relevant account agreement between the FCM and the client. In adopting Rule 17f-6, the Commission acknowledged the protections already provided by applicable CEA and CFTC custody requirements.[92] The Commission should similarly defer to

[89] Proposing Release at 14688.

[90] *Id.*

[91] The Commission does not identify any differences among the regimes.

[92] For example, the Rule 17f-6 Adopting Release states, "The CEA and CFTC rules contain provisions designed to safeguard customer assets held by an FCM. For transactions traded on domestic exchanges, extensive regulations, known as the 'segregation requirements,' are designed to protect customer funds in an FCM's possession." Rule 17f-6 Adopting Release at 66208. The Rule 17f-6 Adopting Release further states, "The adopted rule incorporates the safeguards that are provided for fund assets under the CEA and CFTC rules and, in so doing, generally permits funds to effect domestic and foreign commodity transactions in the same manner as other market participants." *Id.* at 66208-09.

existing regulatory customer protection regimes here and avoid imposing duplicative, and possibly conflicting, requirements on the custody of client assets with broker-dealers and FCMs.

Section 3.3. Custody of Margin Posted to Support OTC Swaps and OTC Security-Based Swaps

The proposed requirements applicable to qualified custodians also create such significant issues with respect to the custody of OTC swaps and OTC security-based swaps that we do not believe that the Commission should move forward with any rule that would apply the substantive conditions under the Proposed Rule to such contracts and related margin. Accordingly, ICI requests that the Commission create an exception to the custody requirements with respect to margin and collateral posted in connection with OTC financial contracts.

Currently, regulatory initial margin for OTC swaps and OTC security-based swaps traded with banks is required to be deposited with a custodian in an arrangement meeting certain specifications under CFTC and prudential regulator rules.[93] Likewise, where a client transacts in a financial contract with a US registered broker-dealer (*e.g.,* TBAs and short sales), the broker-dealer maintains custody of customer securities and cash subject to strict customer protection requirements under the Exchange Act. In each case, these requirements are different than the substantive requirements of the Proposal, even though they offer similar protections to those under the FCM customer funds rules. We believe these arrangements provide sufficient protection to client funds and assets posted as regulatory initial margin, and therefore propose that the Commission provide guidance in connection with adopting a final rule that such custodians should be able to serve as "qualified custodians" without any additional compliance requirements.

Other types of margin for OTC swaps and OTC security-based swaps traded with non-banks and subject to the Commission's security-based swap margin requirements, generally are deposited directly with the counterparty to the financial contract. The counterparty (other than a broker-dealer) may not meet the definition of "qualified custodian" set forth in the Proposal, and even if a counterparty could meet the entity-type requirements to be a qualified custodian under the Proposal, a counterparty typically would not hold client assets posted as margin in an account meeting the Proposal's requirements.

If the custody requirements in the proposal were applied to margin posted in connection with OTC financial contracts, an adviser trading in such contracts for a client would need its client to enter into tri-party account control agreements among the counterparty / broker-dealer, custodian

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[93] *See, e.g.,* CFTC Rule 23.157 and Prudential Regulator Rule §__.7 Segregation of Collateral.

and the client for the posting of margin.[94] These arrangements are generally not used for adviser clients other than registered funds and clients subject to policies or regulatory requirements requiring such arrangements. We understand that putting in place this additional contract creates significant burdens for the client (or its adviser) in terms of human capital and financial expenditures relating to negotiating contracts and developing operational infrastructure.

Moreover, we understand that the staff of the Commission's Division of Trading and Markets has a longstanding view that broker-dealers are generally restricted in maintaining tri-party custody accounts for securities credited to margin accounts, unless transacting with a registered investment company or another customer that is prohibited from maintaining collateral directly with a broker-dealer. Changing the framework for margin posted in connection with financial contracts with broker-dealers would necessitate coordination with the Division of Trading and Markets to obtain guidance for broker-dealers as to how more widespread use of these arrangements would impact the broker-dealer capital charges, among other issues. Otherwise, we expect that broker-dealers would view themselves as limited in engaging in such transactions with advisory clients. Further, we do not see how such a requirement would serve the core protective purposes of the custody requirements given that broker-dealers are subject to strict customer protection requirements as noted above.

In addition, the financial impact that these aspects of the Commission's proposal would have on clients would go beyond the human capital and financial expenditures needed to negotiate agreements and establish operational infrastructure. In this regard, if margin is held in such an account, swap dealers, security-based swap dealers, broker-dealers and other counterparties to client OTC financial contracts would not be able to rehypothecate that margin. Rehypothecation is a significant economic aspect of the trade, and the inability to rehypothecate margin would drive up trading costs that would be passed through to adviser clients. Eliminating rehypothecation also could drive counterparties out of the relevant markets and thereby limit advisers' and clients' choice with respect to the use of OTC financial contracts for investments and hedging for client portfolios.

