May 8, 2023

Via E-Mail to rule-comments@sec.gov
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn: Vanessa A. Countryman, Secretary

Re: **File Number S7-04-23**
SIFMA Comment on Proposed New Rule re:
Safeguarding Advisory Client Assets

Dear Ms. Countryman:

The Securities Industry and Financial Markets Association (***"SIFMA"***)[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (***"SEC"***) proposed new rule for safeguarding advisory client assets, which redesignates current Rule 206(4)-2 to new Rule 223-1 entitled "Safeguarding Advisory Client Assets" (the ***"Proposal"***).[2] SIFMA agrees that safeguarding client assets is a core element of investor protection. For that reason, we have long supported efforts to enhance and strengthen those safeguards where necessary and appropriate.

The Proposal, however, raises a number of critical concerns for our members that are qualified custodians (***"QCs"***) of investor assets (including those members that are not currently QCs, but may need to become QCs under the Proposal), investment advisers responsible for advising investors, and firms that play both of these important roles. These concerns include the potential adverse consequences to clients of investment advisers through reduced numbers of available QCs, reduced access to markets and products, and the imposition of higher custodial

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[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed-income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (***"GFMA"***). For more information visit, http://www.sifma.org.

[2] Release No. IA-6240; File No. S7-04-23 (Feb. 15, 2023), https://www.sec.gov/rules/proposed/2023/ia-6240.pdf; 88 Fed. Reg. 14,672 (Mar. 9, 2023), https://www.federalregister.gov/documents/2023/03/09/2023-03681/safeguarding-advisory-client-assets.

and advisory fees, with little, if any, added protections on client assets. Other important concerns include, among others, the Proposal's jurisdictional overreach, resulting in indirect and inappropriate regulation of QCs (over which the SEC does not have supervisory authority) without regard to compatibility with existing applicable regulatory regimes; overexpansive scope covering assets and a broad range of financial products not traditionally subject to, nor reasonably expected by advisory client to be subject to, the custody of a QC; unworkability; and the insufficient time allocated to comment on and implement the Proposal.

Accordingly, we respectfully submit the following comments and recommendations for your consideration.[3]

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Introduction

The Proposal seeks to impose a new standard of conduct and unreasonable burdens on QCs inconsistent with, or not reflected in, common practice or applicable law. The Proposal requires that a broad range of financial products not traditionally subject to "custody" arrangements be kept "in a custody account," which would reduce market access, reduce the number of, and custodial services offered by, QCs, substantially increase concentration risk across custodians and custodial costs (all of which would negatively impact investors), and dramatically disrupt important and established markets. Yet, the Proposal fails to articulate or demonstrate how the proposed safeguards for client assets would work in practice, and, in many cases, how the purported investor protection benefits would actually benefit investors over and above the well-established and demonstrably effective protections currently in place. Further, the Proposal attempts (without legal basis) to interject the adviser into what is often a relationship to which they are not a party (i.e., a custodial arrangement between a client and QC).

The stated purpose of the Proposal is "to create a minimum floor of custodial protection for investors, including those investors that have little or no power to negotiate for those protections, in the event of custodial misconduct." The SEC, however, has not conducted the predicate fact finding and analysis, or built a proper record, to demonstrate regulatory shortcomings in traditional current custodial arrangements, whether by SEC-regulated QCs (e.g., brokers) or QCs regulated by the U.S. or foreign banking agencies (e.g., Custody Banks) or the Commodity Futures Trading Commission (***"CFTC"***) (e.g., futures commission merchants (***"FCMs"***)).

Any proposed rulemaking on safeguarding of client assets should start with a risk-based analysis of:

- custodial practices by all types of QCs and their strengths and weaknesses;

[3] The Asset Management Group of SIFMA (***"SIFMA AMG"***) is submitting a comment letter under separate cover to express the views of the asset management community. SIFMA supports and incorporates herein the advocacy in the SIFMA AMG comment letter.

- arrangements or practices of investment advisers that pose custodial risks;
- types of assets that lend themselves to greater custodial risks; and
- the types of assets that are not currently "custodied" on behalf of clients by QCs, the reasons therefor, and the feasibility of requiring these assets to be "custodied" by QCs.

This analysis should focus on those practices, arrangements, and asset types that pose the greatest custodial risks and then target specific requirements to address those risks without over-restricting or overregulating industry practices and arrangements in a way that indiscriminately adds unwarranted burdens, restricts investors' investments and disrupts markets.

Such analysis should also be undertaken in coordination with other functional regulators and should give particular consideration to any identified instances of improper custodial conduct, misappropriation of client assets, or other losses. If the SEC's objective is to holistically evaluate custodial arrangements and, as needed, address any perceived shortcomings in custodial arrangements, then the SEC should first establish a dialogue with the other relevant functional regulator responsible for regulation of QCs, perform the aforesaid predicate evaluation and due diligence, and develop a holistic regulatory solution in coordination with other regulators. Thereafter, and only if necessary and appropriate, the appropriate functional regulators should engage in coordinated rulemaking to *directly* regulate all QCs.

The Proposal's attempt to *indirectly* regulate QCs by imposing unreasonable burdens on advisers and their clients, and highly disruptive and in some cases impossible requirements on financial institutions that would become QCs with respect to a broad range of new products under the Proposal, is an ineffective regulatory approach and poor public policy choice. It would effectively make advisers gatekeepers for the custodians that their clients select and engage. Advisers that are not also QCs would essentially become gatekeepers of gatekeepers – gatekeepers for custodians (which the SEC describes as "key gatekeepers") with potential liability for custodians' acts and omissions, even though (i) custodians act as agents of their clients (not their advisers), a point reflected in the SEC's outsourcing proposal,[4] which assumes that custodial services are not "investment advisory services," (ii) custodians typically are engaged by clients (not their advisers), and (iii) advisers, according to the SEC, "are rarely parties to the custodial agreement." Similarly, QCs would become gatekeepers as to the authority granted by the advisory client to the adviser, without regard to the practical implication burdens of QCs having to parse through, and interpret, bespoke authorization documents they had no role in drafting and that vary across clients, nor to the potential liability imposed on QCs and the extent of any adverse impacts on the ability of QCs to facilitate adviser instructions on behalf of clients in an efficient and expeditious manner.

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[4] 87 Fed. Reg. 68,816 (Nov. 16, 2022), https://www.govinfo.gov/content/pkg/FR-2022-11-16/pdf/2022-23694.pdf (***"Outsourcing Proposal"***). If both the Proposal and the Outsourcing Proposal are adopted as proposed, we are concerned that the latter could inadvertently apply to QCs due to the Proposal's required contractual privity between advisers and QCs even though QCs typically provide services to clients, not their investment advisers.

The Proposal, by broadening the scope of the rule to all assets and liabilities, would impose numerous restrictions – that seem grounded in traditional *custodial agent-client relationships* (which the Proposal refers to as "the custodial market") – on financial products (such as derivatives and repurchase agreements (***"Repos"***)) that are by their nature *principal-to-principal relationships* between financial institutions and their clients (i.e., counterparties that are *not* part of "the custodial market"). Together with the requirement to "segregate" assets that serve as collateral for these products in excess of the amount necessary to provide customer protection, the Proposal would have a range of unintended effects, including prohibiting transactions in numerous financial products between financial institutions and their clients and/or dramatically increasing the costs to investors to enter into such transactions, and disrupting vitally important markets, including, for example, the U.S. Treasury securities market, which depends substantially on Repo financing of market participants.

Based on the foregoing, and as described in greater detail in this letter, we recommend that the SEC withdraw the Proposal until such time as it has fully considered and can explicitly address the critical legal, regulatory, policy and practical concerns raised in this letter.

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Executive Summary

The Proposal is a substantial departure from current industry practice and conflicts with numerous existing, well-functioning custodial regulatory frameworks already established by the SEC and other functional regulators. The Proposal would impose and shift substantial burdens and costs among advisers, their clients, and QCs but without demonstrating that any marginal improvement in asset protection would justify such burdens and costs. Unfortunately, it appears that the Proposal's biggest loser would be advisory clients due to fewer QCs to provide services, reduced access to markets and products, and higher advisory and custodial fees.

I. **REGULATORY AUTHORITY: The Proposal exceeds the SEC's regulatory authority.** The Proposal exceeds the SEC's regulatory authority by imposing private contractual terms and other obligations on third-party QCs over whom the SEC does not have jurisdiction, expanding the scope of custody to include discretionary trading authority, expanding the definition of assets to include all assets (not just funds and securities), intruding on non-U.S. laws governing foreign custodians, and failing to perform a proper cost-benefit analysis of the Proposal's cumulative or interactive effects.

II. **BANK CUSTODY OF CASH: The Proposal undermines sound bank management of cash deposit accounts and will result in higher costs for investors.** The requirement to segregate advisory client cash would upend current custody bank practices, which provide a high level of investor protection, and which the SEC has not suggested or shown to be "unsafe or unsound." This requirement would fundamentally alter the custody bank model, increase the cost and complexity of providing custody services to institutional investors, increase operational and settlement risk for investors, significantly impact the funding and liquidity management of a number of custody banks, and result in negative consequences for the orderly operation of financial markets and the

cost of services to clients.

III. **SEGREGATION OF ASSETS: The SEC should clarify that the segregation requirement does not prevent existing effective and beneficial collateral management brokerage practices permitted under existing asset protection regulatory regimes.** Today, banks and prime brokers rehypothecate assets, including margin securities and derivatives variation margin, for example, to support their permitted business purposes and, with their clients' consent, borrow the clients' fully-paid and excess margin securities. The Proposal's segregation requirement, however, prevents rehypothecation, which in turns harms essential market functions and existing well-functioning custodial practices at banks and prime brokers.

IV. **ASSET CLASSES: The Proposal adversely affects various asset classes.** Various asset classes, including without limitation, loans and various other securitized products, repurchase agreements and reverse repurchase agreements, securities loans, derivatives, and annuities, would be adversely impacted because they could not meet the segregation of assets, possession or control, self-custody and/or other requirements of the Proposal.

V. **QC LIABILITY: The QC liability and related provisions adversely affect custodial arrangements, resulting in reduced services, reduced market access, and higher costs to advisory clients.** The Proposal's new indemnification, insurance and other liability-related obligations for QCs would likely cause QCs to reduce services and access to certain markets, and/or increase costs to advisory clients. Many foreign custodians would not meet the QC requirements, effectively foreclosing access to certain foreign markets by advisers and their clients.

VI. **QC MONITORING OF INVESTMENT ADVISER COMPLIANCE: The potential need for QCs to ensure instructions received from advisers are consistent with their authority under bespoke agreements between advisers and their clients is outside the role of a QC as a directed agent, operationally impractical, increases settlement risk, and creates a moral hazard at the expense of clients.** The Proposal's requirement that the investment adviser's written agreement with the QC specify the adviser's "agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations," therefore potentially requiring QCs to ensure trade settlement and other instructions received from advisers are consistent with such authority, is inconsistent with established practices, will result in greater costs to investors, introduce operational risks, and will undermine other regulatory goals relating to trade settlements.

VII. **INVESTMENT ADVISERS: The Proposal adversely affects adviser custody practices to the detriment of clients.**

- **The written agreement requirement is unworkable.** Many QCs would not agree to the required terms, but if they did, they would demand substantial compensation to do so. As a result, advisers and custodians would likely reduce services and pass along higher costs to clients.

- **The written assurance requirement is unworkable.** The requirement to monitor and know the business of the QC would unduly burden advisers, especially smaller ones, and distract them from their primary function.

- **Advisers would likely decline discretionary authority for certain assets.** Advisers would likely decline discretionary authority over assets that trade on a non delivery-versus-payment basis due to significant operational and implementation challenges. In turn, clients would be forced to self-direct in these assets and thus would be deprived of their adviser's advice, guidance, and management services.

- **Privately offered securities could not satisfy the Proposal's requirements.** The Proposal requires the adviser to reasonably determine that ownership of privately offered securities cannot be recorded and maintained by a QC. Advisers likely could not demonstrate or document this condition.

- **The Proposal will negatively impact a broad range of advisory services.** The Proposal will negatively impact managed account and wrap fee programs, and retirement accounts, among others.

- **The Proposal puts SEC-registered advisers at a competitive disadvantage.** SEC-registered advisers and their clients would be at a competitive disadvantage to other fiduciaries who would not be subject to and encumbered by the Proposal's burdensome requirements.

VIII. **DIGITAL ASSETS: The Proposal should be amended to allow QCs to provide digital asset safekeeping services to their clients if they choose to do so.** While we welcome the Proposal establishing clearer "rules of the road" for the safekeeping of digital assets, there are several obstacles that, if left unresolved, will make it difficult for QCs to provide digital asset-related custody services to their clients, including Staff Accounting Bulletin 121.

IX. **COMMENT & IMPLEMENTATION PERIOD: The comment and implementation periods are too short.** We recommend a 120-day comment period. Only if the Proposal is substantially amended to address the critical concerns raised in this letter should it be resubmitted for review, and include at least a three-year implementation period for all advisers and QCs, and a 3.5-year implementation period for smaller advisers (although we disagree with the SEC's premise that larger advisers should be given less time than smaller firms to implement such a new rule, if adopted).

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I. REGULATORY AUTHORITY: The Proposal exceeds the SEC's regulatory authority.

Pursuant to Section 223 of the Investment Advisers Act of 1940, as amended (***"Advisers Act"***), the SEC has statutory authority to issue regulations to safeguard client assets over which

advisers have "custody."[5] Section 223 was added in 2010 by Dodd-Frank Section 411. The SEC's rulemaking authority, however, is not open-ended or unlimited. Rather, it is specifically limited to "safeguarding client assets *over which such adviser has custody*" (emphasis added).[6] Section 223 does not authorize the SEC to issue regulations that extend to non-adviser QCs of client assets over which the adviser does *not* have custody, or to expansively define or redefine what it means to have "custody."

It is also far from clear that Congress intended that the SEC extend its reach beyond funds and securities to other assets, especially since the word "assets" is often used as shorthand for client funds and securities. The SEC used the phrase "client assets" as a convenient shorthand form for "funds or securities" in a 2010 rulemaking.[7] Indeed, in the adopting release for the current Custody Rule, the SEC stated in a footnote, "We use the term 'client assets' solely for ease of reference in this Release; it does not modify the scope of client funds or securities subject to the rule."[8]

If Congress specifically contemplated a broader reach for SEC custody regulation, then they would have made that clear in the legislative text and history for Dodd-Frank. In this connection, one would also expect a clear Congressional focus on whether other Advisers Act provisions should similarly have been revised to reach beyond securities (e.g., Section 206(3)) and whether to use the phraseology "securities and other property" that, by contrast, is incorporated into the Investment Company Act (the Advisers Act's companion statute adopted in 1940 as part of the same bill). Yet, the legislative record reflects no such deliberations or intent by Congress.

1. **The written agreement and written assurances requirements exceed the SEC's regulatory authority.**

The Proposal would essentially impose contractual obligations and terms on QCs over whom the SEC does not have regulatory authority in many cases. As the SEC acknowledges, "an agreement between the custodian and the adviser [whose terms are dictated by the SEC] would be a substantial departure from current industry practice." The SEC, however, would have no regulatory authority to enforce the written agreement with or written assurances from the QC (other than presumably bringing enforcement actions against advisers who cannot establish a "reasonable belief" that the QC is complying).

Notably, the Unites States Department of Labor (***"DOL"***) tried to take a similar approach with its fiduciary rule and related Best Interest Contract Exemption (***"BICE"***). Under the BICE, the DOL would have required financial advisors, by regulation, to enter into private written

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[5] 15 USC § 80b-18b ("An investment adviser registered under this subchapter shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe."), promulgated pursuant to Section 411 of the Dodd-Frank Act (***"Dodd-Frank"***), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[6] *Id.*

[7] SEC, Amendments to Form ADV, 75 Fed. Reg. 49,234 (Aug. 12, 2010).

[8] SEC, Custody of Funds or Securities of Clients by Investment Advisers, 75 Fed. Reg. 1456 & n.2 (Jan. 11, 2010).

contracts with their clients that imposed certain warranty, disclosure, and conduct standard obligations, among others, on the adviser. A panel of the Fifth Circuit Court of Appeals struck the rule in toto as exceeding the agency's regulatory authority, particularly with respect to DOL's attempt to create private contractual rights of action to outsource and compensate for the agency's lack of authority to engage in its own regulatory enforcement.[9]

Similarly, the Proposal, by imposing private contractual provisions and other obligations on third-party QCs over which the SEC does not have jurisdiction, in order to indirectly regulate such entities, likewise exceeds the scope of the SEC's regulatory authority under Section 223 of the Advisers Act and otherwise.[10]

In doing so, the SEC also improperly infringes upon the banking industry regulators' authority to oversee banks, which courts have held falls outside the SEC's authority. In *American Bankers Association v. S.E.C.*, the United States Court of Appeals for the District of Columbia Circuit held that a rule promulgated by the SEC that attempted to regulate banks engaged in certain securities activity was invalid as an attempt by the SEC to expand its own authority beyond the limits set by the Securities and Exchange Act of 1934 (***"Exchange Act"***).[11] Similarly, the SEC's unilateral action through the Proposal to indirectly regulate third-party QCs over which the SEC does not have jurisdiction runs counter to Congress's clear expectations that the SEC act jointly with other functional regulators, including as reflected in the Financial Services Regulatory Relief Act of 2006, requiring that the SEC engage in joint rulemaking with the Federal Reserve after the SEC attempted to define elements of the Gramm-Leach Bliley Act unilaterally.

