May 8, 2023

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-109

Re: The SEC Proposed Safeguarding Rule (File No. S7-04-23)

Dear Ms. Countryman:

JPMorgan Chase & Co. ("**JPMorgan**") appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's (the "**Commission**") proposed new safeguarding rule, which would replace the custody rule (the "**Custody Rule**"), current Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "**Advisers Act**"), with proposed new Rule 223-1 under the Advisers Act (the "**Proposed Rule**").[1]

JPMorgan is a leading global financial services firm. We have world-leading Global Custody and Prime Brokerage businesses servicing institutional clients who focus on protecting the wealth and financial security of end investors, including pensioners and retail investors.[2] These institutional clients critically rely on JPMorgan to provide operational infrastructure, technology, global market access and scale. JPMorgan helps enable them to deliver strong returns and performance, provides access to a full and diverse range of investible assets globally, and ensures the safety of these assets. In addition, JPMorgan is one of the world's largest derivatives dealers, futures commission merchants ("**FCMs**"), financing providers, commodities brokers, and payments providers. Each of these would be heavily impacted by the Proposed Rule in a manner that we believe would be detrimental to our clients and counterparties, and end investors, largely without achieving the benefits that the Commission outlines as the Proposed Rule's goal.

JPMorgan is actively engaged with and generally supports the views expressed by the numerous financial industry trade associations that are commenting on the Proposed Rule.[3] This letter will identify the most impactful provisions of the Proposed Rule and the markets they would disrupt to demonstrate the broad reach of the Proposed Rule, reference relevant trade association letters that address these issues in more depth, and discuss our high-level observations of the consequences of the Proposed Rule and specific recommendations.

I. Executive Summary.

We agree with the Proposed Rule's policy objective of having "a minimum floor of custodial protection for investors—including those investors that have little or no power to negotiate for those

[1] Safeguarding Advisory Client Assets, Release No. IA-6240 (February 15, 2023), 88 FR 14672 (March 9, 2023) ("**Proposing Release**").

[2] Our institutional investor clients include pension funds, governments/states, asset managers, and insurance companies.

[3] These include American Bankers Association/Bank Policy Institute/Financial Services Forum ("**ABA/BPI/FSF**"), Association for Financial Markets in Europe/Association of Global Custodians-European Banking Federation ("**AFME/AGC-EBF**"), Association of Global Custodians ("**AGC**"), U.S. Chamber Center for Capital Markets Competitiveness ("**CCMC**"), Committee on Capital Markets Regulation ("**CCMR**"), Futures Industry Association ("**FIA**"), International Swaps and Derivatives Association ("**ISDA**"), Managed Funds Association ("**MFA**"), and Securities Industry Financial Markets Association ("**SIFMA**").

protections—in the event of custodial misconduct."[4] Given the recent high profile cryptocurrency market events, we understand the Commission's desire to require registered investment advisers ("**RIAs**") to hold crypto assets with qualified custodians ("**QCs**") in an effort to provide minimum custodial protection standards for investors' crypto assets as well as to consider whether other broad enhancements may be needed to better protect investors. Rather than addressing these issues in a targeted manner, the Commission has introduced provisions which fundamentally alter longstanding traditional custody practices for securities and cash, and has taken an overly broad approach of extending the custodial obligations to financial transactions where this construct is not appropriate and in a way which extends the concept of custody to markets where these requirements cannot be met.

The Proposed Rule would not promote additional consumer protection or market clarity for traditional financial markets. Instead, it would alter traditional custody practices and scope in a number of offerings that are already subject to robust regulatory and supervisory standards, some of which fall outside of the jurisdictional purview of the Commission. In fact, traditional financial markets are already well-regulated with regard to investor protections by the Commission itself, the banking or prudential regulators ("**PRs**"), the Commodity Futures Trading Commission ("**CFTC**"), and, in the case of Foreign Financial Institutions ("**FFIs**"), foreign regulators. The Proposed Rule does not appear to have considered this and would disrupt a significant portion of the operations in the financial markets which have been well-functioning for many years as part of a regulated markets infrastructure.