Further, we believe that requiring tri-party account control agreements for client margin would not add meaningful protection from adviser misappropriation and therefore would not be well-suited to addressing the core purposes of the proposal. The generally recognized risk of posting assets to a counterparty is loss of such assets upon the counterparty's insolvency – not the misappropriation of such assets by the client's adviser or the adviser's insolvency. In addition, in

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[94] We note that this tri-party arrangement would still not address all of the Commission's proposed requirements as for OTC financial contracts wherein the parties must post margin to a tri-party collateral control account, the custodian contractually retains a first priority security interest in the collateral for fees related to the custodian providing securities intermediary services. We note that this practice is not prohibited under the functional regulator rules where initial margin is required to be posted to such an account.

order to trade in OTC swaps and security-based swaps, the client is required to be an eligible contract participant, which is inherently highly sophisticated, and therefore is well-positioned to assess the risk of posting assets to its counterparty when engaging an adviser to trade in this asset class on its behalf.[95] Also, as noted above, any advisory client trading with a broker-dealer would be protected by the broker-dealer customer protection requirements discussed above. Further, given that the Congress gave the CFTC, prudential regulators and the Commission ample opportunity under the Dodd-Frank Act to limit swap and security-based swap trading directly, and these regulators only determined to put in place tri-party custody account requirements with respect to certain transaction types, it seems inappropriate for the Commission now to add similar and more broadly applicable requirements with a purpose of preventing advisers from misappropriating client assets.

Finally, requiring tri-party account control agreements for client margin was not contemplated in the Commission's cost-benefit analysis. We note that in connection with its 2003 and 2009 amendments to the custody rule, the Commission recognized that "authorized trading" was not within the definition of "custody," and we understand that many types of funds and accounts are structured in reliance on that position such that the adviser is not deemed to have custody of client funds or securities with respect to those accounts. However, the proposed requirements would fundamentally change current practices and requirements, and clients may be required to enter into tri-party account control agreements to post margin as a result of the rule, which would create significant burdens for the client and its adviser.[96] Changing this framework with respect to OTC financial contracts without opportunity for affected parties to provide meaningful input and the required cost-benefit analysis would not be appropriate.

ICI therefore requests that the Commission create an exception to the custody requirements pursuant to which an adviser would not be deemed to have custody of, and would therefore not trigger the substantive requirements of the Proposal, with respect to, margin and collateral posted in connection with OTC swaps, OTC security-based swaps and other OTC financial contracts.

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[95] CEA Section 2(e) states that only individuals or entities who are eligible contract participants ("ECPs") may enter into swaps that are not executed on, or subject to the rules of, a designated contract market ("DCM"). Securities Exchange Act of 1934 ("Exchange Act") Section 6(l) provides that only individuals or entities who are ECPs may enter into security-based swaps that are not effected on a national securities exchange. In other words, only ECPs may enter into swaps and security-based swaps unless the transactions are exchange traded. The term ECP is defined in Section 1a(18) of the CEA and includes, among certain other persons and entities, "an individual who has amounts invested on a discretionary basis, the aggregate of which is in excess of— (I) $10,000,000; or (II) $5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual." *See* CEA Section 1a(18)(xi). The Exchange Act cross-references the CEA for its ECP definition. *See* Exchange Act Section 3(a)(65).

[96] We also note that the Commission just recently finalized security-based swap margin requirements in 2019. It is not clear from the Proposing Release why the Commission now seeks to impose additional, burdensome requirements on such arrangements.

Section 3.4. Proposed Requirements for a Written Agreement and Reasonable Assurances

ICI has significant concerns about the proposed written agreement and reasonable assurances requirements, which we detail in Sections 3.2.1, 3.2.2 and 3.2.3 of the letter above. Those concerns equally apply to financial contracts and margin posted in connection with those transactions.

Section 3.4.1. Proposed Written Agreement of the Adviser

Proposed Rule 223-1(a)(1)(i) would require a written agreement between the adviser and the FCM or other qualified custodian that includes specific provisions. We understand that current market practice is for contractual privity under a futures account agreement or other agreement to be solely between the client and the FCM or other qualified custodian. An adviser is typically only a party to the agreement, if at all, as agent of the client. We understand that these types of agreements tend to be highly tailored and vary significantly across different entities that act as FCMs and broker-dealers, and redocumenting the agreements with every FCM or other qualified custodian for every advisory client would be extremely burdensome in terms of time and costs, especially for smaller advisers with relatively fewer internal human capital resources. Consistent with our comments in Section 3.2.1 of the letter above, we recommend that the proposed requirement for a written agreement between the adviser and each client's qualified custodian, including FCMs and broker-dealers, be eliminated from any final rule.