[9] *U.S. Chamber of Commerce v. U.S. Department of Labor*, No. 17-10238, 2018 WL 1325019 (5th Cir. Mar. 15, 2018), http://www.ca5.uscourts.gov/opinions/pub/17/17-10238-cv0.pdf ("DOL may not create vehicles for private lawsuits indirectly through BICE contract provisions where it could not do so directly."). *See also Alexander v. Sandoval*, 532 U.S. 275, 286 (2001) ("private rights of action to enforce federal law must be created by Congress"). As another example, the SEC recently attempted to extend another Dodd-Frank provision, Section 941, by regulation to apply to collateralized loan obligation managers (***"CLO managers"***). Section 941 requires any securitizer of an asset-backed security to retain a portion of the credit risk for any asset it transfers to a third party. CLO managers, however, do not *hold* the securitized loans at any point; so, if Section 941 were to apply, then CLO managers could only *retain* risk by acquiring it. A panel of the District of Columbia Court of Appeals struck the SEC rule as it applied to CLO managers, holding that the language of the statute did not encompass their activities. *Loan Syndications & Trading Assoc. v. SEC*, 882 F.3d 220, 221-22 (D.C. Cir. 2018), https://cite.case.law/f3d/882/220/ ("The agencies have gone beyond the statute to require managers to 'retain' risk by acquiring it. Even if their concerns about a policy loophole had merit, the statutory language does not support this radical shift in meaning.").

[10] The Proposal's requirement that QCs contract with the adviser to pay end clients for economic loss resulting from the QC's negligence also conflicts with the state law "Economic Loss Doctrine." The Economic Loss Doctrine has been adopted by numerous states in various forms and provides that purely economic losses are not recoverable in tort actions in the absence of personal injury or property damage.

[11] *Am. Bankers Assoc. v. S.E.C.*, 804 F.2d 739 (D.C. Cir. 1986).

2. **Equating discretionary authority with custody exceeds the SEC's regulatory authority.**

The Proposal deems investment advisers who have discretionary trading authority to have custody of the client's assets. Congress, however, never contemplated that providing discretionary investment advice implied that the adviser asserted control over a client's assets. Nothing in the legislative history or record of Dodd-Frank Section 411 suggests that Congress intended, or delegated authority to, the SEC to expand the definitional scope of custody. By expanding the scope and definition of custody to explicitly include discretionary trading authority, the Proposal also exceeds the scope of the SEC's regulatory authority under Section 223 of the Advisers Act.

3. **The Proposal overstates an adviser's responsibility for client QCs.**

The Proposal wrongly asserts that "advisers must . . . exercise their fiduciary duties to clients in connection with selection and monitoring of the [QCs]," citing the 2019 Fiduciary Interpretation.[12] That interpretation, however, simply states that "the investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship." In many cases, the custodian relationship is not part of the "adviser-client relationship" (unless explicitly included in the agreement with the client). In attempting to make it one under the guise of an investment adviser's fiduciary duty, the Proposal mischaracterizes the SEC's prior interpretations and overstates the scope of an adviser's fiduciary duty.

4. **The Proposal does not include the required cost-benefit analysis of its cumulative or interactive effects.**

The Proposal acknowledges that in many respects it represents a major departure from current market practices. Its effects would ripple across and significantly impact everyone it touches, including custodians (whether, bank, broker-dealer, foreign, or other), investment advisers, and, of course, advisory clients. Yet, the Proposal fails to perform or present any analysis of certain key costs, including without limitation the following:

- The costs to custody banks to completely restructure their cash deposit accounts, the resulting loss of net interest income, and the resulting negative impact on U.S. financial markets (see Part II);

- The costs of the displacement, consolidation, and systemic restructuring in the QC marketplace that would likely follow from the Proposal's new requirements for QCs (see Parts III, IV and V);

- The ongoing costs to advisers to perform due diligence on and monitor the QCs (see Part VII);

[12] 84 Fed. Reg. 33669 (June 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.

- The costs to the many separately managed accounts that are not now covered by the custody rule but would be covered by the Proposal because of the expanded definition of custody to include discretionary authority (see Part VII); and

- The costs to advisers' clients in the form of higher costs passed along by advisers and/or QCs, the loss of their preferred custodians, and/or decreased services, including loss of access to certain asset classes (see generally Parts II – VIII).

The SEC is regulatorily and legally obligated to evaluate and weigh these costs in its Proposal. The SEC is not only required to analyze these costs individually, as standalone silos, but also required to analyze how these separate costs cumulatively impact custodians, advisers, clients, and the marketplace generally. Because the SEC has failed to do so, we have no sense of clarity or certainty about what the Proposal's overall changes to the marketplace would look like, or how negatively they may impact adviser clients. We urge the SEC to perform the necessary, statutorily required, and more robust cost-benefit analysis required before proceeding further with the Proposal.

II. BANK CUSTODY OF CASH: The Proposal undermines sound bank management of cash deposit accounts and will result in higher costs for investors.

The Proposal's segregation requirement is fundamentally incompatible with long-established banking industry practices. If implemented, it would force unwarranted structural changes on certain market participants, impede the orderly functioning of the financial markets, and materially increase costs for advisory clients without any corresponding investor protection benefit.

In a sharp departure from existing market practice, the Proposal would require a QC that is a bank or savings association to segregate cash "in an account designed to protect such assets from creditors of the bank in the event of the insolvency or failure of the bank." The Proposal further states that "the account terms should identify clearly that the account is distinguishable from a general deposit account" so that client assets are protected "from creditors of the bank or savings association in the event of [its] insolvency or failure."

As such, the Proposal conflates the structural role of a custodial account, which is to safeguard client assets from potential misappropriation or loss, including in the event of a bank or savings association insolvency, and deposit accounts which are used to hold cash balances that result from the ongoing day-to-day management of client investment portfolios. This includes payment activity related to the purchase or sale of investment assets, the receipt of income payments and proceeds from maturing assets, the processing of corporate actions events, the management of tax reclamations and the payment of fees and other expenses.

These deposit accounts are mainly used for operational purposes related to their post-trade processing activity. Compared to the total assets under custody and turnover of portfolios that custodian banks process on behalf of their clients, the actual cash balances and overdrafts are minor and essential for the provision of post-trade services.

While assets held in a custodial account are explicitly excluded from the bank's balance sheet, this is not the case for deposit accounts, where cash is held as a liability of the bank and therefore available for use by the bank in the ordinary course of its business activities. This treatment of cash is well-disclosed and understood by market participants, including by custodial clients, and the resulting credit risk is managed in the same way as any other credit relationship. In addition, clients also have a number of tools available to manage this deposit risk, including the use of "cash sweep" vehicles to reduce cash left on deposit while maximizing investment returns.

The cash deposits that custody banks receive from their asset servicing and settlement relationship with clients are a crucial component of their funding structure, providing the means for the bank to conduct its day-to-day operations, and are intrinsically linked to the provision of custody services. This includes the intermediation of credit on behalf of its clients through services such as the extension of intra-day and overnight credit for settlement purposes, the contractual settlement of securities transactions, the payment of pre-determined income, and the execution of foreign currency transactions. Segregating cash into bankruptcy remote accounts would make the provision of custody services extremely complex and in some cases even impossible.

The asset liability management practices of custody banks also involve the purchase of a conservative portfolio[13] of investment assets used to generate net interest income, and in the case of less stable deposits, the holding of excess cash at the Federal Reserve and other national central banks. For those banks that provide custody services as part of a broader range of businesses, a portion of these deposits may also be deployed to support the economy, through providing financing to corporations, federal, state, and local governments, and to individuals with loans for homes, automobiles, and growing a small business. These activities are subject to numerous regulatory requirements, including minimum liquidity ratios, liquidity stress testing and supervisory oversight of interest rate risk and other key financial metrics. For these reasons, custody banks are viewed as having a highly stable funding structure that is well-adapted to the needs of their custodial clients. If any changes to these regulatory requirements are required, they should be made by the banking regulators after due consultation and analysis, and not indirectly through SEC regulation for advisers.

If implemented, the requirement to segregate advisory client cash would force highly undesirable changes to the custody bank business model, with profound implications for the orderly operation of the U.S. financial markets and negative implications for clients.

Furthermore, as intimated above, the Proposal would remove from custody banks a core component of their funding structure, likely forcing them in the process to rely on alternative wholesale funding sources that are materially less stable, particularly in periods of financial market stress. Additionally, without normal access to client deposits, custody banks could be forced to suspend extensions of credit to clients which today support the efficient functioning of payment, clearing and settlement activities in the U.S. and other markets. Moreover, the

[13] While there is risk in the existing banking system, these reserve assets are regularly stress tested in the case of global systemically important banks (G-SIBs).

processing of core custody activities such as settlement, asset servicing and tax withholding would become very complex, create other risks, and run counter to the SEC's objective of shortening settlement cycles.[14]

Despite these profound changes, nowhere does the SEC suggest that current market practices in the traditional custody industry are "unsafe or unsound," which in any event is a determination to be made by the federal banking agencies, and not the SEC. Moreover, there appears to be no regard for whether U.S. banks currently offer such "bankruptcy remote" accounts to depositors. We therefore strongly urge the SEC to maintain without change the existing requirements which apply to qualifying banks or savings associations for purposes of the Proposal, or alternatively to clarify that advisory client deposits held at banks or savings associations are not required to be segregated in a "bankruptcy remote" account. At a minimum, we urge the SEC to discuss with the relevant banking regulators the advisability as a policy matter of the SEC essentially requiring U.S. banks and savings associations to create a class of depositors made up of advisory clients that ranks ahead of general depositors in an insolvency.

III. SEGREGATION OF ASSETS: The segregation requirement prevents effective collateral management and beneficial prime brokerage practices.

By expansively defining assets, the Proposal pulls in many asset classes that already transact within well-functioning trading and custodial systems, many subject to state and/or federal regulations that protect those assets from loss, theft, misuse, or misappropriation.

1. Financial instruments are not susceptible to custody arrangements.

A significant category of the assets captured by the Proposal are commonly traded financial instruments, including direct principal-to-principal contracts between financial institutions and their clients, including, without limitation:

- loans and various other securitized products;
- securities loans;
- repurchase agreements and reverse repurchase agreements (***"Repos"***);
- derivatives; and

[14] As an example, custody banks could insist that a sell transaction used to fund a buy transaction (e.g., the sale of 100 shares of Apple to buy 100 shares of Microsoft) settle first to fund the client account without the use of intra-day credit. This would vastly increase the number of late-day and or failed transactions as the purchase cannot be settled before the sale proceeds of the sale have been credited. As another example, custody banks would be unable to provide contractual settlement services, ahead of the anticipated receipt of proceeds from a maturing asset, foreign currency transaction or inbound wire as is routinely done today. Finally, in order to offset the loss of net interest income earned on client deposits, defray the additional costs of securing wholesale funding and the vast expense needed to reengineer core processes and systems, custody banks would have to dramatically increase the pricing of their services, which are today generally limited to a few basis points of total assets under custody.

- annuities.

These assets do not currently involve any custodial agent. They are fundamentally bilateral (i.e., two-party) arrangements. Regardless, under the Proposal, a QC could not have "possession or control" of the asset because the "asset" is not the contract itself, but the value of the contractual rights under the contract, to which the adviser is not a party. Presumably, the adviser would need to become a party to the financial instrument. In doing so, the adviser would likely assume new obligations and risks (per the Proposal's written agreement and assurances, among other things), but without any corresponding compensation or benefit. Adding a third wheel to financial instruments makes little practical sense, would complicate negotiations, and increase costs for all parties, but without providing any appreciable enhancement to client asset protection. Moreover, if requiring advisers to become third parties to financial instruments became the rule, then it would likely require that all existing financial instruments be amended, which could conflict with previously agreed terms and conditions and require extensive negotiation.

Absent a QC to hold these assets, advisers must rely on the self-custody exception under the Proposal. That exception requires an independent public accountant to "promptly" verify any purchase, sale or other transfer of beneficial ownership of the asset. This requirement, however, is also untenable for these types of assets.

Accordingly, if the Proposal is adopted, we recommend that the SEC expressly exclude financial instruments, including those listed above, among others, from the definition of "assets" in the Proposal.

2. Transactions involving financial instruments are often collateralized, which conflicts with the Proposal's limitation on rehypothecation.

Financial institutions today are generally free to rehypothecate assets that serve as collateral for these types of products, among others, in the ordinary course of their financial services businesses. In most cases, this collateralization of current or potential future exposures is required by regulations applicable to the financial institution, which are intended for the protection of the financial institution itself.

For instance, reverse Repo financings entered into by U.S. broker-dealers are viewed as extensions of credit to the Repo counterparty by the broker-dealer and are subject to regulatory "haircuts" (margin requirements) under the Financial Industry Regulatory Authority (***"FINRA"***) Rule 4210. Similarly swap dealers and securities-based swap dealers are required (under rules promulgated by the various regulatory agencies with regulatory jurisdiction, including the SEC for Securities-based Swap Dealers) to collect variation margin (***"VM"***) on a daily mark-to-market basis as security for amounts that would be owed by the counterparty if the transactions became subject to immediate close out, as well as initial margin to protect against additional exposures created by future market movements.

The Proposal's requirement to segregate client assets, however, is incompatible with the practice of rehypothecation; it would effectively eliminate a financial institution's ability to

rehypothecate as part of the normal trading and banking services that they provide, and efficiently and cost effectively fund extensions of credit to clients and counterparties. In doing so, financial institutions would be forced to substantially reduce liquidity available to advisers and clients, and substantially increase their costs, which would be borne by clients.

Notably, under Article 8 of the Uniform Commercial Code (***"UCC"***), there is no requirement for a custodian to segregate a client's financial assets (whether in an omnibus account or by client) from proprietary assets. Article 8 relies on the custodian's books and records to evidence ownership and, if there is a shortfall of a particular type of financial asset maintained for a client, the custodian's proprietary financial assets of that type must be used to remedy the shortfall. Additionally, with respect to cash held in deposit accounts, banks typically freely use these assets in the ordinary course of their banking business.

3. **The SEC should clarify in the rule that broker-dealers' (including prime brokers') margin lending and related businesses would not conflict with the Proposal's limitation on rehypothecation.**

Margin lending in the U.S. is a product offered by SEC-registered broker-dealers and their affiliates that involves aspects of traditional custody with the addition of leverage through margin loans and short positions maintained in regulated "margin accounts." Under SEC Rule 15c3-3, fully paid for and excess margin securities must be segregated and kept within the broker-dealer's possession and control, but margin securities (securities held in margin accounts) may, up to certain limits, be "de-segregated" and rehypothecated.

Similarly (and similar to cash maintained at a U.S. bank), cash credited to accounts held at a broker-dealer may be used to fund customer debits, while excess cash credits must be held in a special reserve account for the benefit of customers. In the event of an insolvency of the broker-dealer, under applicable law (the Securities Investors Protection Act of 1970 (***"SIPA"***)), all customers have a claim for their "net equity," the amount that their assets (long securities and cash credits) exceed their obligations to the broker (short positions and cash debits). In other words, customers do not have a claim for all assets held in a brokerage account but, rather, for the net equity in the account. The existing protections of SEC Rule 15c3-3, which are specifically designed to dovetail with SIPA, have historically been successful in ensuring that all such claims have been satisfied, even in the largest and most complex broker insolvencies.

In the Proposal, the SEC indicated that the segregation requirement was "drawn from Rule 15c3-3" and, accordingly SIFMA does not believe that the SEC intended to override a broker-dealer's ability to rehypothecate a customer's margin securities as permitted by the Rule 15c3-3. However, the Proposal does not (1) provide an exception from the segregation requirement for written client consent (which would be comparable and complementary to the proposed exception for prohibitions on liens and security interests) or (2) clarify in the text of the

Proposal that rehypothecation is permissible under Rule 15c3-3 (and other regulatory regimes, such as CFTC asset protection rules applicable to FCMs).[15]

To provide clarity on this point, the SEC should amend the Proposal to include two exceptions from the segregation requirement: (1) when the client consents in writing, and (2) when a broker-dealer complies with Rule 15c3-3 and/or other applicable regulatory asset protection regimes.