In the sections below, we discuss the following observations regarding the Proposed Rule:

- **The Proposed Rule has not provided clear evidence of shortcomings in existing regulations or sufficient cost-benefit analysis of the impacts on financial markets.**

- **The Proposed Rule inappropriately expands the concept of custodial obligations to markets where compliance would not be possible and/or costly for investors.**

- **The Proposed Rule's segregation of cash requirement is unworkable and will result in reduced market efficiency and increased costs for clients.**

- **The Proposed Rule's segregation of all client assets requirement will potentially preclude trading activity, impact market liquidity, and increase costs for clients.**

- **The Proposed Rule's reasonable assurances requirement unreasonably expands QC liability for losses outside of a QC's control and could result in reduced services and limited market access.**

- **The Proposed Rule's indemnification and insurance requirement is unnecessary, unworkable, and will likely result in increased costs for clients.**

- **The Proposed Rule's requirement to specify an RIA's level of authority to effect transactions will likely reduce market efficiency, increase settlement risk, and result in worse outcomes for clients.**

[4] Proposing Release at 88.

For the reasons discussed in detail below, JPMorgan strongly believes the Commission should re-propose a rule that is more appropriately targeted to achieve the Commission's regulatory objectives and less disruptive to traditional markets.

II. Discussion.

The impacts resulting from the Proposed Rule are potentially very disruptive and consequential as discussed in more detail below. We urge the Commission to consider these effects and coordinate with the regulators that directly regulate and/or have a vested interest in the orderly workings of the financial markets and longstanding custody practices.

a. The Proposed Rule Has Not Provided Clear Evidence of Shortcomings in Existing Regulations or Sufficient Cost-Benefit Analysis of the Impacts on Financial Markets.[5]

The Commission has not conducted the necessary fact finding and analysis, or built a proper record, to demonstrate regulatory inadequacies in traditional custodial arrangements. In fact, the assets and activities that are scoped in by the Proposed Rule are already subject to effective regulatory oversight. The Commission, CFTC, and PR margin rules govern uncleared swaps and/or security-based swaps and the treatment of variation margin ("**VM**") and initial margin ("**IM**") collateral, and are inconsistent with the Proposed Rule. Prime brokers are subject to the Commission's own customer protection rules (i.e., Rule 15c3-3), which have proven to be effective for decades. FCMs are already subject to a robust regulatory framework under the Commodity Exchange Act and CFTC regulations relating to the treatment of all customer funds which offer the safeguards the Proposed Rule seeks to establish. Custody banks are subject to the Office of the Controller of the Currency ("**OCC**") supervision and regulatory oversight. All of these existing regulations are specifically tailored to the unique arrangements involved in the transactions, as detailed in the relevant sections below.

While the Commission makes references to these regulations, it fails to provide clear evidence of their inadequacy in safeguarding customer assets or any additional benefit the Proposed Rule would provide. Despite these existing safeguards that have proven effective, the Proposed Rule creates several requirements that are inconsistent with these regulations and risks harming, rather than enhancing, the investment environment for end investors. In doing so, the Proposed Rule intrudes on the jurisdiction of federal regulators and exceeds the Commission's regulatory authority by imposing contractual obligations and terms on custodians over whom the Commission does not have regulatory authority.[6]

In addition, the Proposed Rule fails to provide the required cost-benefit analysis on the impacts on financial markets; where it is provided, the analysis is flawed and insufficient. First, the Commission does not appear to have carefully considered the impact of the Proposed Rule on broader financial market activities, nor its cumulative effect with other Commission rulemaking (e.g., the Commission's proposed rule regarding outsourcing by RIAs).[7] The Proposed Rule also fails to analyze the impact on investor choice of providers and the burden of costs associated with compliance that investors would ultimately need to bear. There is no analysis of the impact on the competitive positioning of RIAs and QCs in the U.S., nor on the extraterritorial impacts of these rules, notably in relation to FFIs and sub-custodians in non-U.S. jurisdictions. Crucially, the Commission does not quantify the impact of a

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[5] Also refer to comment letters from the following trade associations for more detail: ABA/BPI/FSF, AGC, CCMC, FIA, ISDA, and SIFMA.