Section 3.4.2. Proposed Reasonable Assurances Regarding Indemnification

Proposed Rule 223-1(a)(1)(ii) would also require an adviser to obtain reasonable assurances from the qualified custodian, including an FCM, that it will comply with certain requirements. Similar to our more generally applicable comments in Section 3.2.3.1 of the letter, certain aspects of the proposed reasonable assurances requirements raise significant concerns.

The Proposal would require that the FCM or other qualified custodian indemnify the client and have insurance arrangements in place that will adequately protect the client against risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct. ICI expects that this requirement will increase the costs of transacting with broker-dealers and FCMs. Broker-dealers and FCMs typically do not provide this type of standard of care to their clients today, and we highly doubt they will agree to do so in the future. We also understand that broker-dealers and FCMs typically do not carry insurance that would satisfy the proposed requirements and are not aware that a market for such insurance exists or would exist, leading to the concern that this may be an uninsurable risk. We urge the Commission to not include this requirement in any final rule with respect to broker-dealers and FCMs, and at a minimum first carefully consider whether such insurance even is available in the market before imposing such a requirement in this context.

Section 3.4.3. Proposed Reasonable Assurances Regarding Use of Sub-Custodial Arrangements

Proposed Rule 223-1(a)(1)(ii)(C) would provide that the use of a sub-custodial, securities depository or similar arrangement would not excuse the FCM's obligations to the client. This appears to include in its scope the FCM's deposit of client assets with a derivatives clearing organization ("DCO"). We understand that this proposed requirement would be highly problematic for FCMs, and that FCMs may be unwilling to provide this required assurance because it runs contrary to the standard operation of DCOs and their relationships with FCMs. The CEA and CFTC regulations require that customers of an FCM post initial margin to the FCM to secure the clients' payment obligations under their futures contracts or other transactions. The FCM is, in turn, required to post to the DCO all or part of the margin it receives from its customers. The CEA and CFTC regulations impose customer fund requirements on DCOs that mirror the FCM customer funds rules.

The Proposing Release highlights a concern that use of sub-custodians or other entities can create opaque structures and can increase the risk to client assets because clients and advisers are not in direct contractual privity with the sub-custodian or other entities. We are concerned that FCMs would not be in a position to guarantee the DCO. We submit that the CFTC has addressed the concern of loss of client assets as a result of actions by the FCM and DCO under its customer funds requirements, and that FCMs are required to use DCOs for clearing of their customers' transactions and therefore that these arrangements do not pose the concerns cited by the Commission with respect to sub-custodians. Accordingly, consistent with the position articulated in Section 3.2.3.2 of the letter above, we recommend that this proposed requirement be removed from any final rule; however, if the Commission determines to move forward with this aspect of the proposal, we request that the Commission provide an exemption from Proposed Rule 223-1(a)(1)(ii)(C) for FCMs that serve as qualified custodian to advisory clients.

Section 3.4.4. Proposed Reasonable Assurances Regarding Segregation of Client Assets

Proposed Rule 223-1(a)(1)(ii)(D) requires the qualified custodian to clearly identify the client's assets as such and segregate all client assets from the qualified custodian's proprietary assets and liabilities. ICI requests that the Commission explicitly except an FCM's residual interest from any such requirement in any final rule or adopting release.[97] Doing so would be consistent with statements in the proposing release,[98] which suggest that the Commission would view the residual interest requirements as consistent with the proposed segregation requirement. Furthermore, ICI requests that the Commission confirm that FCMs would be permitted to hold

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[97] A residual interest consists of FMC proprietary assets required to be included in the FCM customer funds account.

[98] Proposing Release at n. 112.

futures collateral at a DCO in an omnibus account (i.e., without operational or legal segregation among client accounts). Currently, consistent with CFTC rules, FCMs hold futures customer funds in omnibus accounts at DCOs, and a CFTC rule change would be necessary to require "operational segregation" and "legal segregation" at the DCO for futures and options on futures. The Commission therefore should explicitly clarify that written assurances would satisfy the proposed segregation condition if the FCM agrees to comply with existing, applicable CFTC segregation requirements. The recommended approach would mirror Rule 17f-6(a)(1)'s framework.