Again, SIFMA does not believe the SEC intended for the Proposal's requirement to segregate assets to prohibit broker-dealers (including prime brokers) from rehypothecating these assets. Eliminating rehypothecation and requiring all cash, not just net credits, to be segregated, would require self-funding of all prime brokerage exposures, long and short, and would necessarily precipitate a dramatic re-pricing of the product for RIA-advised prime brokerage customers. In addition, because brokerage customers have only a "net equity claim" in bankruptcy, eliminating rehypothecation would have no effect on their level of customer protection.

In short, segregation prevents rehypothecation which in turn harms essential market functions and existing well-functioning custodial practices at banks, prime brokers and other financial institutions, and provides no benefit to clients. We recommend the Proposal provide explicit exceptions to its requirements under either of the following conditions: (1) the client consents in writing to the re-use of the assets by the QC; and (2) the QC maintains custody of and uses the assets consistent with an applicable regulatory regime (e.g., bank, broker-dealer).

IV. ASSET CLASSES: The Proposal adversely affects various asset classes.

The Proposal's requirements would likely limit a number of asset classes from being held in custody including, among others:

1. Loans and various other securitized products.

It is unclear how the asset verification requirement could be met generally, or specifically on the timeline set in the Proposal. The conditions of the self-custody exception cannot be satisfied or otherwise do not make practical sense with respect to these assets.

2. Repos.

Repos are a form of short-term borrowing for dealers in government securities, whereby a dealer sells government securities to investors, usually on an overnight basis, and buys them back the next day at a slightly higher price. Repos are typically used to raise short-term capital. Given current industry practices, Repos may not meet the segregation requirement. The self-custody exception requires "prompt" asset verification. Many Repo trades, however, are overnight and settled daily. Asset verification in this context makes little sense.

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[15] See Part IV.3.c. infra.

3. Derivatives.

The Proposal's expansion of the scope of the current Custody Rule from "funds and securities" to "assets" 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."[16] The definition of "assets" would include: bilateral over-the-counter (***"OTC"***) derivatives, including bilateral OTC security options, security-based swaps, bilateral OTC securities forwards, and bilateral OTC derivatives (non-securities); cleared derivatives (futures, options on futures and cleared swaps and security-based swaps); and collateral posted in connection with these products.[17]

OTC derivatives and related collateral do not pose the type of risks that the Proposal seeks to address. The Dodd-Frank Act – and the SEC, CFTC and U.S. federal prudential banking regulators (the ***"Prudential Regulators"***) regulations thereunder – provide for the robust regulation of OTC derivatives, including the mandatory exchange of variation and initial margin between financial counterparties for uncleared derivatives, mandatory clearing of certain derivatives, business conduct standards and regulations, and real-time public reporting of such transactions.

a. For bilateral OTC derivatives, the client's "asset" is the value of a contractual right, for which segregation does not make sense.

Bilateral derivatives are financial contracts, typically governed by a master agreement (e.g., the ISDA Master Agreement) between the adviser's client and a swap counterparty. They are direct, principal-to-principal contracts between the two parties to the transactions, and do not currently involve a custodial agent in any manner. It is unclear how it would be possible to insert a custodial agent into this two-party arrangement, or how doing so would enhance customer protection. In any event, under the Proposal, a QC could not have "possession and control" of the asset because the "asset" is not the contract itself, but the value of the contractual rights under the contract, to which the adviser is not a party.

b. The Proposal is inconsistent with the bilateral nature of uncleared OTC derivatives transactions.

For bilateral OTC derivatives transactions that are not required to be cleared or are not cleared voluntarily, the adviser's client and swap counterparty are parties to the transaction for the life of the trade and therefore are responsible for making payments or deliveries to one another under the terms of the applicable transaction. The value of a bilateral derivatives

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[16] 88 Fed. Reg. at 14,679.

[17] ISDA and FIA are separately submitting comment letters, detailing the Proposal's negative impacts on derivatives in greater detail. SIFMA agrees with and supports the observations and comments in the separate ISDA and FIA letters.

transaction fluctuates, and because of the treatment of the counterparties under existing margin regulations, such transactions are generally required to be collateralized daily.[18]

Although the payment and delivery obligations are bilateral, custodians play a role in the current market for bilateral derivatives. For example, with respect to variation or initial margin that is required to be segregated at a custodian by law or requested by a counterparty, collateral is held by a custodian in a segregated account. However, even where such collateral is segregated at a custodian, neither the master agreement between the counterparties nor any transaction thereunder is held in custody. In fact, the account control agreement governing the pledge of collateral often makes explicit that the custodian has no responsibility concerning the master agreement, including collateral terms. The Proposal would effectively end the bilateral nature of the uncleared derivatives markets for advisory clients.

The application of such requirements to collateral posted in connection with uncleared OTC derivatives would introduce an onerous and unnecessary set of requirements to an already heavily regulated marketplace representing a substantial departure from market practice and the uncleared swap margin rules implemented under the Dodd-Frank Act. The Proposal would impose segregation requirements where U.S. and global regulators did not and would also prevent swap counterparties from rehypothecating such VM and voluntary initial margin. This directly contradicts the CFTC, the SEC, and Prudential Regulators, none of which require segregation of VM or independent amount and all of which permit rehypothecation of such posted collateral. Notably, the SEC recognized that "[e]xisting market practice under the baseline is for dealers generally not to segregate initial margin related to OTC derivative transactions" and declined to require segregation of initial margin.[19]

If swap counterparties lose the ability to rehypothecate, then their trading costs will likely increase significantly. Moreover, the Proposal's requirements and their resulting increased costs would not benefit asset protection because, broadly speaking, VM is not "owed back" to the advisory client, by definition. VM reflects amounts owed to the financial institution collecting it and, barring additional market movements in the derivative, would be "netted off" in any close out under the applicable contract. For that reason, existing customer protection regimes relating to bilateral OTC derivatives (including those recently adopted by the SEC in connection with securities-based swap dealers) do not require segregation of VM or voluntary initial margin.

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[18] Advisers and, generally, their clients are "financial end users" as defined in the CFTC, SEC, and Prudential Regulators margin rules for uncleared derivatives, and are subject to margin requirements when trading with a swap dealer or security-based swap dealer, as applicable.

[19] Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 Fed. Reg. 43,872, 43984 (Aug. 22, 2019), https://www.govinfo.gov/content/pkg/FR-2019-08-22/pdf/2019-13609.pdf. Unlike the SEC, the CFTC and the Prudential Regulators require segregation of initial margin. However, an adviser's compliance with the CFTC's or Prudential Regulators' margin regulations for initial margin may not satisfy the requirements of the Proposal (in particular, with respect to the reasonable assurances required to be obtained) even though there is substantial overlap between the policy objectives of such regulators' margin regulations and the Proposal.

Accordingly, we recommend the SEC exclude VM, regulatory initial margin, and non-regulatory initial margin posted or exchanged in connection with bilateral OTC derivatives from the Proposal's definition of "assets."

c. The Proposal creates significant challenges and uncertainty for advisers entering into futures and cleared swaps on behalf of their clients.

Listed exchange traded commodity futures contracts (or options thereon) and cleared swaps are held through FCMs. The SEC previously analyzed the CFTC's customer protection regime, describing its "extensive regulations" governing the safekeeping of customer funds held by an FCM.[20] The SEC further noted that third-party custodial arrangements for futures margin of registered investment companies held by FCMs may be "redundant in view of the safeguards for customer assets afforded by the CEA and CFTC rules."[21]

Under the Proposal, however, FCMs could not serve as QCs with respect to collateral held by an FCM in relation to futures and cleared swaps because the FCM could not meet the "possession and control" requirement. This is because under CFTC rules governing FCMs, an FCM cannot accept as collateral an account of an FCM client that is segregated at a custodian. Advisers that trade futures and cleared swaps on their clients' behalf through FCMs would be prevented from doing so under the Proposal because FCMs would not qualify as QCs for such purposes.

In addition, a requirement that FCMs indemnify customers against losses associated with custodied assets would override the CFTC's considered judgment regarding the appropriate balance between customer protection and costs. The CFTC has developed a well-established and respected customer protection regime that seeks to use numerous tools, including segregation requirements, capital, and investment restrictions, to protect customers. These requirements have been extremely effective in protecting customers while limiting costs that are passed on to customers. Were the SEC to undermine this regime through the Proposal, it would increase costs for market participants by making them pay for an indemnification provision and associated insurance without any clear benefit. Furthermore, it would likely be impossible to implement since FCMs cannot control the actions of the derivatives clearing organization to which they are required to post substantial customer property.

Accordingly, we recommend that cleared derivatives held through FCMs be exempt from the Proposal's requirements. Our recommendation is consistent with the sound and enhanced protections afforded to these assets under existing CFTC regulations.[22]

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[20] Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, 61 Fed. Reg. 66,207 (Dec. 17, 1996), https://www.govinfo.gov/content/pkg/FR-1996-12-17/pdf/96-31891.pdf.

[21] *Id.* at 66,208.

[22] See **Appendix 1**, Question #26: FCMs.

4. Annuities.

The expanded scope of the definition of assets that would be covered by the Proposal could be interpreted to encompass annuities. Though it is not clear from the language of the Proposal that it is the SEC's intention to include annuities, doing so would prove untenable, because annuities are fundamentally a private contractual arrangement between an annuitant and an insurance company (often referred to as a carrier), not a custodial arrangement between and among a QC, adviser, and/or client. For that reason, the concerns expressed by the SEC that seem to be the impetus for expanding the array of assets subject to the Proposal do not apply to annuity contracts, especially fixed annuity contracts. Further, annuities are already heavily regulated in every state (including several model rule regimes that standardize highly protective measures across the country) and subjecting these products to the requirements in the Proposal would upend a part of the market that already functions well. As such, we believe that the SEC should clearly and explicitly exclude annuity products from the scope of the Proposal.

An annuity (both fixed and variable) is a contract between the purchaser (the annuitant) and an insurance company. By operation of state law, an annuity contract is delivered by the carrier to the annuitant upon issuance of the contract. The contract is held by the annuitant and not by the insurance company. While an investment adviser may play a role in an annuitant's decision to purchase an annuity, the adviser is not party to and does not custody the contract (nor does the insurance company).

To the extent there is any "asset" at issue in an annuity, it is the contract itself, not any underlying funds that relate to that contract. Both fixed and variable annuities require the provision by the annuitant to the carrier of a premium payment or payments in exchange for the contract. The carrier then invests the premiums it receives from clients to support its obligations under the contract. This structure is comprehensively regulated by state insurance law and has been for over one hundred years. Pursuant to that regulatory structure, it is the insurance company – not the annuitant, and again, not the adviser – that owns and controls the premiums once paid, and the assets that are ultimately purchased with the premium funds. Indeed, while the assets underlying an annuity contract are held in a separate account by the carrier, the carrier may pay on the contract from the separate account or its general account.

A variable annuity is arguably differently situated from a fixed annuity, in that the payments on the contract are tied to performance of an investment option like securities. However, those investment options are not client securities or client assets held by the insurance company (as is the case with other assets contemplated by the Proposal), and an insurance company's payment obligations to the annuitant are guaranteed by the terms of the annuity contract (regardless of the status of the premium payment and underlying securities held).

There is no concern of which we are aware (and none articulated in the Proposal) that insurance carriers are not properly holding premiums or underlying investments, such that new and duplicative regulation around how insurance companies handle assets is necessary. Even if there was such a concern, regulation would be in the remit of insurance regulators, who are likely in the best position to assess any market-wide problem and propose a well-suited solution.

Like the expanded definition of "assets," the expanded definition of "custody" to include adviser discretion should not apply to annuities. The proposed expansion of the definition of custody to encompass an expanded scope of adviser discretion is similarly counterintuitive in the context of an annuity. The Proposal defines discretionary authority as "the authority to decide which assets to purchase and sell for the client." It is unclear what this could mean in the context of a fixed annuity. First, there is no underlying asset or security to purchase or sell. Second, if the Proposal is meant to cover an adviser that has the authority to decide whether a client should purchase an annuity, the fact remains that the annuity is a contract between the carrier and the annuitant and must be executed and held by the annuitant. Where a variable annuity is involved, the Proposal could be interpreted to apply where an adviser has discretion to allocate the client's funds among sub-account investments held by the insurance company. Even in this scenario, the assets in the sub-accounts are owned by the insurance company and contractual safeguards are in place ensuring that the insurance company fulfills its contractual obligations to the annuitant.

For the reasons discussed above, the SEC should clearly and explicitly exclude annuity products from the scope of the Proposal.

V. QC LIABILITY: The QC liability and related provisions adversely affect custodial arrangements resulting in reduced services, reduced market access and higher costs for clients.

The Proposal requires an adviser to obtain a QC's written assurances that, among other things, the QC will indemnify the client against loss, segregate client assets, and not subject client assets to security interests or liens aside from what is authorized in writing by the client. The Proposal could be read to preclude QCs from limiting or disclaiming their liability (including for sub-custodians, central securities depositories (***"CSDs"***) and others). The Proposal also requires the QC to have insurance to adequately protect the client against risk of loss of the client's assets maintained with the QC in the event of the QC's own negligence, recklessness, or willful misconduct.

1. The indemnification, insurance and other liability-related provisions will negatively impact the cost and level of QC services.

Today, QCs negotiate liability-related contractual terms that appropriately allocate risk between the parties. The Proposal, by imposing these new costs and liabilities on QCs by regulation, would materially and negatively impact the services that QCs would be willing to provide, and the costs to clients for such services. It could also lead some QCs to stop offering custodial services at all for certain higher risk markets or asset classes.

a. Indemnification and insurance requirements.

The Proposal's required written assurance that the QC will indemnify the client against losses is inconsistent with current practices and reasonable commercial standards. Further, the Proposal's requirement that a QC agree to indemnify the client against loss is oversimplistic. Indemnification is never a required provision in any given contract, including that of a QC, but, to the extent agreed by the parties, is part of the overall scope of the relationship between contractual parties. The absence of indemnification does not mean that a party is stripped of

legal rights or remedies because they always have the ability to sue the counterparty for breach of contract in accordance with the contract's terms.

Moreover, there is a broad spectrum of indemnification provisions that typically reflect the parties' approach to allocating risk in various circumstances and correspondingly, are typically negotiated to establish the parameters of the indemnity, including scope, limits (such as limitation proportionate to fault), obligation to defend, limitation to third-party claims (which is the proper use of indemnification clauses), ability of one party to settle, and other terms that can be very complicated. Often indemnities are reciprocal and, depending on their drafting, a party's indemnification obligation may not be insurable. There is always a direct correlation between a party's willingness to agree to indemnities and, for that matter, related limitations on liability and the cost of the party's services.

Finally, SIFMA is concerned that the Proposal does not consider how the requirement that a QC indemnify the client against loss in the event of negligence may increase the potential for such indemnifications to be triggered and potentially reflected as a liability, which could have significant capital impacts on QCs, such as broker-dealers and banks, that are subject to capital or net capital requirements. Any resulting increases in capital requirements will further drive up the cost of custodial services that will be passed on to advisory clients, or, in a capital-constrained environment, potentially lead to a reduction of custodial services offered to advisory clients.

Similarly, the Proposal's requirement that a QC "have insurance arrangements in place that will adequately protect the client . . . against the risk of loss of the client's assets maintained with the QC in the event of the QC's own negligence, recklessness, or willful misconduct" disregards the fact that such insurance is not currently widely available and, even if it were, it would likely be prohibitively expensive. In the absence of an established insurance market covering QC errors and omissions, it would be completely unknown whether such an insurance market could meaningly develop to a point of spreading the risk among a prudent number of reputable providers, would offer what the SEC would consider "adequate coverage" and whether it would be cost prohibitive or result in material increased costs being passed along to advisory clients that outweigh the benefits. Accordingly, we urge the SEC to retract the proposed requirement for insurance coverage.

In the event QCs are contracting directly with advisers under the current regulatory scheme, QCs today (including a number of SIFMA's prime brokerage members) are only willing to negotiate their contractual liability provisions with certain advisers, particularly advisers with more client accounts or more client assets under management. The Proposal would unduly interfere with their commercial negotiations and according to some, would materially impact whether they would continue to provide custodial services, as well as the level of services they would be willing to provide, especially to smaller advisers including newly established advisers.

b. The imposition of liability for acts of sub-custodians and CSDs.