[6] Comment letters from ABA/BPI/FSF and SIFMA also discuss this point in more detail.

[7] Outsourcing by Investment Advisers, Release No. IA-6176 (October 26, 2022), 87 FR 68816 (November 16, 2022).

number of key proposals in its cost-benefit analysis, including the cost associated with the segregation of assets requirement, liability for central securities depositories ("**CSDs**") and expanded liability for sub-custodians, and additional transaction monitoring of RIA instructions pre-trade/pre-settlement which would require large system changes and increased operational costs and risks. Analyses of all of these impacts, among others, are critical in balancing the costs and benefits of the Proposed Rule.

b. The Proposed Rule Inappropriately Expands the Concept of Custodial Obligations to Markets Where Compliance Would Not be Possible and/or Costly for Investors.[8]

The Proposed Rule would extend the assets covered from "funds and securities" to "funds, securities, *or other positions* held in a client's account."[9] This 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."[10]

The Proposed Rule attempts to apply custodial obligations to transactions that, by their structure and purpose, do not include "assets" that can or should be custodied such as principal-to-principal transactions, collateralization, and derivatives. In doing so, the Proposed Rule attempts to apply legal protections that naturally flow from the relationship between a custodial agent and a client, for whom the agent is safekeeping securities, to a range of other well-established and highly regulated activities, to which such a "custodial agent" construct currently does not and should not apply (e.g., over-the-counter ("**OTC**") derivatives, cleared derivatives, secured financing transactions ("**SFTs**," including repurchase agreements/reverse repurchase agreements, securities lending), mortgage backed securities ("**MBS**", including "to-be-announced" obligations and collateralized mortgage obligations ("**CMOs**")), and commodities).

As discussed in specific sections below, the numerous requirements set forth in the Proposed Rule would be difficult to implement, and even impossible if applied to certain transactions (e.g., principal-to-principal transactions such as bilateral OTC derivatives and SFTs, where segregation is not possible). Even where they can be implemented, they would result in reduced market liquidity and significant increase in costs for investors that utilize RIAs (e.g., derivatives, commodities). Imposing numerous impractical requirements and multiple regulations that are inconsistent with one another would make the markets less efficient, would be contrary to the Commission's policy objective of promoting market efficiency, and would harm investors.

[8] Please refer to comment letters from the following trade associations that discuss each market/asset type in more detail: OTC derivatives (ISDA, MFA, and SIFMA), cleared derivatives (ISDA, MFA, and SIFMA), futures (FIA, ISDA, MFA and SIFMA), SFTs (ISDA, MFA, and SIFMA), commodities (ISDA, MFA, and SIFMA), MBS (SIFMA) and traditional custody (ABA/BPI/FSF, AGC, CCMC, and SIFMA).

[9] Proposed 17 C.F.R. § 275.223-1(d)(1) (definition of "Assets") (emphasis added).

[10] Proposing Release at 28.

c. The Proposed Rule's Segregation of Cash Requirement Is Unworkable and Will Result in Reduced Market Efficiency and Increased Costs for Clients.[11]

The Proposed Rule would require custody banks to hold "client assets in an account designed to protect such assets from creditors of the bank … in the event of the insolvency or failure of the bank."[12]

Custody banks are hired to safekeep securities. Also, they provide settlement, payment, liquidity, and asset services, for which a custody bank will typically open one or more cash accounts as an operational account for the custody relationship.[13] For custody banks, while client securities are segregated from custody bank assets, cash balances are held as a general deposit and reflected on the custody bank's balance sheet as a liability to the client. This longstanding market practice provides multiple benefits to clients. First, it allows custody banks to provide comprehensive and efficient custody services to clients. Cash accounts are fully integrated into the bank's core settlement and asset servicing processing systems, allowing for straight-through processing ("**STP**").[14] Holding the cash on balance sheet gives custody banks the flexibility and infrastructure to utilize and deploy cash and make real-time credit decisions, enabling them to provide tailored liquidity and foreign exchange services to clients.[15] These services are crucial for clients as they allow clients to navigate the complexities of markets, currencies and settlement cut-offs at high levels of efficiency and with minimal friction. Second, the ability to use cash held as a general deposit allows custody banks to invest and earn returns (also known as net interest income ("**NII**")) that are used to support the cost of securities custody, thereby allowing for low overall client fees.