The Proposal also states that the segregation requirements "are drawn from Rule 15c3-3 of the Exchange Act, which requires broker-dealers to safeguard their customer assets and keep customer assets separate from the firm's assets."[99] There is concern that, although the Proposal is drawn from the safeguards proscribed under Rule 15c3-3, there may still be inconsistencies between the final rule and current requirements for broker-dealers. In light of these concerns, we urge the Commission to ensure that any final rule stemming from this Proposal will not require broker-dealers to have to change their practices with respect to carrying customer assets in order for an investment adviser to custody customer assets with a broker-dealer in compliance with the final rule.

Section 3.4.5. Proposed Reasonable Assurances Regarding Qualified Custodian Security Interests

Proposed Rule 223-1(a)(1)(ii)(E) raises further concerns regarding the liens that are involved when an entity—whether FCM or other qualified custodian—is holding margin and/or trading contracts. The proposal would require that the adviser obtain reasonable assurances from a qualified custodian that it will not subject the client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to, or authorized in writing, by the client. The Proposing Release notes that the requirement would help ensure that client assets are protected and free of claims by the qualified custodian, including in cases of the qualified custodian's insolvency or bankruptcy. The Proposing Release acknowledges that margin accounts can be beneficial and also provides guidance that this would not prohibit the use of margin accounts, but rather that it would require the adviser to obtain reasonable assurances from the qualified custodian that the client has authorized the lien.

We strongly support the inclusion of the carve-out for client written consent. In a futures, options on futures and cleared swap trading relationship with a broker-dealer or FCM, all the contracts and margin that the broker-dealer or FCM holds typically are subject to a general lien and a

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[99] Proposing Release at n. 171.

continuing, perfected first priority security interest for the benefit of the broker-dealer or FCM, and usually for the benefit of its affiliates, to secure any and all of the customer's indebtedness or other obligations and/or liabilities owed to the broker-dealer or FCM. The types of financial contracts that broker-dealers and FCMs intermediate for their clients—whether those clients are advised or not—can have the potential for unlimited client losses. The broker-dealer or FCM needs this lien as protection in the event that the client's losses mount, and the client defaults. Without the carve-out for client written consent, the proposal's prohibition on custodial liens would most certainly prompt broker-dealers or FCMs to find other ways to protect themselves, resulting in higher trading costs for client funds and accounts.

However, we also submit that this type of custodial relationship is different from others because the client and the broker-dealer or FCM are engaged in a transaction rather than the qualified custodian solely providing custodial services. In a sense, the custody relationship is tangential to the trading relationship. The Commission's rule should reflect this. Where a qualified custodian and the client are engaged in a transaction, the Commission should go further to provide guidance that the prohibition on liens should not apply at all, and certainly should not involve any additional steps for the qualified custodian and adviser to take beyond the client entering into the trading agreement. For margin accounts, it is difficult to fathom how the broker-dealer or FCM would give the adviser reasonable assurances that the client has consented unless the trading agreement itself is the evidence of such consent. Accordingly, we recommend that the Commission provide an exception for margin posted in connection with cleared and OTC financial contracts.

Absent these requested changes, it is vitally important that the SEC maintains the carve-out in the proposal for liens authorized by the client. If not, the Commission should provide clear guidance that the grant and authorization of such security interests in a written agreement with the broker-dealer or FCM or in the account control agreement for OTC financial contracts sufficiently evidences client consent. For margin accounts, it is difficult to fathom how the broker-dealer or FCM would give the adviser reasonable assurances that the client has consented unless the trading agreement itself is the evidence of such consent.[100] This should apply even if the adviser signs the applicable agreement as agent of the client. We submit that, given long-standing market practice and the recognition of such liens in the Uniform Commercial Code, the execution of the applicable agreement by the client—even if the adviser signs as agent—is adequate to meet the requirement that the client consent to the lien in writing. Without the lien, broker-dealers, FCMs and other qualified custodians may no longer be willing to provide their services to client accounts and funds.

[100] If a client could continue to trade OTC swaps without a tri-party collateral control account, the entity holding the margin would not be a qualified custodian, and this requirement could not apply.

As noted above, current market practice is for contractual privity to be between the broker-dealer or FCM and the client, and the adviser is only a party to the futures trading agreement, if at all, as agent of the client. Accordingly, if the Commission determines to apply the reasonable assurances requirement to arrangements with broker-dealer and FCMs, we recommend that the Commission recognize that a written agreement between the client and the broker-dealer or FCM would be sufficient to address the reasonable assurances requirement regarding liens so long as the agreement includes the client's consent to the broker-dealer or FCM placing a lien on its assets.