The requirement that QCs not avoid liability for acts of sub-custodians, CSDs and others makes them potentially strictly liable for losses caused by entities that they do not fully or even

partially control. It is not clear what level of responsibility the SEC intends to impose from the vague and ambiguous wording of the rule itself ("the existence of any sub-custodial or securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the [QC's] obligations to the client"), but the wording and commentary can be read to suggest strict liability. As the Proposal recognizes in several places in connection with foreign financial institutions (***"FFIs"***), there may be risks that are outside the control of not only the custodian but also the sub-custodian (which, by and large, are FFIs), such as government takings, that may lead to the loss of assets. QCs are not expected by their clients to absorb those risks or losses, because clients understand that it is the client (and its advisers) that choose to invest in any particular market, not the QC. The QC is only relied upon to exercise diligence in choosing and monitoring the ongoing suitability of the sub-custodian within the given market.

With respect to CSDs, these considerations do not apply, because it cannot meaningfully be said that a QC "chooses" or "hires" the CSD and therefore QCs routinely (and we believe appropriately) disclaim liability for CSDs. This is because CSDs, in their role as the official book of record for the issuer of securities in a given market, function as a component of the local market infrastructure over which the QC has no control or discretion. If an adviser makes the decision on behalf of its client to invest in a given market, the QC has no practical choice but to make use of the CSD for that purpose.

Requiring custodians to remain responsible for actions occurring at sub-custodians that are outside their or the sub-custodian's control, or for CSDs, would inevitably be viewed as taking on "country risk" traditionally borne by investors and not custodians, and lead many custodians to restrict their custodial activities to only the most developed markets. This would substantially extend the obligations imposed on QCs, including events beyond their control. In many cases, it would require them to take on country investment risk, especially for sub-custodian insolvency and CSD issues. As stated above, custodians do not delegate custody to CSDs nor have any ability to select them, as they are market infrastructures. Accordingly, we propose that any liability of a QC should be limited to that of diligence in choosing and monitoring ongoing suitability of the sub-custodian within the given market, and the reference to "securities depository" in subsection (C) of the Proposal should be stricken.

This provision does not differentiate circumstances where the client has a separate agreement with a sub-custodian, in which case the primary QC should unquestionably not be subject to liability. Nonetheless, QCs may require direct privity of contract between clients (and advisers) on the one hand and sub-custodians, CSDs and others on the other hand, or outright refuse to custody assets where sub-custodians, CSDs and others would be involved and would expose the QCs to potential liability under the terms of the Proposal.

c. The obligation not to impose a lien on client assets.

To the extent that the proposed assurance that the QC will not seek to impose a lien on customer assets precludes the imposition of rights, charges, security interest, liens or claims, including rights of setoff, in favor of a QC that are permitted by applicable law (e.g., the UCC) or reasonable commercial standards without the need for written client authorization, this will be a significant issue for QCs. It is important to note that, while the UCC generally requires that the

grant of a security interest be in a writing or an electronic record signed or otherwise authenticated by the debtor, the grant does not need to be in writing if the custodian has possession or "control" of the collateral, which will likely be the case for a QC. In that case, the grant of the security interest may be oral, and the custodian would not need to have written authorization from a customer in order to assert a lien or security interest (indeed a perfected security interest).[23]

The limitation on liens is also inconsistent with existing law. Even without a signed or otherwise authenticated grant of a security interest, a custodian has common law rights of set off and recoupment against a customer, absent a waiver of those rights. The custodian cannot set off or recoup securities against a monetary obligation owed to the custodian, but it can set off or recoup free cash balances. The standard of care for a custodian under Article 8 of the UCC is that which the parties agree, subject to the UCC's general requirement of good faith (i.e., honesty in fact and the observance of reasonable commercial standards of fair dealing). It is only when there is no agreement that the standard of care is that the custodian must exercise "due care in accordance with reasonable commercial standards." While custodians may agree to a reasonable care standard for certain customers, typically the custodian has no liability short of gross negligence or willful misconduct.

The proposed requirement that all assets or liabilities over which the adviser has investment discretion be held "in a custodial account, [segregated] from the [QC's] proprietary assets and liabilities," would, perhaps unintentionally, attempt to force a range of already regulated financial transactions and products into a "custodial construct," without any apparent customer protection benefit over those protections currently applicable, with the effect of either prohibiting them for investment adviser-advised counterparties, or making them dramatically more expensive. These issues are addressed more fully in the context of specific products in this letter. Many if not all of the proposed requirements above are based on the assumption that all assets are held "in a custody account." Given the proposed expansion of the rule to all assets over which an adviser has discretionary authority, this would clearly no longer be the case if the Proposal were adopted as proposed, and it is quite unclear how these requirements could be made to sensibly apply to non-custodied financial transactions.

For instance, how can a financial institution that has entered into an interest rate swap with an adviser's client (and is therefore deemed to be a QC with respect to that asset) enter into insurance arrangements that will "adequately protect the client against the risk of loss" of that asset? And how can that financial institution "implement appropriate measures to safeguard client assets from misuse, appropriation, [etc.]"? These are concepts that do not appear to have any actual meaning in the context in which the Proposal would purport to apply them.

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[23] *See* UCC § 9-206. Moreover, the Proposal does not address circumstances where client assets have to be transferred to a successor QC because the original QC becomes subject to bankruptcy, a proceeding under the Securities Investor Protection Act or a resolution administered by the federal banking authorities. Notably, an adviser will not be in a position to secure a written agreement or obtain written assurances from the successor QC, and indeed, it can be expected that any bankruptcy trustee or receiver in such a proceeding would itself assert on behalf of the debtor-in-possession rights, charges, security interest, liens or claims in favor of the debtor's estate regardless of whether there is an agreement with the customer.

2. Foreign Financial Institutions.

There is a significant global dimension to an adviser's relationship with its clients, who frequently seek to trade in different markets across jurisdictions. In order to invest in markets outside their home country, investors must have access to the financial system infrastructure of other jurisdictions. Global custodians provide this access through their sub-custodian networks and participation via those networks in central securities depositories or securities settlement systems.

As the Proposal would impose new onerous requirements on FFIs, however, this access would be jeopardized due to conflicts and inconsistencies between the Proposal and certain foreign laws and regulations. While regulatory frameworks and market practices of other countries also provide for the safe custody of client assets, approaches vary and may not accord with the specific requirements that the SEC seeks to impose. Such conflicts with international regulatory norms may result in reduced access to relevant foreign markets or to certain assets within those markets.

For FFIs, one of the most problematic aspects of the Proposal is, similar to the new requirements that would be applicable with respect to cash deposits in a U.S. bank or savings association, all assets, including cash, must be held "in an account designed to protect such assets from creditors of the [FFI] in the event of [its] insolvency or failure." As with deposits in U.S. banks, this would be a dramatic departure from current practice, under which cash deposits create a debtor/creditor ("title transfer") relationship. There is broad recognition by advisers and their clients that evaluation of the creditworthiness of the FFI is a key aspect of choosing an FFI. Essentially, all of the disruptive aspects discussed in connection with cash deposits in U.S. banks apply here as well.

In addition, it should be noted that advisers that could not satisfy the proposed new requirement that, among other things, the SEC be able to enforce judgments, including civil monetary penalties, against FFIs. It is unclear whether FFIs could meet the requirements of the Proposal. It could create an extraterritoriality issue where the FFI could not comply with both the Proposal's requirements and applicable foreign law where the FFI is located.

In those circumstances where advisers engage QCs, the engagement may include the ability of the QC to sub-custody, including with FFIs. These arrangements ensure that advisers and clients can access foreign markets. To the extent FFIs cannot meet the requirements of the Proposal, advisers and clients would be shut out of those foreign markets and would be unable to invest in foreign securities in overseas markets. This, in turn, would force advisers and their clients to execute foreign securities trades on their own, without the intermediation of their adviser, or instead to trade in American depository receipts (***"ADRs"***) even when the underlying non-U.S. securities offer more favorable terms, including price, because the markets for the underlying non-U.S. securities are typically far more liquid than the corresponding market for ADRs. In a number of cases, it would limit the choice of investors and advisers in global markets.

The above examples highlight a few of the conflicts and inconsistencies the Proposal would raise in relation to foreign laws and regulations. Given the limited timeframe provided for public comment, however, the full scope of issues with respect to FFIs are still being identified and considered. As such, SIFMA believes continued analysis and dialogue with the SEC may be necessary (and further comments may be submitted), as additional FFI-specific complexities are identified.

3. Clearing brokers.

In practice, clients or advisers may choose the services of an introducing broker rather than a QC. In such case, the introducing broker will introduce the client's account to their clearing firm, which acts as the de facto custodian of assets, but typically has no day-to-day contact or dealings with the client, acts on the instructions of the introducing broker, and may have no relationship with or even awareness of the adviser delivering advice to the client.

In such cases, neither the adviser nor the client may have selected the custodian of assets. The requirements that each QC enter into written agreements with and provide written assurances to each adviser to an introduced clearing client would be burdensome to custodians like clearing brokers but also run contrary to the introducing broker clearing model that is designed to ensure that key aspects of the customer relationship are maintained with the introducing broker while physical possession or control of customer assets is maintained by the carrying firm. The SEC has followed the long-established principle that, in an introducing/carrying arrangement, it is the carrying broker that acts as broker to each introduced customer for purposes of the SEC's customer protection rule governing custody of customer assets.[24] FINRA Rule 4311(c)(2), in turn, specifically requires that "[e]ach carrying agreement in which accounts are to be carried on a fully disclosed basis shall expressly allocate to the carrying firm the *responsibility for the safeguarding of funds and securities* for the purposes of SEA Rule 15c3-3 and for preparing and transmitting statements of account to customers." (emphasis added.) Further, both carrying brokers and introducing brokers are subject to regulatory requirements specifically designed to prevent misappropriation and fraud, including in connection with transfers of client funds or securities.[25]

The SEC also incorrectly assumes that QCs, including clearing brokers, are required to perform signature verifications, which is not the case. The SEC states that "the types of financial institutions identified as meeting the proposed definition of [QC] are required by their primary functional regulator or otherwise to perform procedures to verify the instruction and authorization, through a signature review and, if determined to be necessary, based on the facts

[24] *See e.g.,* SEC Release No. 34-31511, 57 Fed. Reg. 56973, 56980 (Dec. 2, 1992) ("The Division [of Market Regulation] has interpreted the net capital rule and Rule 15c3-3 to require that, for purpose of the Commission's financial responsibility rules and SIPC, the introducing firm's customers should be treated as customers of the clearing firm"); *see also, e.g.,* FINRA Guidance, SEA Rule 15c3-3 and Related Interpretations (Feb. 23, 2023).

[25] *See, e.g.,* FINRA Regulatory Notice 20-13, FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic (May 05, 2020); FINRA Regulatory Notice 19-18, FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations ((May 06, 2019); FINRA Regulatory Notice 12-05, Verification of Emailed Instructions to Transmit or Withdraw Assets From Customer Accounts (Jan. 26, 2012); FINRA Regulatory Notice 09-64, Verification of Instructions to Transmit or Withdraw Assets from Customer Accounts (Nov. 13, 2009). *See also* FINRA Rule 4515 and Supplementary Material .01 (Allocations of Orders Made by Investment Advisers) (warning brokers against knowingly facilitating misallocation of fills resulting from aggregated orders by investment advisers for which allocation instructions may be accepted on the trading day following the execution of the orders).

and circumstances, another method of verification." However, for example, clearing firms subject to FINRA Rule 4311 are not specifically required to collect new account forms, often do not have signature exemplars, and correspondingly may not undertake signature verifications but may rely on their introducing brokers in this regard.

4. Retail custodians.

Not all broker-dealer custodians cater to investment advisers with retail clients. Regardless, below are our observations on how the Proposal would affect those particular custodians who do.[26]

As discussed in greater detail below, certain components of the written agreement requirements are unworkable. For example, the requirement to specify an adviser's agreed-upon authority seems based on a misunderstanding of current custodial practices (specifically, those custodial platforms that serve independent investment advisers).

The Proposal notes that "advisers have limited visibility into their client's custodial arrangements . . . *which can result in inadvertent custody*" (emphasis added). This statement seems inconsistent with current practices in the retail broker custodial market, including where client funds and securities are held through custodial platforms designed specifically for advisers and their clients, or through QCs that are dual registrants or affiliated with client advisers. In the case of custodial platform, advisers often have full visibility into each client's custodial arrangements and related custodial agreements on an account-by-account basis. This information is easily accessible to advisers. Moreover, investment advisers that "select" or "recommend" such a custodian to their clients often assist clients with completing custodial account applications, agreements and forms and advise their clients on making certain selections related to optional account features (like adviser authority, margin, and other selections), so they have full visibility into the custodial terms in the custodial agreement and any authority attributed to the adviser. However, as discussed in Part VI below, QCs do not have access to agreements between clients and their advisers, and should not be required to verify the adviser's instructions to the custodian.

The Proposal also states, "we understand that some custodial agreements empower investment advisers with a broad array of authority that they neither want nor use. . . . Our staff has observed that [QCs] have been reluctant to modify or customize the level of authority of investment advisers with respect to customer accounts." This statement is not true of all custodians, as many custodians updated their practices following the Staff's Risk Alert on Inadvertent Custody[27] to align authorities with the adviser's understanding and its acceptance of authority and allow advisers to downgrade a custodian's authorities when requested.

[26] In addition, the Proposal does not provide clear guidance that a broker, and not its sub-custodian, is subject to the requirements of the Proposal, including in situations where, for example, a dual registrant deposits cash with another custodian (e.g., a bank), which may be acting as a good control location under the Advisers Act.

[27] SEC Staff of the Division of Investment Management, IM Guidance Update No. 2017-01, Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority (Feb. 2017), https://www.sec.gov/investment/im-guidance-2017-01.pdf.

VI. QC MONITORING OF INVESTMENT ADVISER COMPLIANCE: The potential need for QCs to ensure instructions received from advisers are consistent with their authority is outside the role of a QC as a directed agent, operationally impractical, increases settlement risk, and creates a moral hazard at the expense of investors.

The Proposal would require that the investment adviser's written agreement with the QC specify the investment adviser's "agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations." The SEC's objective in proposing this requirement is to address situations in which the standardized terms of the custodian's agreement with the custody client confer broader authority on the adviser than is provided in the advisory contract between the adviser and the client. The Proposal states that QCs are reluctant to customize the level of investment adviser authority because doing so would increase "their need to monitor customer accounts, and to accept liability, for unauthorized transactions by an adviser and its personnel." The Proposal would force QCs to accept this monitoring responsibility and the attendant liability exposure.

The Proposal requires that an adviser's written agreements with a QC specify the adviser's "agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations, and permits [the adviser] and the client to reduce that authority."

The SEC also expresses concerns in the Proposal that QCs are reluctant to customize the level of investment adviser authority because doing so would increase "their need to monitor customer accounts, and to accept liability, for unauthorized transactions by an adviser and its personnel." The Proposal explains that the reason for this new requirement is to reduce the "risk that a custodian may follow an instruction with respect to client assets presuming authority that the adviser does not have under its advisory contract with the client." As such, the Proposal appears to be intended to require QCs to review trade settlement instructions from an adviser before settlement to determine whether that instruction is outside the investment authority of the adviser. If this is the case, it will create significant issues impacting QCs, advisers, and clients.

QCs are directed agents of their clients, or advisers when acting on behalf of a client, and it is not the role of a QC to perform checks on the advisers' compliance with its agreements with its clients. QCs do not have access to agreements between clients and their advisers, and they do not have the information, expertise, or authority to determine the reasons, dynamics, or context of trading activity. Exercising investment authority requires an understanding of the context and interpretation of the financial situation, and an investment agreement between a client and adviser may have various limits on certain kinds of investment, countries of investment, or investments over a certain percentage that apply conditionally or only in circumstances that a QC cannot assess. This approach would effectively place liability for unauthorized trade settlement on QCs. This will not only add costs for QCs but also create risks for clients, as QCs would effectively become liable for adviser misconduct. This in turn could create a moral hazard that increases risk of harm to clients.

The monitoring of instructions to confirm if they fall within the adviser's authority would require significant process and system changes for QCs. Moreover, it would not be possible for

QCs to fully automate these processes and checks because QCs would need to review each settlement instruction, interpret the context for the trade, and subjectively judge whether an instruction falls under an adviser's investment authority. The efforts associated with implementing these processes to review large volumes of transactions daily would be enormous and disrupt straight-through processing. Additionally, the combination of reviewing each transaction, plus the liability QCs could face for unauthorized adviser trades, would have a negative impact on settlement efficiency. For example, while QCs perform such reviews and checks, there would likely be significant settlement delays and the associated buildup of counterparty risk in the market which would run counter to the SEC's objective to shorten U.S. settlement cycles to T+1.

Accordingly, SIFMA recommends that the SEC withdraw the provisions in the Proposal that would require QCs to review investment adviser instructions.