The Proposed Rule would require the segregation of these operating deposits into bankruptcy remote accounts. It is unclear how this would work operationally. A likely possibility is that the cash accounts would need to be held at another bank to protect them from the insolvency of the custody bank. This would create global inefficiencies in trading, settlement, and asset servicing. Without the ability to deploy cash or make real-time credit decisions, custody banks could no longer provide intraday liquidity and foreign exchange services. Without access to these services, clients would likely need to set up an exponentially increased number of separate deposit accounts for each market or currency compared to today and engage in individual foreign exchange transactions. Such segregation would delay settlements, as credit checks or pre-funding would need to be performed before processing any settlement, disrupting the STP of these core custody activities.[16] Ultimately, clients and their advisers would be unable to invest efficiently and across a broad range of markets with optimized processing and minimal operational and credit risks. The increase in settlement processing time would also impact the

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[11] Please refer to the comment letters from the following trade associations for detailed discussions on impact of cash segregation: ABA/BPI/FSF, AGC, and SIFMA.

[12] Proposed 17 C.F.R. § 275.223-1(d)(10)(i).

[13] In limited circumstances, an RIA may be considered to have custody over a client's demand deposit accounts as a result of the client granting such RIA discretionary authority over the account. If the proposed rulemaking were to take effect as drafted, the bank would be required to segregate the funds in the demand deposit account as well. Similar to custody banks, this would impact the bank's ability to deploy these funds for liquidity purposes. As a result, the cost to the client of providing a demand deposit account with RIA discretionary authority would increase.

[14] The processing of these transactions electronically, without manual intervention.

[15] These services include, but are not limited to, the extension of intraday liquidity (which allows clients to avoid the need to prefund every trade), FX services, Continuous Linked Settlement, collateral management, sweep services, and securities lending.

[16] For example, if a client (under instruction of the RIA) purchases securities, the custodian bank will check the availability of funds on the cash account prior to processing the settlement. This happens STP if the cash account is held at the custodian. If the cash is held at a third party bank, that process would require checking and blocking the balances on the segregated account at the other bank. Once settlement is completed, the funds will need to be debited from that segregated account. These extra interactions (multiplied over thousands of movements per day) will introduce delays and disrupt STP.

securities market generally and would run counter to, and complicate compliance with, the Commission's priority of reducing the standard settlement cycle for U.S. securities to T+1 (i.e., one day after the trade date). The consequences of this segregation requirement and NII impacts will likely force a number of custody banks to exit the business due to the high costs of operating a large scale custody bank business and limit provider choice for investors without a clear benefit.[17] For those custody banks that do not exit, the inability to use cash held as a general deposit to earn returns would result in a significant increase in custodial fees for clients and result in complexity for clients investing across the globe.

More importantly, the Proposed Rule would not accomplish its objective of eliminating deposit risk. The establishment of separate cash accounts at other banks would merely shift deposit risk to another institution, which may have higher credit risk than the custody bank. In addition, the alternative suggested by the Commission to leverage special deposit accounts would increase operational complexity but not remove deposit risk. Although special deposits may have characteristics that differentiate them from general deposits, as a practical matter, a bank that holds cash—even in a special deposit—has a deposit liability to its client. Therefore, this requirement would not support the Commission's policy objective of mitigating deposit risk for cash, but could create material financial market disruption and increase costs for clients.