VII. INVESTMENT ADVISERS: The Proposal adversely affects current adviser custody practices to the detriment of clients.

The Proposal requires each adviser (other than dual registrants that self-custody) to enter into a written agreement with each QC for the adviser's clients, essentially inserting the adviser into the contractual relationship between the client and the custodian as if to help guarantee the custodian's protection of client assets. The written agreements would require the QC to, among other things, (i) provide records to the SEC upon request, (ii) send account statements to the client at least quarterly, (iii) provide the client with an annual internal control report that includes an opinion of an independent public accountant, and (iv) specify the adviser's agreed-upon authority to effect transactions. Advisers would also be required to have an ongoing reasonable belief that a custodian is complying with such provisions. The Proposal also requires the adviser to obtain the custodian's "reasonable assurances" in writing that the custodian will exercise due care, indemnify the client against loss, segregate client assets, and not subject client assets to security interests or liens.

1. The written agreement requirement is unworkable.

From a practical and workability perspective, it will be difficult, if not impossible, for advisers to get third-party custodians to enter into such agreements and provide such assurances, especially where such agreements and assurances differ from what has otherwise been agreed to between the client and the custodian and otherwise conflicts with commercial standards and applicable legal requirements. The Proposal assumes that advisers will invariably be able to secure necessary agreements with QCs and obtain the required written assurances from them but in the Proposal, the SEC staff concedes:

- "[W]e understand that some advisory clients' custodial agreements empower investment advisers with a broad array of authority that they neither want nor use. Advisers have little to no ability to eliminate this authority because they are usually not parties to the custodial agreements between clients and [QCs]."

- "We understand that advisers have had little success in modifying or eliminating their unwanted authority."

- Likewise, clients "have little or no power to negotiate for [minimum floor of custodial] protections."

The Proposal offers no explanation why or how investment advisers would be able to exert bargaining power over custodians that the adviser did not necessarily hire or with whom they are not in contractual privity. Even where an adviser has a contract with a QC, such as where the QC also sponsors a custodial platform or managed account program in which the adviser wishes to participate, the adviser seldom has any bargaining strength to push for nonstandard terms that a QC views as contrary to its interests. In short, by imposing certain contractual terms and obligations by regulation, the Proposal unreasonably expects advisers to insist on fundamental changes to QCs' practices and agreements (to which advisers are seldom a party) when historically, neither advisers nor their clients have been able to successfully negotiate such changes. This underscores the misdirected nature of the Proposal in placing substantial direct burdens on advisers in an effort to indirectly affect the practices and agreements of QCs.

In reality, custodians can be expected to reject the SEC's prescribed terms. Often, custodians view the terms of their custody agreement as non-negotiable. Often, they do so for good reasons, including that standardization of agreements and their commercial terms is the best and only way to administer custody relationships involving a large number of customers. For custodians that do agree to the SEC's prescribed terms, the custodian can be expected to demand additional compensation; the adviser would have no negotiating leverage, since the terms are dictated by the SEC. This would likely result in the clients being subject to substantially higher fees charged by the custodian, whether charged directly to the client or, if custody fees are assumed by the adviser, the adviser passing along the costs to the client in the form of higher advisory fees. This can also be expected to force custodians to limit services to those client assets that are easier to custody, including by eliminating assets or asset classes that it would otherwise look to maintain through a sub-custodian, thereby limiting the range of securities and other assets that are available to advisers and their clients.

2. The written assurances requirement is unworkable.

a. The implicit due diligence and monitoring requirements would be unduly burdensome on advisers, particularly smaller advisers.

The requirements for advisers to enter into an agreement and obtain written assurances appear to go beyond simply entering into an agreement with or obtaining written assurances from the QC. Although not clearly reflected in the text of the Proposal, the SEC states that "advisers should enter into a written agreement with a [QC] based upon a reasonable belief that the [QC] is capable of, and intends to, comply with the contractual provisions." In so stating, the SEC is essentially mandating that advisers conduct due diligence and ongoing monitoring of custodians, to wit:

> We also recognize that while the understanding of appropriate safeguarding measures is generally expected to be within the expertise of the [QC], *advisers also generally should seek to become sufficiently familiar with safeguarding practices to identify concerns or red flags in order to, among other things, form an opinion as to whether the assurance that they receive from the [QC] that the [QC] is acting with due care is reasonable. More broadly, identifying concerns and red flags is an important factor in the adviser forming a reasonable belief that the protections in the proposed written agreement have been implemented*. (emphasis added).

In other words, advisers must not only enter into contracts with and obtain written assurances from QCs, but also monitor and become knowledgeable about the custody business and the practices of their QCs. This will pose substantial burdens on advisers large and small, with disproportionate impact on smaller and startup advisers whose resources will be strained to meet this obligation. Placing this burden on advisers will distract them from performing their primary function (i.e., manage client investments). This requirement also fails to consider that many practices of custodians may be proprietary information that custodians are unwilling to share. For example, if some of this information is cyber related, sharing that information could increase the risks faced by the custodian, and in turn their clients.

b. The written assurances requirement is essentially an additional, burdensome contractual requirement and obligation for both advisers and QCs.

The Proposal draws, without explanation, a clean delineation between the written agreement and the written assurances requirements. The written agreement is of course a legally enforceable contract, while the written assurances are presumably something else: a unilateral contract?; a good-faith undertaking by the QC?; a provision in the existing agreement? The Proposal does not explain why the distinction is drawn, or clarify its legal or regulatory import for advisers and QCs.

As a practical matter, advisers would not create two separate writings, one for the written agreement and one for written assurances requirements under the Proposal. Instead, they would all be lumped into a single contract between the adviser and the QC, and the written assurances provisions would be negotiated equally with the terms of the written agreement under the Proposal. In this regard, the written assurance requirements essentially constitute additional, burdensome contractual obligations for both advisers and QCs, not appropriately acknowledged or accounted for as such in the Proposal's cost-benefit analysis.

3. The written agreement and assurances requirements would limit client service, increase client costs, and create undue regulatory confusion.

Finally, the Proposal does not address how the challenges that advisers will face by virtue of the written agreement and written assurance requirements will translate into client service issues and practical conundrums. For example:

- What happens if an adviser is unable to secure an agreement with or obtain required assurances from a QC?
- What if a QC terminates its agreement with the adviser but not the client?
- What if an adviser learns of facts that call into question a QC's reasonable assurances?
- Is the adviser liable for violating the Proposal's requirements?
- Does the adviser need to resign from the client account, cease discretionary advice (or revert to non-discretionary advice and, if so, what notice should be afforded clients), if the above scenarios occur?
- Will advisers need to address these scenarios in client agreements, and will the SEC treat these as impermissible "hedge clauses"?

The Proposal's written agreement and written assurances requirements can reasonably be expected to prompt advisers to restrict clients' abilities to select QCs of their choice because an adviser will have to prefer QCs with which it has conducted due diligence and established pre-existing agreements and arrangements. Clients may choose their QCs for various reasons, including preferring QCs with whom they have previously dealt, QCs that provide them with other services, as well as QCs that maintain custody of the client's other assets. In these instances, clients will be disserved by their inability to engage the custodian of their choice.

Even if an adviser permits a client to select its own QC, the adviser can reasonably be expected to add a surcharge to its fees to reimburse the advisers for the costs associated with dealing with the other QC. This outcome would vastly increase the burdens and costs involved, which would ultimately be passed on to clients.

4. With respect to discretionary trading, the Proposal's distinction between how a trade settles would likely present significant operational and implementation challenges to advisers.

The Proposal would apply the safeguards to discretionary trading, i.e., when the adviser buys or sells the client's assets on the client's behalf. The Proposal, however, draws a distinction between whether a discretionary trade settles on a delivery-versus-payment (***"DVP"***) basis or a non-DVP basis. The Proposal could force investment advisers to decline to accept discretionary authority over assets that trade on a non-DVP basis and may limit the circumstances in which they even provide non-discretionary advice because of logistical challenges in seeking client direction. In turn, this would force clients to engage in DIY (do it yourself) investing for assets that trade on a non-DVP basis, whereas such clients would be better served by having access to an adviser's guidance or management services with discretionary authority.

Moreover, there is no evidence of custodial misconduct or misappropriation in connection with discretionary trading on a non-DVP basis by the adviser. The reduced settlement time and electronic nature of many transactions have resulted in virtually

simultaneous delivery and payment for non-DVP trades. Thus, there is scarce opportunity for custodial misconduct or misappropriation or custodial misconduct by the adviser, providing little justification for the Proposal's non-DVP distinction and the negative consequences that would follow.

5. **With respect to privately offered securities, advisers would be challenged to demonstrate compliance with the Proposal's requirement that the adviser reasonably determine that ownership cannot be recorded and maintained by a QC, and it is questionable whether custodians would accept the responsibilities taken on by transfer agents with respect to policing transfer restrictions.**

Although the Proposal creates greater flexibility in some respects for assets that are not maintained with a QC, the combination of the burdens associated with those assets and SEC dicta in the Proposal will likely foreclose advisers from providing discretionary advice on those assets. In this regard, the SEC's dicta that "[w]hen an adviser has custody of client physical assets that are not maintained with a [QC], *the ultimate obligation to safeguard those assets falls to the adviser*," which makes an adviser a guarantor of the safety of those assets. This statement is of substantial concern in that it does not differentiate between authority-based custody and possession-based custody. Nor does it reflect any role played by the client either in transferring into the client's account such assets or the client making his or her own arrangements for safekeeping those assets, and whether the adviser will still be held responsible if it is deemed to have discretion over the assets.

The Proposal would continue to except privately offered securities from the QC requirement. It would, however, also require the adviser to reasonably determine that ownership "cannot" be recorded and maintained by a QC. It is unclear how an adviser could demonstrate and document this negative condition (i.e., to prove a negative), especially given the dynamic and ever-changing nature of financial services, including service offerings by custodians. Nor is it clear how frequently an adviser would have to make or reevaluate this determination or how extensively it would have to search for a QC for these securities. Moreover, although custodians tend to concentrate on custody of assets for which such custody services can be offered at a reasonable cost, that is not to say that a custodian might be willing to custody assets no one else will for an exorbitant fee, essentially making the required determination both vague and meaningless in practice. This requirement is not susceptible to meaningful or reasonable compliance and should be stricken.

The obligation to have an independent public accountant "promptly" verify transactions in assets that cannot be recorded and maintained by a QC will raise significant practical considerations and will be burdensome. In addition, independent public accountants may find it challenging to "verify" any such transactions, which could result in independent public accountants notifying the SEC of "material discrepancies" simply because the asset is of a type for which transactions are not easily verifiable on a prompt basis.

Although the SEC has offered limited anecdotal examples of how independent public accountants can perform transaction verification and tracing of transaction of such assets (e.g., in the case of privately offered securities, by contacting the issuer or its agent, and reviewing

private placement memoranda in the issuer's Regulation D filings), variations in the type of asset subject to verification and tracing and variations in the attendant circumstances will pose substantial burdens and add substantially to the costs imposed on independent public accountants, which will be passed on to advisers, and in turn, clients. Depending upon the asset, many independent public accountants may not possess the requisite expertise or experience in performing such verification and tracing and will decline to offer such services, except at a substantial surcharge.

Indeed, independent public accountants will likely respond to the Proposal, and the increased role they will play, particularly in areas and with assets with which they may not have had substantial prior experience, by dramatically increasing their charges for asset verification, transaction verification and tracing, and related services to compensate them for the additional costs they will bear and for their exposure to potentially greater liability. This is especially so given the prospect that, by analogy to the role of independent public accountants in the public company context, they may themselves be viewed as watchdogs with "ultimate" responsibility (watchdogs of advisers, which according to the Proposal are watchdogs of custodians, which are watchdogs of customer assets).[28]

Advisers will also need to develop a process and protocol to notify independent public accountants of transactions involving these assets within one business day of the transactions (presumably based on the closing date of given transactions), and this process will need to be automated through functionality integrated into adviser order management or transaction systems. Automating this functionality will take years to develop, including through advanced budgeting, defining needs and requirements, considering how to implement this automation across a range of different technologies and systems (both current and legacy) and various other steps, all of which would require substantial lead time.

In addition, the Proposal's discussion of the "privately offered securities exception" fails to consider that the securities involved are restricted, not-freely tradeable securities, or the role that transfer agents play in policing issuers' securities laws-based restrictions. Transfer agents are the true "gatekeepers" for these restrictions. Unlike "the custodial market," where freely tradeable securities are kept safe by custodians acting as agents for investors, transfers agents are agents of the issuers of securities who must restrict sales of those securities under the regulatory regime imposed by Section 5 of the Securities Act of 1933 and related rules, so that the issuer does not violate that central provision of the securities laws by engaging in an impermissible public offering of unregistered securities.

Transfer agents perform such functions as reviewing legal opinions provided by investors wishing to sell such securities describing the legal basis upon which the seller is relying (i.e., the relevant exemption from the registration requirement, such as a "private sale" or the elapsing of a

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[28] *See United States v. Arthur Young & Co*., 465 U.S. 805, 817-18 (1984) ("By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.").

holding period). For securities that must be sold pursuant to a registration statement, transfer agents require a "broker letter" from the broker executing a sale transaction attesting that the broker is aware of the sales restrictions, a key "gatekeeping" function as it puts the broker on notice of restrictions it would otherwise not be aware of. Even when such securities are held by brokers, they are typically held in non-saleable, "legended" form and must be sent to transfer agents before sale to be "de-legended." It is questionable whether any traditional custodian, bank or broker-dealer, would want to take on those core transfer agent functions.

6. The Proposal will negatively impact a broad range of services offered by advisers.

As discussed below, the Proposal will negatively impact a broad range of services offered by advisers to the detriment of their clients.

a. Managed accounts and wrap fee programs.

The Proposal does not adequately consider how investment advice is provided to clients across a spectrum of different arrangements, many of which can involve multiple investment advisers that each pursue specific strategies or may perform different functions. For instance, institutional investment advisers may offer manager of manager strategies that combine advisory services of multiple investment advisers responsible for sub-strategies or for specialized services such as portfolio optimization, tax-loss harvesting, evaluation of wash-sale issues, etc. Similarly, current retail managed account programs (also known as "wrap fee programs") are offered under various structures, including the following:

Single-contract programs, pursuant to which a client engages a primary adviser (often the program sponsor) that is typically also a broker-dealer (dual registrant) that custodies client assets, which curates the field of, and engages other advisers that manage, specific strategies, which may be offered in so-called "sleeves" of a client's account.

Dual-contract programs, pursuant to which the client has a contract with a dual registrant or broker-dealer sponsor of the program or other QC (which may or may not serve as investment adviser) and where the client directly selects and contracts with a separate adviser, which typically does not select or contract with the broker-dealer or other QC (and which is often hired by the client to act as an intermediary between the client and the adviser).

Unified Managed Accounts (UMAs), whereby the primary adviser or dual registrant (often the program sponsor) typically offers a multi-strategy portfolio divided into sleeves that can include not only separate portfolios managed by separate advisers, but also separate sleeves consisting of mutual funds, ETFs, strategies or other assets managed in a commingled form, often with a so-called "overlay adviser" responsible for functions such as monitoring portfolio concentration, providing tax optimization advice and similar services.

Model-based programs, which can follow the structures discussed above and provide for an adviser to manage a client portfolio or sleeve of a portfolio based upon non-discretionary model portfolios provided by other third parties, which may or may not be investment advisers.

In all the above structures (except dual contract arrangements), there is a primary adviser that has contracted with the client and coordinates with other investment advisers in various respects. Many if not most of these advisers play no role in the selection or engagement of the client's QC and have no contract with the QC as it pertains to the QC's provision of custodial services. To the extent the Proposal would require each adviser participating in this managed account ecosystem to satisfy the requirements that an adviser enter into written agreements and receive written assurances from each QC, doing so would effectively shut down these programs and impede the ability of primary advisers to deliver "best-of-breed" services to their clients by tapping into the specialized capabilities and services of a broad variety of other advisers.

It is important to note that these managed account programs are relatively fluid in the sense that client assets are often reallocated across different advisers, with underperforming advisers being substituted with other advisers, and the addition of new advisers to offer new strategies possibly involving new types of asset classes and other custodians or sub-custodians in a highly dynamic process, all designed to deliver the best service to clients. If each adviser participating in these programs, up and down the chain, were required engage in negotiations with and sign written agreements and obtain written assurances from each custodian participating in the program before providing investment advice, there would be no practical way that they could do so without substantial disruptions in client advice. Very often, the advisers (other than the primary adviser) participating in these managed account programs concentrate on delivering their best advice but do so on relatively thin profit margins. The imposition of the significant burdens contemplated by the Proposal would effectively render advising managed accounts, especially retail managed accounts, completely unworkable and uneconomical. The Proposal fails to acknowledge, address, or justify those negative consequences, particularly for retail clients.

b. Financial Planning.