Furthermore, the creation of a separate class of deposit holders with rights exceeding those of ordinary deposit holders would result in inequitable treatment and have the effect of elevating RIA clients' claims above those of other depositors. Even if a custody bank were, in fact, able to insulate funds held for RIA-advised clients, other bank depositors, as well as the Federal Deposit Insurance Corporation as insurer of retail deposits and the Deposit Insurance Fund, would all be subordinated to such clients.[18]

JPMorgan notes that in response to recent difficulties with some banks, PRs both domestically and globally are evaluating any necessary revisions to improve the resilience of the banking system. Any revisions are far better reflected in those rules. The Commission should not duplicate these protections by requiring bankruptcy remoteness for the same purpose for regulated banks, especially considering the very significant financial market disruptions these provisions would cause. However, JPMorgan accepts that for other QCs (that are not regulated banks, broker-dealers, or FCMs), additional protection may be warranted.

d. The Proposed Rule's Segregation of All Client Assets Requirement Will Potentially Preclude Trading Activity, Impact Market Liquidity, and Increase Costs for Clients.[19]

The Proposed Rule would require an RIA to obtain reasonable assurances in writing from the QC that the QC will clearly identify the client's assets as such, hold them in a custodial account, and

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[17] The Proposed Rule would also impose onerous requirements on FFIs, the most problematic of which is that all financial 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." Proposed 17 C.F.R. § 275.223-1(d)(10)(iv)(D). If applied to cash, as with deposits in U.S. banks, this would have the same negative effects on FFIs. In addition, it might require complete segregation of cash throughout the custody chain, including where FFIs provide sub-custody services, and conflict with their local regulations thereby likely resulting in fewer custodians. Please refer to the comment letter from AFME/AGC-EBF for a detailed discussion of FFIs.

[18] *See* ABA/BPI/FSF comment letter at 11-13.

[19] Please refer to comment letters from the following trade associations that discuss each market/asset type in more detail: OTC derivatives (ISDA, MFA, and SIFMA), cleared and uncleared derivatives (ISDA, MFA, and SIFMA), SFTs (ISDA, MFA, and SIFMA), commodities (ISDA, MFA, and SIFMA), and MBS (SIFMA).

segregate them from the QC's proprietary assets and liabilities.[20] These requirements are broadly consistent with the requirements and market practices that already govern custody of securities. For example, under the Uniform Commercial Code, a financial institution (such as a bank or a broker-dealer) that acts as a "securities intermediary" is required to record the ownership of securities on behalf of its clients on its books[21] and securities held in this manner are bankruptcy remote.[22] Established practices within the international multi-tiered "indirect holding system" [23] for securities, such as holding customer securities in "segregated" omnibus accounts at sub-custodians, also make customer securities easier to identify in the case of the intermediary's insolvency.[24]

However, these concepts simply do not apply to a broad range of assets over which RIAs have investment discretion. Applying a regulatory label of "custodian" to the legal relationships that are created by these transactions, as the Proposed Rule would do, would not change this. In effect, the Proposed Rule would require a re-examination and restructuring of all those established, highly regulated legal relationships currently not characterized by a custodial-agent structure. Where a novel restructuring in a manner consistent with the Proposed Rule is not possible, such activity would be prohibited for RIA-advised clients.[25] These include highly-regulated transactions such as OTC derivatives, cleared derivatives (including cleared futures), [26] SFTs, and MBS.

i. The Contractual Rights for Bilateral Principal-to-Principal Transactions Cannot be Segregated.

Applying the segregation requirement to transactions in which both sides are counterparties to an executory, bilateral, principal-to-principal contract with mutual rights and obligations, which include OTC derivative transactions, MBS, and SFTs, would effectively make these transactions impermissible with RIAs.[27] In these transactions, the rights and obligations create a debtor/creditor relationship, not a custodial agent/beneficial owner relationship. OTC derivatives, for example, are proprietary assets and liabilities of the financial institution entering into them, not "client assets" that can be segregated from

[20] Proposed 17 C.F.R. § 275.223-1(a)(ii)(D).

[21] U.C.C. § 8-501.

[22] "To the extent necessary for a securities intermediary to satisfy all securities entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to the claims of the creditors of the securities intermediary[.]" U.C.C. § 8-503(a).

[23] Carl S. Bjerre and Sandra M. Rocks, The ABCs of the UCC. Article 8: Investment Securities (American Bar Association, Second Edition, 2004) at 33 ("The indirect holding system is . . . a pattern of securities ownership and transfer in which investors, the ultimate beneficial owners of securities, have no direct relationship with the issuer; instead, they hold entitlements to securities through a securities intermediary.").

[24] Further, the requirements of the Proposed Rule, as applied to the maintenance of securities entitlements by U.S. securities intermediaries under the UCC, are consistent with and are the natural consequence of current law and practice relating to securities safekeeping, such as bankruptcy remoteness and the fact that by their nature only securities intermediaries can effect "a change in beneficial ownership" in securities entitlements, since such entitlements only exist, under law, on the books of those securities intermediaries. *See* U.C.C. § 8-503. Similarly, CFTC regulations mandate segregation of client assets from the FCM's own assets (regardless of whether they are related to cleared transactions in U.S. markets, non-U.S markets, or cleared swaps), and protect client assets against inclusion in the FCM's bankruptcy estate. 17 C.F.R. § 1.20; § 30.7; § 22.2; Part 190, respectively.

[25] 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. Proposed 17 C.F.R. § 275.223-1(b)(2)(iii)(A). This requirement, however, is also infeasible for these types of assets.

[26] As discussed in detail in the FIA comment letter, FCMs are already subject to CFTC Regulation that governs how customer funds should be segregated.

[27] *See supra* footnote 25.

the "proprietary assets and liabilities" of the QC.[28] The same is true for MBS that settle after trade date. Similar logic would apply to certain SFTs, such as repurchase ("Repo") transactions. Repo transactions are in form purchases of securities, which, upon the initial purchase, become the proprietary assets of the Repo purchaser (i.e., in a financing transaction, the financial institution that is providing the financing). As a result, it would not be legally possible to "segregate" such assets in a way that is "bankruptcy remote." The Proposed Rule, if applied to these transactions, would make it impossible for RIAs to enter into such transactions.

ii. The Lack of Ability to Rehypothecate Collateralization of These Contracts Will Prohibitively Make These Transactions More Expensive for Clients.

The segregation requirement would dramatically increase the costs of transactions for which rehypothecation is currently permitted, including derivatives and SFTs, which are used by RIAs for hedging, investment, and financing purposes. Banking and trading counterparties in derivatives transactions generally require that pledged securities or cash (e.g., VM) be subject to rehypothecation, which allows the financial institution that is receiving the collateral to use it to fund its provision of leverage to the RIA client that is the counterparty in the transaction. The proposed segregation requirement would essentially eliminate the ability to rehypothecate and, as a consequence, would drastically alter the economics of traditional financial transactions such as cleared and uncleared derivatives for RIAs and their clients. Without the ability to rehypothecate, financial institutions would need to self-fund the exposures (rather than using client collateral) involved in these transactions and this would result in a dramatic re-pricing of these products for RIA-advised clients. In addition, the SFT business relies on rehypothecation as a means of providing cost-effective financing. Similar issues will present themselves for MBS when FINRA's amendments to Rule 4210 (Margin Requirements) become effective and require exchange of margin for most MBS trades.[29]

Similarly, for commodities such as precious metals, the segregation requirement would disrupt the current practice of holding these assets and would reduce the ability for brokers to facilitate these transactions. Currently, it is common for a client to hold an unallocated account (meaning the custodian holds legal title to the commodity and the client holds a credit for its share). This structure enables the efficiency of trading by allowing clients to trade on electronic platforms that settle into an unallocated account. The segregation requirement would force clients to trade via voice as counterparties and agree bar-level details for precious metal trades (to thousandth fine troy ounce) during trade execution. Clients would also be required to both hold a custody account with the same custodian (as specific bars would need to be transferred), decreasing optionality for the client. This requirement could adversely impact liquidity in the precious metals market.[30]

[28] Proposed 17 C.F.R. § 275.223-1(a)(ii)(D).

[29] FINRA's amendments to Rule 4210 (Margin Requirements) were most recently delayed to October 25, 2023.