If the requirements to obtain a written agreement and written assurances from a QC otherwise apply to an account (e.g., because the client has given the adviser a standing letter of authorization), an investment adviser that provides nondiscretionary investment advice in the form of financial planning would have no practical means to comply with these requirements insofar as client assets can be expected to be housed by various QCs and other persons (in the case of nonfinancial assets), including bank deposit and savings accounts, securities accounts, retirement accounts in the form of 401(k) plans and IRA accounts with qualified IRA custodians, vacation property, artwork, and other assets of various kinds. If an investment adviser were required to obtain a written agreement and written assurances from each custodian of those assets, then the adviser would be forced by practical considerations to limit the scope of advice substantially, and thereby dramatically reduce the value proposition of investment advice to clients.

c. DC (defined contribution) and DB (defined benefit) Pension Plan Advisers, including with plans subject to custody requirements under ERISA.

Many investment advisers provide advice on the investment or allocation of a client's assets within a pension or profit-sharing plan, including a 401(k) plan, in which the client is a

participant. In many cases, these investment advisory services are provided outside any formal arrangement with the plan sponsor, its recordkeepers or any QC of the plan's assets. Moreover, the advisory client only has a beneficial interest in the plan assets, not actual legal title to them. In these circumstances, it would likely be impossible for an investment adviser to obtain a written agreement with or written assurances from the custodian for the plan's assets because plan sponsors can be expected to restrict plan service providers like custodians from contracting directly with participants or their outside advisers, including to negotiate for changes in applicable terms as this could dramatically increase the costs otherwise born by the plan sponsor, the plan and all of its participants.

d. Referral Arrangements.

Many advisers refer clients to other advisers to manage the clients' assets. The managing adviser has the same responsibilities as the primary adviser described above; it has a contract with the client; coordinates with other advisers in various respects; and selects, engages, and enters into a contract with the client's QC. Although the referring adviser does not play a role in the management of the client's account, the managing adviser (not the QC) may view the referring adviser as a "relationship manager," accept service requests on behalf of the client from the referring adviser, including withdrawal requests, and submit these service requests to the QC. By removing the reference "to the custodian" from the arrangement category of the definition of custody (see proposed Rule 223-1(d)(3)), the referring adviser (who has no direct interaction with the QC) would be required to enter into a written agreement with and receive written assurances from the client's QC, obligations that the managing adviser is already obligated to fulfill.

7. The Proposal creates competitive disadvantages for SEC registered investment advisers.

Other fiduciaries provide investment advice comparable to that provided by SEC-registered advisers, including federal and state-chartered banks and trust companies, exempt reporting advisers and state registered advisers. The Proposal would place SEC-registered advisers and their clients at a competitive disadvantage relative to these other fiduciaries that are otherwise not encumbered by these unnecessary and burdensome requirements. Because the SEC is using its regulatory authority over advisers as leverage to force changes in custodial practices rather than approaching the issue on a multilateral basis in conjunction with other functional regulators, advisers, including advisers affiliated with banks, will be incentivized to transition advisory services to bank fiduciary platforms.

8. The Proposal should revise Form Custody for broker-dealers.

Together with the Proposal's amendments to Form ADV 1A, the SEC should also revise Form Custody[29] for broker-dealers to remove Items 8 and 9 relating to broker-dealers dually registered as investment advisers and investment adviser affiliates of broker-dealers because the

[29] Form Custody for broker-dealers, https://www.sec.gov/files/formcustody.pdf.

data collected through Form Custody is redundant and overlaps with the data called for by amended Form ADV 1A, Item 9.

VIII. DIGITAL ASSETS: The Proposal should be amended to allow QCs to provide digital asset safekeeping services to their clients if they choose to do so.

Please note that SIFMA generally uses the term "digital assets" in this section instead of the term "crypto assets." The SEC has used the term "crypto assets" to mean a wide variety of digital assets, including tokenized and digitally native versions of traditional assets that use permissioned blockchains. In our view, the term "crypto assets" should be more narrowly defined as referring to those native crypto assets operating on permissionless blockchains, such as cryptocurrencies. We would note further that our members are generally most concerned with the custody of regulated digital assets, and not cryptocurrencies. The importance of digital asset taxonomies is also discussed in **Appendix 2**.

SIFMA agrees that there should be a minimum floor of custodial protections for investors investing in digital assets through an investment adviser. Permitting QCs to provide custodial services for digital assets is a step towards ensuring that digital asset markets develop in a responsible manner that protects investors. QCs should however always maintain the freedom to choose whether and under what circumstances they are willing to provide custody services for different types of assets, including digital assets.

We commend the SEC for adopting an approach that relies on "the expertise of custodians with a long history of developing different procedures for safeguarding a variety of assets" rather than one that relies principally on the types of assets held in custody.[30] We agree that regulated institutions meeting the QC standard have the proven expertise, experience, and risk control frameworks in place to safeguard a wide variety of asset classes, including digital assets. We also agree that this broadly asset-neutral approach to custody regulation will better enable the rules to remain "evergreen as the types of assets held by custodians evolve."[31]

While we welcome the Proposal establishing "rules of the road" for the safekeeping of digital assets, there are several obstacles that, if left unresolved, will make it difficult for QCs to provide digital asset-related custody services to their clients. First and foremost, the Proposal conflicts with Staff Accounting Bulletin (***"SAB"*** or ***"the Bulletin"***) 121, as well as with the SEC's safe harbor for brokers using a Special Purpose Broker Dealer (***"SPBD"***), in ways that will make it difficult for many QCs to provide these services to their clients. We recommend that the SEC revise SAB 121, as well as the SEC's safe harbor for brokers using a SPBD, to better align with the Proposal and enable QCs to provide digital asset custody services to their clients. We discuss the SAB 121 issue below and both issues in **Appendix 2**.

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[30] *Id. at 79.* As the Proposal also appropriately notes, "although crypto assets are a relatively recent and emerging type of asset, this is not the first-time custodians have had to adapt their practices to safeguarding different types of assets."

[31] *Id. at 78.*

Second, while we support the Proposal's overall commitment to treating custodial assets in a neutral fashion, there are important distinctions between different types of digital assets (*e.g.,* tokenized traditional assets versus cryptocurrencies) and between different configurations of the underlying DLT on which they operate (*i.e.,* private versus public blockchains, and "permissioned" versus "permissionless" networks) that need to be considered. Third and finally, the Proposal needs to be amended in several areas to account for the unique features of digital assets and their underlying technology. For example, the Proposal's definition of "exclusive control" may not be consistent with operating models of some digital asset infrastructure, even when controls equivalent to traditional asset markets are in place. Other provisions, such as the indemnification, insurance, and audit requirements, may be unworkable when applied to digital assets products. Additionally, it is important to recognize the many opportunities for digital assets to improve markets for regulated products, such as by providing greater operating efficiency, reducing risk, and providing greater market depth and liquidity. These issues are discussed in **Appendix 2**.

a. SAB 121 should be brought into alignment with the Proposal by creating a QC exemption to SAB 121.

As noted above, the Proposal provides a workable pathway for QCs to maintain digital assets in custody on behalf of their clients. In most cases, those QCs will be banking organizations. In practice, however, the ability of banks to provide digital asset safekeeping services will be severely constrained unless the SEC also addresses the limitations created by SAB 121.[32] SAB 121 applies a novel accounting treatment to the safeguarding of what it terms "crypto assets,"[33] as explained in **Appendix 2**.

In issuing SAB 121, SEC staff cited technological, legal, and regulatory risks associated with the safeguarding of digital assets.[34] As SIFMA and others have noted in prior comments, the risks that may be associated with the safekeeping of digital assets are already managed effectively by banking organizations operating within strict regulatory and supervisory frameworks.[35] Moreover, the Proposal itself addresses many of the key risks identified in SAB 121. For example, the Proposal creates a clear legal and regulatory standard, requiring advisers

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[32] Staff Accounting Bulletin No. 121, Securities and Exchange Commission (March 31, 2022), https://www.sec.gov/oca/staff-accounting-bulletin-121.

[33] As SIFMA has noted in prior comments, the scope of assets that fall within the SAB's definition of "crypto assets" is overly broad, encompassing virtually all forms of "digital assets." SAB 121's definition should be narrowed to apply only to native crypto assets that operate on permissionless blockchains, thereby excluding tokenized and digitally native versions of traditional assets that typically use permissioned blockchains. The former class of assets do incur many of the risks identified in SAB 121 and should therefore be its proper focus. However, as SIFMA notes here and in prior comments, these risks can effectively be mitigated by banking organizations. See American Bankers Association, Bank Policy Institute, and SIFMA Letter "Staff Accounting Bulletin No. 121 Issued by the Staff of the Office of the Chief Accountant of the Securities and Exchange Commission" (June 23, 2022), https://www.sifma.org/wp-content/uploads/2022/06/ABA-BPI-and-SIFMA-SAB-121-Letter-6.23.22.pdf (hereinafter ***"Joint Trades SAB 121 Letter"***).

[34] SAB 121 discusses these risks in general terms. For example, in regard to "technological risks," SAB 121 states "there are risks with respect to both safeguarding of assets and rapidly-changing crypto-assets in the market that are not present with other arrangements to safeguard assets for third parties."

[35] See Joint Trades SAB 121 Letter, in particular Section IV.

that custody digital assets to maintain those assets at a QC, and clarifying the conditions under which a qualified custodian would be considered to have "possession or control" of client assets.[36] It also clarifies the regulatory requirements that apply to the safeguarding of crypto/digital assets by QCs, mitigating the regulatory risks identified in SAB 121.

Given the foregoing matters, and given the extensive risk mitigants that bank custody providers have already put in place for the safekeeping of a wide variety of assets, it is clear that SAB 121 should not apply to banks that meet the Proposal's QC standard. While the SEC could consider exemptive requests to SAB 121 from individual bank QCs, a more effective and efficient approach would be for the SEC to provide for a QC exemption to SAB 121's accounting treatment of digital assets held in custody. Doing so would appropriately recognize that the risks identified in SAB 121 have been mitigated in the case of QC banks, and therefore the SAB's requirements are unnecessary for such institutions.

In addition, exempting bank QCs from SAB 121 would resolve an inherent tension between the Proposal and the Bulletin. In the Proposal, the SEC outlines a framework that would enable QC banks to provide digital asset-related safekeeping services to their clients in a manner that ensures that investors are appropriately protected. In doing so, it takes an "asset neutral" approach, which the Proposal argues is more effective than the alternative (*i.e.,* an asset-specific approach).[37] SAB 121 directly contradicts the Proposal by taking an asset-specific approach to the treatment of digital assets held in custody, effectively preventing QC banks from providing digital asset-related custodial services at scale to their clients. This tension should be resolved by aligning SAB 121 with the asset neutral approach adopted in the Proposal and exempting bank QCs from SAB 121's accounting treatment.

IX. COMMENT AND IMPLEMENTATION: The comment and implementation period are too short.

Given the expansive scope of the Proposal, the significant other concerns discussed above, and the SEC's already overloaded rulemaking docket, which is expected to expand even further with the spring agenda, a 60-day comment period does not provide sufficient opportunity for public comment.

Likewise, the one-year implementation period for large advisers and 18-month implementation period for smaller advisers are too short. The Proposal constitutes a major overhaul of the custody and safeguarding regulations and will require significant industry expenditure of time and resources to implement. While focusing on the transition burdens on investment advisers, the SEC does not adequately consider the transition burdens on QCs, which would be substantial, especially given the very large population of advisers in relation to the relatively concentrated population of QCs.

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[36] As the Proposal states, "a [QC] would have possession or control of a crypto asset if it generates and maintains private keys for the wallets holding advisory client crypto assets in a manner such that an adviser is unable to change beneficial ownership of the crypto asset without the custodian's involvement." *Id.* at 67.

[37] *Id. at 78.*

The SEC also proposes different implementation periods for advisers, based on the adviser's regulatory assets under management (***"RAUM"***), one year for advisers with more than $1 billion and 18 months for firms with up to $1 billion in RAUM. The Proposal assumes that the time required for a firm to implement the Proposal bears some relationship to the amount of assets it manages but offers no rationale for this assumption. We disagree that large firms would require less time to implement the Proposal.

For example, larger advisers may need to enter into a far greater number of written agreements with, and obtain written assurances from, QCs than smaller advisers, and could be expected to need substantially *more* time to transition to any new rule if the Proposal were adopted. We also note that larger QCs can be expected to have dealings with a large universe of advisers with which they will need to contract with and provide written assurances to.

Accordingly, we recommend a comment period of at least 120-days, if the SEC chooses to re-propose, and a three-year implementation period for advisers and QCs generally. As stated above, while we disagree with the SEC's presumption that firms with greater RAUM would require less time to comply with the Proposal, if the SEC insists on making such a distinction, we propose a 3.5-year implementation period for smaller advisers.

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See **Appendix 1** for our important but secondary comments and responses to select SEC questions raised in the Proposal.

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If you have any questions or would like to further discuss these issues, please contact the undersigned at 202-962-7300, or Steven W. Stone in Morgan, Lewis & Bockius's Washington, D.C. office at 202-739-3000 or Ellen G. Weinstein in Morgan, Lewis & Bockius's New York office at 212-309-6000.

Sincerely,

Kevin M. Carroll
Deputy General Counsel
SIFMA

Attached: **Appendix 1** and **Appendix 2**.

cc: Honorable Gary Gensler, Chair, SEC
Honorable Caroline A. Crenshaw, Commissioner, SEC
Honorable Jaime Lizárraga, Commissioner, SEC
Honorable Hester M. Peirce, Commissioner, SEC
Honorable Mark T. Uyeda, Commissioner, SEC
Haoxiang Zhu, Director, Division of Trading and Markets, SEC
Emily Russell Westerberg, Chief Counsel, Division of Trading and Markets, SEC
Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, SEC

APPENDIX 1:

Secondary Comments and Responses to Select SEC Questions Raised in the Proposal

1. Restrictions on a QC's ability to show "hearsay assets" on account statements raise client service issues because many clients rely on their account statements to show both "held" and "not held" assets to gain an overall picture of their investments.

Account statements, particularly those provided by broker-dealers subject to customer account statement rules adopted by FINRA and NYSE and approved by the SEC and related FINRA guidance,[38] are already subject to requirements that the display of "not held" assets clearly reflect that they are not held by the broker-dealer and therefore appropriately mitigate the potential for client confusion.

The Proposal, however, states that the "practice [of accommodation reporting] undermines the account statement's integrity and utility in helping to verify that the client owns the assets and they have not been stolen or misappropriated." This statement contradicts the SEC's rationale in approving the FINRA and NYSE rules that create a sound framework for accommodation reporting, yet the Proposal offers no evidence of customer protection concerns, such as actual instances of client confusion or loss associated with accommodation reporting in compliance with applicable FINRA and NYSE rules. At a minimum, the Proposal should be amended to permit accommodation reporting by QCs that are broker-dealers and other custodians that comply with FINRA and NYSE rules approved by the SEC.

2. The Proposal's segregation requirements should more clearly articulate propriety of nominee conventions.

To the extent that the proposed segregation requirement requires that assets titled or registered in nominee name specify *the specific client* as compared with "for the benefit of clients" generally, with a firm keeping underlying records of the interests of each client, doing so would neither be necessary from a bankruptcy protection perspective nor consistent with current widespread practice. In this regard, we are concerned about statements in the Proposal that "[t]he proposed requirement that a client's assets be titled or registered *in the client's name* is designed to ensure that the client's assets are clearly identified as belonging to the appropriate client, regardless of whether a [QC] is holding the assets."

The Proposal would also permit advisers to identify the assets "for the benefit of" *a particular client* where assets may not be "titled or registered" in the client's name. This statement appears inconsistent with later statements describing how "clients may hold securities in 'street name' or 'nominee name' through a book-entry account with a broker-dealer, and the broker-dealer will keep records showing the client as the real or 'beneficial' owner. This requirement would protect client assets even if the assets are maintained with a broker-dealer in such a manner that gives the broker-dealer legal ownership of, or access to, the assets." We

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[38] FINRA Notice 10-19, FINRA Reminds Firms of Responsibilities When Providing Customers with Consolidated Financial Account Reports (Apr. 08, 2010), https://www.finra.org/rules-guidance/notices/10-19.

encourage the SEC to provide clear guidance that the nominee practice in the broker-dealer and other areas recognize the appropriateness of having assets registered in the name of the "[nominee] FBO its customers."

3. Amendments to recordkeeping rule, Advisers Act Rule 204-2.

The Proposal requires an adviser to maintain records to evidence that it has an "ongoing reasonable belief that the custodian is complying with [specified] requirements." The Proposal, however, is unclear as to what types of records would be sufficient to evidence such a reasonable belief. For example, would an annual certification from the custodian (assuming the custodian would be willing to provide one) be sufficient? Are there questionnaires that should be completed periodically (and how often is often enough)? The Proposal also requires the adviser to obtain the custodian's "reasonable assurances" in writing. Are these assurances kept for so long as the custodian is used? How long after the relationship ends must they be maintained?

4. Question #26: FCMs.

The Proposal requests responses to certain questions about FCMs, including in light of the CFTC's 2013 enhanced protections. The futures structure was considered a sound structure during the financial crises and was used as the model for cleared swap transactions. Swaps are subject to the exclusive jurisdiction of the CFTC. Security-based swaps are subject to the exclusive jurisdiction of the SEC. Mixed swaps are subject to the jurisdiction of both the CFTC and SEC. The Proposal should clarify that assets held at an FCM are held by a QC. However, no additional duties should be imposed upon the FCM as a result of being a QC without a specific determination by the SEC (to the extent it has jurisdiction) that there is a weakness in the regulatory regime. Moreover, investment advisers can be charged with the duty to ensure that the risks of using any particular market infrastructure are in the best interests of the client and an acceptable risk for the client, but investment advisers should not be charged with ensuring market infrastructure.

5. Question #247: Signature Verifications.

An advisory client signs a standing letter of authorization (***"SLOA"***) for a QC to transfer assets to a third party, and the introducing broker with the more direct client relationship, and not the custodian, should be required to verify the authenticity of the signature. This exception assumes that the adviser only has custody because of a SLOA and is only available if the QC is not a related person of the adviser. However practically, an introducing broker acting on behalf of an adviser should verify the SLOA signature and not the clearing broker that is acting as the QC.

APPENDIX 2:

General Comments on the Digital Assets Implications of the Proposal

Please note that SIFMA generally uses the term "digital assets" in this section instead of the term "crypto assets." The SEC has used the term "crypto assets" to mean a wide variety of digital assets, including tokenized and digitally native versions of traditional assets that use permissioned blockchains. In our view, the term "crypto assets" should be more narrowly defined as referring to those native crypto assets operating on permissionless blockchains, such as cryptocurrencies. We would note further that our members are generally most concerned with the custody of regulated digital assets, and not cryptocurrencies.

SIFMA agrees that there should be a minimum floor of custodial protections for investors investing in digital assets through an RIA. Permitting QCs to provide custodial services for digital assets is a crucial step in ensuring that digital asset markets develop in a responsible manner that protects investors. QCs should however always maintain the freedom to choose whether and under what circumstances they are willing to provide custody services for different types of assets, including digital assets.

We commend the SEC for adopting an approach that relies on "the expertise of custodians with a long history of developing different procedures for safeguarding a variety of assets" rather than one that relies principally on the types of assets held in custody.[39] We agree that regulated institutions meeting the QC standard have the proven expertise, experience, and risk control frameworks in place to safeguard a wide variety of asset classes, including digital assets. We also agree that this broadly asset-neutral approach to custody regulation will better enable the rules to remain "evergreen as the types of assets held by custodians evolve."[40]

While we welcome the Proposal establishing "rules of the road" for the safekeeping of digital assets, there are several obstacles that, if left unresolved, will make it difficult for QCs to provide digital asset-related custody services to their clients. First and foremost, the Proposal conflicts with Staff Accounting Bulletin (***"SAB"*** or ***"the Bulletin"***) 121, as well as with the SEC's safe harbor for brokers using a Special Purpose Broker Dealer (***"SPBD"***), in ways that will make it difficult for many QCs to provide these services to their clients. We recommend that the SEC revise SAB 121, as well as the SEC's safe harbor for brokers using a SPBD, to better align with the Proposal and enable QCs to provide digital asset custody services to their clients.

Second, while we support the Proposal's overall commitment to treating custodial assets in a neutral fashion, there are important distinctions between different types of digital assets (e.g., tokenized traditional assets versus cryptocurrencies) and between different configurations of the underlying DLT on which they operate (i.e., private versus public blockchains, and

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[39] Proposal at 79. As the Proposal also appropriately notes, "although crypto assets are a relatively recent and emerging type of asset, this is not the first-time custodians have had to adapt their practices to safeguarding different types of assets."

[40] *Id.* at 78.

“permissioned” versus “permissionless” networks) that need to be considered. Third and finally, the Proposal needs to be amended in several areas to account for the unique features of digital assets and their underlying technology. For example, the Proposal’s question on “exclusive control” may not be consistent with operating models of some digital asset infrastructure, even when controls equivalent to traditional asset markets are in place. Other provisions, such as the indemnification, insurance, and audit requirements, may be unworkable when applied to digital assets products, suggesting that the SEC should consult with digital asset providers to understand the full implications of the Proposal before adopting amendments to the current Custody Rule.

We propose a number of solutions that would ensure that QCs are able to provide digital asset related custodial services to their clients:

- ***SAB 121:*** many of the key risks cited in SAB 121 are addressed by the Proposal. Given this, and given that banking organizations have a proven ability to manage a range of technological, legal, and regulatory risks, QC banks should be exempt from the Bulletin’s accounting treatment. The most effective and efficient way to accomplish this would be for the SEC to provide a “QC exemption” to SAB 121.

- ***SPBD Safe Harbor:*** SPBD framework should be revised to allow broker-dealers to demonstrate possession and control of digital assets within their existing broker-dealer entities.

- ***Digital Asset Taxonomies:*** the final rule should contain a clearer and more nuanced taxonomy of digital asset types, which is aligned with existing regulatory frameworks and broadly consistent with definitions used by other U.S. regulators and international standard setters.

- ***DLT Configurations:*** the final rule should reflect greater nuance between DLT technology configurations, including recognition for a future role for public blockchains provided suitable controls are in place.

- ***Subcustodial Liability:*** subcustodial liability provisions create specific potential challenges for firms working with digital asset infrastructure providers, in addition to the broader concerns on subcustodial liability.

- ***Definitions of “Physical” or “Exclusive” Possession or Control:*** the final rule should include a nuanced treatment of ways to demonstrate of possession or control to ensure it is compatible with secure DLT operating models, such as requiring QC “participation,” as opposed to “exclusive” or “physical” control.

- ***Insurance and Audit Requirements:*** digital asset custody presents additional challenges in meeting these proposed requirements, making them unworkable in the context of these products; they should be removed from the final rule.

SAB 121 Should be Brought into Alignment with the Proposal by Creating a QC Exemption to SAB 121.

As noted above, the Proposal provides a workable pathway for QCs to maintain digital assets in custody on behalf of their clients, should they select to do so. In most cases, those QCs will be banking organizations, which have extensive expertise and experience in providing custody services to their clients. In practice, however, the ability of banks to provide digital asset safekeeping services will be severely constrained unless the SEC also addresses the limitations created by Staff Accounting Bulletin 121 ("SAB 121").[41] SAB 121, which became effective on April 11, 2022, applies a novel accounting treatment to the safeguarding of "crypto assets."[42] In contrast to established accounting treatment, which generally records client assets held in a custodial capacity as off-balance sheet items, SAB 121 would require public companies to recognize a broad range of digital assets held in custody as on balance sheet items, measured at the fair value of the customer custodial digital assets. For banks, this would result in a punitive capital charge that would effectively preclude such organizations from providing at-scale digital asset-related safekeeping services to their clients.

In issuing SAB 121, SEC staff cited technological, legal, and regulatory risks associated with the safeguarding of digital assets.[43] As SIFMA and others have noted in prior comments, the risks that may be associated with the safekeeping of digital assets are already managed effectively by banking organizations operating within strict regulatory and supervisory frameworks.[44] Banks have developed extensive and unique expertise in safeguarding client assets for over eighty years and are well positioned to provide client custody services for this new class of assets. They have led the way in developing innovative practices, processes, and controls for the safekeeping of digital assets, addressing many of the technology risks that prompted the issuance of SAB 121. Such organizations are also subject to long-standing legal precedents for safeguarding assets, and bank custody arrangements clearly document and disclose to customers their rights and responsibilities. Finally, banks are subject to

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[41] Staff Accounting Bulletin No. 121, Securities and Exchange Commission (March 31, 2022), https://www.sec.gov/oca/staff-accounting-bulletin-121.

[42] As SIFMA has noted in prior comments, the scope of assets that fall within the SAB's definition of "crypto assets" is overly broad, encompassing virtually all forms of "digital assets." SAB 121's definition should be narrowed to apply only to native crypto assets that operate on permissionless blockchains, thereby excluding tokenized and digitally native versions of traditional assets that typically use permissioned blockchains. The former class of assets do incur many of the risks identified in SAB 121 and should therefore be its proper focus. However, as SIFMA notes here and in prior comments, these risks can effectively be mitigated by banking organizations. See American Bankers Association, Bank Policy Institute, and SIFMA Letter "Staff Accounting Bulletin No. 121 Issued by the Staff of the Office of the Chief Accountant of the Securities and Exchange Commission" (June 23, 2022), https://www.sifma.org/wp-content/uploads/2022/06/ABA-BPI-and-SIFMA-SAB-121-Letter-6.23.22.pdf.

[43] SAB 121 discusses these risks in general terms. For example, in regard to "technological risks," SAB 121 states "there are risks with respect to both safeguarding of assets and rapidly-changing crypto-assets in the market that are not present with other arrangements to safeguard assets for third parties."

[44] See Joint Trades SAB 121 Letter, in particular Section IV.

comprehensive regulatory and supervisory frameworks established by their primary regulators to ensure that safeguarding activities are conducted in a safe and sound manner.[45]

Moreover, the Proposal itself addresses many of the key risks identified in SAB 121. For example, the Proposal creates a clear legal and regulatory standard, requiring advisers that custody digital assets to maintain those assets at a QC, and clarifying the conditions under which a QC would be considered to have "possession or control" of client assets.[46] It also clarifies the regulatory requirements that apply to the safeguarding of crypto/digital assets by QCs, mitigating the regulatory risks identified in SAB 121.

Given this, and given the extensive risk mitigants that bank custody providers have already put in place for the safekeeping of digital assets, it is clear that SAB 121 should not apply to banks that meet the Proposal's QC standard. While the SEC could consider exemptive requests to SAB 121 from individual bank QCs, a more effective and efficient approach would be for the SEC to provide for a QC exemption to SAB 121's accounting treatment of digital assets held in custody. Doing so would appropriately recognize that the risks identified in SAB 121 have been mitigated in the case of QC banks, and therefore the SAB's requirements are unnecessary for such institutions.

In addition, exempting bank QCs from SAB 121 would resolve an inherent tension between the Proposal and the Bulletin. In the Proposal, the SEC outlines a framework that would enable QC banks to provide digital asset-related safekeeping services to their clients in a manner that ensures that investors are appropriately protected. In doing so, it takes an "asset neutral" approach, which the Proposal argues is more effective than the alternative (i.e., an asset-specific approach) "because it relies on the expertise of the various types of QCs and allow the rule to remain evergreen as the types of assets held by custodians evolve."[47] SAB 121 directly contradicts the Proposal by taking an asset-specific approach to the treatment of digital assets held in custody, effectively preventing QC banks from providing digital asset-related custodial services at scale to their clients. This tension should be resolved by aligning SAB 121 with the asset neutral approach adopted in the Proposal and exempting bank QCs from SAB 121's accounting treatment.

The Proposal's clarification of important legal and regulatory standards related to the safekeeping of digital assets, as well as existing risk controls at banks, address the concerns underpinning SAB 121. As such, we urge the SEC to exempt QC banks from SAB 121. Doing so would recognize that the risks identified in SAB 121 have been largely mitigated in the case

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[45] Banks are permitted to custody cryptocurrency for customers pursuant to the Office of the Comptroller of the Currency (***"OCC"***) interpretive letters. In 2021, the OCC issued additional guidance requiring a bank to notify its supervisory office, in writing, of its proposed cryptocurrency activities and receive written notification of non-objection. OCC Interpretive Letter No. 1179 (Nov. 18, 2021), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf. To custody cryptocurrency, a bank should demonstrate that it has established an appropriate risk management and measurement process for the proposed custody activities that addresses cryptocurrency-related risks, such as operational, liquidity, strategic, and compliance risks. *Id.* at 4.

[46] As the Proposal states, "a [QC] would have possession or control of a crypto asset if it generates and maintains private keys for the wallets holding advisory client crypto assets in a manner such that an adviser is unable to change beneficial ownership of the crypto asset without the custodian's involvement." Proposal at 67.

[47] *Id.* at 78.

of QC banks. It would ensure alignment with the asset-neutral approach it adopts in the Proposal, enabling QC banking organizations to provide digital asset services to their clients consistent with the Proposal's enhanced protections. More generally, by aligning SAB 121 with the Proposal, the SEC would help ensure that the broader digital asset markets develop in a responsible manner that protects investors.

The SEC's SPBD Safe Harbor Should be Replaced with a Path to Secure Client Assets in Existing Broker Dealers.

The SEC should also consider interactions between the framework in the Proposal with the other challenges broker-dealers would face in becoming QCs for digital assets in light of other SEC regulatory statements, in particular the SEC's Safe Harbor for broker-dealers to hold digital asset securities (hereinafter "the Statement) in compliance with requirements of Rule 15c3-3 under the Securities Exchange Act of 1934.[48] We encourage the SEC to revisit the Statement and develop an alternative model where broker-dealers can meet custody requirements within existing broker dealer entities, similar to the QC framework in the Proposal.

To comply with the Statement, a broker-dealer that would custody digital asset securities must "limit its business exclusively to . . . digital asset securities" in order to "isolate risk."[49]

SIFMA provided extensive comments on the challenges the industry sees in taking advantage of the safe harbor provided by the Statement, and instead argued for providing a framework for broker-dealers to demonstrate that they have established suitable controls within their existing broker dealers.[50] We argued that the challenges created by the requirements to confine digital asset security activities to a ring-fenced SPBD would effectively prevent broker-dealers from entering this space.

Nearly two years after its introduction, our understanding is that the industry broadly remains constrained by these limitations, and SIFMA members largely have not chosen to apply for the SPBD safe harbor.

Additionally, the safe harbor offered by the Statement was only for a 5 year period, starting in the second quarter of 2021; given that it is scheduled to sunset in less than 3 years, SIFMA members would not feel confident in building a long-term custody solution based on this model.

In contrast, the Proposal moves away from the concept of ring-fencing digital asset activity, and instead develops a framework for controls that would be applied within the broader entity to demonstrate the digital assets are being handled securely.

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[48] Custody of Digital Asset Securities by Special Purpose Broker Dealers, Securities Exchange Act Release No. 90788 (Dec. 23, 2020), 86 FR 11627, 11627 n.1 (Feb. 26, 2021).

[49] *See* the Statement at 3 and 8.

[50] SIFMA comment re: File No. S7-25-20: SEC Statement And Request For Comment on Custody of Digital Assets Securities by Special Purpose Broker-Dealers (May 20, 2021), https://www.sifma.org/wp-content/uploads/2021/05/Digital-Asset-Security-Custody-SIFMA-Comment-Letter.pdf.

We encourage the SEC to apply this framework to broker-dealers' handling of digital asset securities, and move away from the SPBD concept, and instead provide a path to hold these assets within their existing broker dealer entities.

Benefits of Digital Assets and DLT for Regulated Products & Activities.

SIFMA and its members believe that the application of digital asset technology has the potential to drive substantial improvements in the U.S. capital markets. Digital assets innovation by regulated entities in regulated products arguably offers the best venue for digital assets experimentation and innovation; building on existing regulatory frameworks and protections.

The applications of DLT to regulated products across the securities lifecycle offer a range of benefits not only to their users, but supporting the broader objectives of the SEC, such as increasing operational efficiency, providing greater depth and liquidity in markets, and developing new ways of serving clients while remaining within the regulatory guardrails ensuring market quality and investor protection.

Regulated financial institutions also offer a proven track record of responsible innovation, and new digital asset ventures can draw on such institutions' established and robust frameworks for technology and operational risk management, as well as existing client suitability frameworks, anti-money laundering (AML) and know-your-customer (KYC) procedures, cybersecurity requirements and data protection processes.

SIFMA members are exploring a range of applications of DLT to enhance regulated products and markets. Members have a particular focus on using blockchain based infrastructure to support existing processes; native digital security issuance; tokenization of existing financial instruments; tokenized non-security assets such as commercial bank deposits; and cross-border transfers.

SIFMA has provided extended discussions of the benefits of applying DLT to regulated products and activities, as well as exploration of specific use cases, in our responses to RFIs in connection with the March 2022 Executive Order on Digital Assets as well as the January 2023 White House Office of Science and Technology Policy. We encourage SEC staff to review them for additional detail.[51]

Clear, Consistent, and Nuanced Taxonomies and Definitions for Digital Asset Types Are Necessary, and the Proposal should be Based on Them.

SIFMA would like to reiterate the foundational importance of clear, consistent taxonomies for digital asset types for effective regulation. As the SEC moves forward with

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[51] *See* SIFMA response to Treasury Department's Request for Comment ("RFC") on "Ensuring Responsible Development of Digital Assets," August 2022, https://www.sifma.org/wp-content/uploads/2022/08/Ensuring-Responsible-Development-of-Digital-Assets.pdf. *See also* SIFMA Response to White House Office of Science and Technology Policy Request for Information (RFI) on "Digital Assets Research and Development Agenda," March 2023, https://www.sifma.org/resources/submissions/request-for-information-digital-assets-research-and-development-agenda/.

incorporating digital assets into existing regulatory frameworks, both in this Proposal and in the future, it is essential that regulation is grounded in clear, consistent taxonomies and definitions. They should provide sufficient nuance to allow for regulation that suitably reflects the characteristics of specific digital assets and the regulatory regimes under which they are issued. These definitions should be both consistent within a regulator and across other regulators and ideally internationally.

However, we are concerned that the Proposal instead takes a broad approach to different digital asset types, and does not build on the SEC's prior work in integrating digital assets into existing regulatory frameworks. Instead, we encouraged the SEC to build on the existing taxonomies developed by regulators and policy makers in the US and internationally and by industry.

Clear definitions and taxonomies allow for distinguishing between digital asset types with fundamentally different regulatory treatment and technological features, and aligning regulation to specific asset types based on the principle of "same activity, same regulatory outcome," and will allow the SEC to more easily make the focused changes to existing rulesets which will accommodate regulated products which are based on blockchain networks (such as tokenization of existing registered securities and issuance of registered natively digital securities).

In contrast, the absence of consistent definitions or a nuanced taxonomy of different digital asset types used by regulators creates major challenges and stifles innovation, while inconsistency in taxonomies internationally leads to differential treatment for certain classes of assets and activities depending on jurisdiction.

While there are broader questions of how different digital asset types align with the products covered by different US regulatory agencies, clear taxonomies and consistent definitions of digital asset types are critical, regardless of the how open jurisdictional questions are ultimately resolved.

Regulators and Industry have Developed Foundational Taxonomies Which We Encourage the SEC to Build Upon.

While a range of taxonomies and terminology are used to categorize DLT-based assets, we recommend the SEC look to the framework adopted by the Basel Committee on Bank Supervision (BCBS) and the more granular taxonomy developed by the Global Financial Markets Association (GFMA). The framework adopted by the BCBS differentiates between three broad categories: tokenized traditional assets, which often create efficiencies within the well-established banking framework; crypto assets with effective stabilization mechanisms (i.e., stablecoins); and unbacked crypto assets, such as Bitcoin.[52]

[52] Basel Committee on Banking Supervision, "Prudential treatment of cryptoasset exposures" (December 2022), https://www.bis.org/bcbs/publ/d545.pdf.

The Global Financial Markets Associations (GFMA), of which SIFMA is a member, has developed a taxonomy that further differentiates digital assets into six categories: (1) value-stable digital-assets, including CBDCs, financial market infrastructure (FMI) tokens, tokenized commercial bank money, and stablecoins; (2) security tokens; (3) cryptocurrencies; (4) settlement tokens; (5) utility tokens; and (6) other crypto-assets (i.e., those not structured as value-stable crypto-assets).[53]

The Proposal's Definitions of Digital Assets Need Greater Nuance.

We are concerned that the Proposal and the SEC's statements about the Proposal do not offer sufficient nuance or precision to appropriately treat the diversity of different digital asset types and the regulatory frameworks they operate under. The lack of appropriate granularity likely will cause confusion about how and whether a qualified custodian is permitted to custody different types of digital assets, thereby preventing any adviser or qualified custodian from accepting digital assets to avoid exposure to regulatory risk.

We note that the Proposal itself uses the term "crypto" broadly, even as industry taxonomies and regulatory frameworks such as the BCBS framework differentiate clearly

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[53] The full taxonomy is provided in Annex 1 to the GFMA response to the Financial Stability Board's (FSB) questions for consultation on "International Regulation of Crypto-Asset Activities – A Proposed Framework," (December 2022), https://www.gfma.org/wp-content/uploads/2022/12/gfma-response-to-fsb-crypto-asset-consult-15-december-2022.pdf.

A) ***Value-stable digital-assets***, including CBDCs, financial market infrastructure (FMI) tokens, tokenized commercial bank money, and stablecoins, and some stablecoins, which represent a claim on a fixed value, and may or may not pay interest.

B) ***Security Tokens***: Tokens issued solely on DLT or blockchain infrastructure that satisfies the applicable regulatory definition of a security; or Token that represents on DLT or blockchain infrastructure underlying securities/financial instruments issued on a different platform where such representation itself satisfies the definition of a security/financial instrument under local law.

C) ***Cryptocurrencies***: Digital representations of value with no redemption rights against a central party and may function within the community (enabled through peer-to-peer networks) of its users as a medium of exchange, unit of account or store of value, without having legal tender status. They may also act as an incentive mechanism and/or facilitate functions performed on the network they are created in; their value is driven by market supply/demand therein.

D) ***Settlement Tokens***: Representation on DLT or blockchain infrastructure of underlying traditional securities/financial instruments issued on a different platform (e.g., a traditional CSD, registrar, etc.) where such representation itself does not satisfy the definition of a security or financial instrument under local law and is used solely to transfer or record ownership or perform other mid/back-office functions

E) ***Utility Token***: A means of accessing a DLT or blockchain platform and/or a medium of exchange which participants on that platform may use e for the provision of goods and services provided on that platform, whether they are native to that platform itself or built upon it

F) ***Other Crypto-Assets*** (not structured as value-stable crypto-assets): Representation on DLT or blockchain infrastructure of ownership in tangible or intangible underlying assets or of certain rights in those assets (such as interest, e.g., loans), which are not securities or financial instruments (e.g., real estate, art, intellectual property rights, precious metals, grains, or non-fungible assets that only exist in digital form on a DLT network); they may represent a claim on the issuing entity or the underlying assets.

between the types of registered securities which are represented or created on a blockchain and unbacked crypto assets, which are commonly thought of as "crypto" by the general public.

Additionally, the Proposal and the statements by the SEC associated with it introduce further uncertainty around the definitions of different digital asset types. While SEC rulemaking and statements (such as around the SPBD safe harbor) developed the concept of a "digital asset security," a registered security on a blockchain, the Proposal, in contrast, seemingly breaks down the distinction between blockchain based registered securities and crypto assets more broadly.[54] For example, the Proposal comments that "To the extent digital assets rely on cryptographic protocols, these types of assets also are commonly referred to as 'crypto assets.' For purposes of this release, the SEC does not distinguish between the terms 'digital asset' and 'crypto asset.'"[55]

Similarly, SEC Chair Gensler in his statement on the release of the Proposal noted that the Proposal "covers a significant amount of crypto assets" and that "most crypto assets are likely to be funds or crypto asset securities covered by the current rule."[56]

Regulation Should Take a Nuanced Approach to Technology Differences among DLT Network Types and their Risk Implications.

Just as it is critical for policymakers to understand and define the differences between digital asset types and to ensure that policy and regulatory frameworks reflect those differences, it is equally important to differentiate among different configurations of the underlying technology infrastructure that enables digital asset products and services. Discussions of DLT or blockchain infrastructure often conflate all types of network configurations and obscure the very real differences between them – differences that have major impacts on risk, users, and how technology innovation can be integrated within existing regulatory frameworks.

In particular, we want to stress the importance of taking a nuanced view of the controls offered by specific network configurations, and recommend the SEC to reassess elements of the Proposal which take a broad-brush approach to certain DLT network types. Most notably, we recommend modification of the Proposal's overly restrictive approach, and not risk based approach to use of public permissionless networks.

There are a range of different DLT configurations, and further nuances are created by technological overlays which can add more controls or features. In this response, we will not provide an extended discussion of the nuances of DLT infrastructure configuration, but encourage SEC staff to explore these issues more deeply given their impacts on the Proposal,

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[54] Custody of Digital Asset Securities by Special Purpose Broker Dealers, Securities Exchange Act Release No. 90788 (Dec. 23, 2020), 86 FR 11627, 11627 n.1 (Feb. 26, 2021).

[55] Proposal, footnote 25.

[56] SEC Chair Gary Gensler "Statement on Proposed Rules Regarding Investment Adviser Custody," February 15, 2023, https://www.sec.gov/news/statement/gensler-statement-custody-021523.

including through recent SIFMA publications which provide a more detailed overview of these issues aimed at the financial regulatory and policy community.[57]

At a high level, the key features of DLT networks can be differentiated along two axes – the accessibility of the network (whether it is restricted only to certain users or is publicly available) and the control of privileges for users of the network (i.e., authentication of who can carry out specific actions, such as writing changes to the ledger). This schema results in three main types of distributed ledgers:

- ***Private Permissioned:*** Closed-loop, private networks, which restrict access to predetermined users only.
- ***Public Permissioned*****:** These applications are built on a public network foundation but with the addition of use controls on top of the underlying network to create what are effectively closed networks (which vary by design), given selective restriction of access through authentication for governance, administration, or other privileges.
- ***Public Permissionless*****:** Open, public networks that do not restrict access for privileges. These networks are among the largest operating today and present a track record of resilience.[58]

It is important not to assume that any one type of network is inherently more risky than other types. The key is understanding applicable risk management features and how they align with the goals of the product they are supporting, other organizational controls that may be in place, and any regulatory requirements. Instead, we urge the SEC to take a risk-based approach, as opposed to broad brush elimination of a particular network types.

While the industry to date has focused on technology configurations other than public permissionless, we are still in early stages of development of this technology, and there may be use cases where regulated products can effectively be supported by this kind of network, particularly given the ongoing efforts to develop innovations in digital identity management and authentication, or other control frameworks which can provide the necessary oversight while building on the particular strengths of these types of networks, or that they may play a role in supplementing other network types. For example, a specific strength of public networks (permissioned and permissionless) is the ability to act as a neutral settlement layer. A growing number of firms see public network based blockchains as an important option to develop a thriving tokenization market, as the public layer is agnostic among providers and suitable controls can be built on it.

[57] SIFMA Response to White House Office of Science and Technology Policy Request for Information (RFI) on "Digital Assets Research and Development Agenda," March 2023, https://www.sifma.org/resources/submissions/request-for-information-digital-assets-research-and-development-agenda/.

[58] The summary above introduces at a high level the risk management controls associated with each type of technology configuration. SIFMA would be happy to discuss in greater depth the risk management controls associated with each network type and how they are consistent with the oversight and risk management requirements of regulated financial institutions.

Additionally, the U.S. Department of the Treasury's April 2023 "Illicit Finance Risk Assessment of Decentralized Finance" noted that there are a number of regulatory, infrastructure, and industry operational / technological solutions which can mitigate the risks associated with decentralized financial networks. The report noted the potential of solutions such as digital identity technology, zero knowledge proofs, the use of oracles for screening, and integration of controls into smart contract codes.[59]

Potential Liability Exposure to Digital Asset Infrastructure.

We are also concerned that the Proposal's requirements around custodian's liability could expose QCs of digital assets to potential liability from issues at underlying digital asset networks. The Proposal "would require that the adviser obtain reasonable assurances in writing from the [QC] 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 [QC]'s obligations to the client," and creates requirements for indemnification for losses.[60]

This raises questions of whether the underlying blockchain infrastructure can be considered as a settlement rail for digital assets, and so suggests a client could be positioned to ask for the indemnification of losses due to the failures of that DLT infrastructure, independent of the specific roles of the custodian.

The expansion of this requirement to "other third-party arrangement implemented by the custodian" in this section can be read expansively enough to cover the entire operator of a blockchain infrastructure, so that a QC would then have liability for them as well. This could potentially be interpreted to include reliance for cybersecurity issues at the DLT infrastructure provider that the assets are based on, creating third party obligations for that as well.

While the issue of expansive interpretations of subcustodial liability issue will exist for custodial relationships for "traditional" products as well (and are treated elsewhere in this letter), it raises particular concerns for DLT based assets and infrastructure.

While exposure to subcustodial liability creates challenges for broader securities markets as discussed above, these digital assets-specific potential interpretations of subcustodial liability would discourage further firms from serving as QCs for digital assets. Additionally, their potential interpretation to cover the role of technology and infrastructure providers is inconsistent with both the role of a custodian and its exposure to liability in "traditional" asset markets as well as the ways in which digital asset infrastructure can be configured to manage risk and the role of a digital assets custodian in securing client assets.

We recommend the SEC modify the custodian's liability requirement to clearly exclude exposure to underlying technology and settlement infrastructure.

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[59] U.S. Department of the Treasury "Illicit Finance Risk Assessment of Decentralized Finance," (April 6, 2023), https://home.treasury.gov/system/files/136/DeFi-Risk-Full-Review.pdf.

[60] Proposal, 2-C-a-iii.

Definitions of "Physical" or "Exclusive" Possession or Control May be Inconsistent with Secure DLT Operating Models.

The Proposal also questions whether custodians be required to have "physical" or "exclusive" possession or control of the client's assets – we strongly recommend against this. Any specific language around control requirements must be interpreted in the context of digital assets products and infrastructure, and whether the rule as proposed is feasible for digital asset custodians broadly. As discussed above, there a range of current and emerging digital assets operating models, reflecting different combinations of underlying technology, regulatory frameworks under which the products were created, and the interactions among market participants and infrastructure providers. Different digital asset operating models can offer robust investor protections through combinations of technology platforms and their embedded safeguards, product regulation, and risk mitigation through infrastructure providers.

Regulation should focus on meeting the broader objectives of investor protection and risk reduction, as opposed to a narrow focus on "physical" or "exclusive" possession by the custodian. Instead, the proposed language of possession and control (i.e., that a QC is necessary to effectuate a change in beneficial ownership) is a better alternative.

An overly prescriptive approach to defining the role of the digital asset custodian may also create challenges with the operational and trading flows and technology configurations market participants are developing, even when those models build on a custodian to secure client assets and reduce risk. For example, participation in change of beneficial ownership may take different forms depending on the asset involved. Similarly, control of digital assets can be demonstrated through various mechanisms which may include contractual or technical components which are highly dependent on the nature of the specific crypto asset network.

A narrow definition of "exclusive" control could also prevent custodians from employing certain technological solutions to secure client assets, which in fact actually increase the security of systems safeguarding client assets. For example, storing wallet keys with a secure cloud provider, who replicates data across multiple cloud servers, could be interpreted as not providing "exclusive" control, despite the benefits it would offer in terms of security and resiliency.

Similarly, the private key for the customer's account can be subdivided so that the customer has to provide a transfer instruction via its shard in addition to the custodian to provide greater security. However, this risk mitigating technology control which advances the Proposal's objective of providing greater security when safeguarding client assets could constitute an illegal arrangement.

Where custody of a digital assets involves use of a private key to effect transfer, it is reasonable to assume that the custodian should maintain at least part of the key material. However, it is critical to bear in mind that not all digital asset operating models are built on this technology configuration.

A nuanced treatment of the role of the custodian and its interaction with other technology and process safeguards is critical, even as the broader role of the custodian in digital asset

markets evolves towards a model where digital asset custody is separated from the trading infrastructure.

Infeasibility of Meeting Insurance & Audit Requirements for Digital Assets Custodians.

The safeguarding rule in the Proposal would create requirements for audits and insurance coverage for the QC. Meeting these requirements for digital assets at present is effectively impossible. Both the audit and insurance requirements would need to be specialized providers who are not available at the scale necessary based on the providers currently in the market, nor can it be expected they would become available within compliance timeframes.

The proposed audit requirements cannot be met given the short implementation timeframe. Meeting the audit requirement would require reliance on specialized third-party audit providers, with dedicated expertise in digital asset custody issues. There are a limited number of certified audit practitioners who have the necessary expertise in digital assets, their cryptographic and cyber security techniques, and in particular their unique custodial issues. Their audit capacity will not be sufficient to meet the new requirement for potential QCs, particularly given the other audit requirements in the broader digital assets marketplace.

In addition to broader challenges created by the Proposal's insurance requirements as discussed above, potential QCs of digital assets would face additional challenges, as digital asset insurance is an emerging product. As a result, QCs would likely be unable to meet the proposed requirement to have insurance arrangements in place to adequately protect the client against the risk of the loss of the client's assets within a reasonable timeframe following the adoption of the rule. In its current state, specialized digital assets insurance coverage is simply not available in the volumes necessary to cover QCs who wished to handle digital assets.

Extension of the proposed insurance requirements would also create challenges in the digital assets markets, due to different storage and coverage models. For example, currently, most custodians look to ensure balances held in their "hot" wallets or funds that are not sitting in cold storage. There is limited loss data on losses from assets held in "cold" storage and therefore limited actualized losses from a cold storage incident to based pricing on additional coverages. If there was a requirement for assets held by a QC to be insured one to one, it would not be possible in today's market and there would be no path to satisfy the requirement. Most custodians today carry as much insurance as they are able to purchase at a financially reasonable premium. Additional coverage (if available) would likely cost upwards of 100 bps dollar for dollar making the coverage cost prohibited.