[30] For precious metals, financial institutions holding these accounts only face clients on a principal basis and do not have insight into their marketing strategy and whether they are RIA-advised. While the size of RIA-advised client holdings cannot be determined, the average amount of gold transferred across unallocated accounts each day in the London OTC market is ~$33 billion, with silver at ~$6 billion. London Precious Metals Clearing Ltd, "Net Clearing Data (Daily Averages): February 2023," https://www.lpmcl.com/news/lbma-net-clearing-data-daily-averages-february-2023 (last visited May 8, 2023).

iii. The Segregation Requirement Conflicts with Other Regulations and Provides No Additional Protection.

The segregation requirement would not fundamentally improve customer protection and conflicts with existing customer protection rules. As an example, a substantial portion of posted collateral serves as security for the amounts owed, meaning a client posting such collateral would not be entitled to its return in the event of the financial institution's insolvency. Specifically, VM is posted by the RIA for the benefit of the financial counterparty to cover losses should an immediate close-out of the derivative transaction be required. Should the counterparty be insolvent, the VM is used to cover the market value loss on the transaction, and only the excess of this over what is needed could be returned to the client. In addition, a client of an SEC-registered broker-dealer is only owed "net equity position" in the event of bankruptcy. As such, the segregation requirement would not provide any additional customer protection. For this reason, the existing customer protection regimes across prime brokers, swap dealers and security-based swap dealers recognize this and only require segregation of some, but not all, collateral.[31] Some of these rules have been in effect for many decades (e.g., the Commission's Rule 15c3-3), while others, in particular those relating to derivatives, are post-Dodd-Frank (e.g., the Commission's security-based swap dealer rules relating to collateral segregation adopted as recently as 2021). All of these rules were demonstrably based on empirically correct and sound customer protection principles and have been extremely effective in protecting customers from losses.

iv. The Segregation Requirement Would Negatively Impact Market Liquidity.

Repo financing plays an extremely important role in ensuring the liquidity of numerous vital markets, most importantly the market for U.S. Treasury ("**UST**") securities.[32] By requiring the segregation of assets into bankruptcy remote accounts, the Proposed Rule would make these transactions impermissible for RIA-advised clients.[33] In addition, prohibiting rehypothecation for these RIA managed accounts would result in effectively removing these securities from trading in the market and materially impact liquidity in Repo-financed markets, particularly those for UST securities.[34]

[31] 17 C.F.R. § 23.157 (requiring segregation at a third party custodian for regulated IM only); and 17 C.F.R. § 23.700 et seq. (addressing third party segregation at a custodian at the election of the counterparty); 17 C.F.R. § 240.18a-4 and 17 C.F.R. § 240.15c3-3 (requiring segregation of regulated IM only upon request of the counterparty).

[32] *See* Federal Reserve Bank of Richmond, Economic Brief No. 21-31, "The Fed's Evolving Involvement in the Repo Markets" (September 2021), https://www.richmondfed.org/publications/research/economic_brief/2021/eb_21-31 ("While the full size of the Repo market is not precisely known, the Federal Reserve Bank of New York tallies a large share of trades every business day and publishes the information in its Markets Data Dashboard. This data helps explain why the market for recently issued U.S. Treasury securities is so liquid: reported financing transactions averaged nine times the average of Treasury coupon auctions."). The fact that financing transactions average nine times the size of each auction implies that the securities are reused (in effect, "rehypothecated") to support liquidity in the market. The Proposed Rule could be read to either eliminate this market support entirely to the extent supplied by RIA-advised clients, or if only read to require that all "purchased securities" in Repo transactions must be "held in a custody account" and "segregated," to reduce such financing support by up to 8/9, or approximately 89%.

[33] *See supra* footnote 25.

[34] We estimate UST Repo activity is ~$3.0 trillion in terms of dealer intermediated financing activity across the street (i.e., where dealers provide long financing on a bond and subsequently lend out the bond to secure a cash reinvest (e.g., money market fund) or cover a client/street short position) (*See* SIFMA, "The US Repo Markets: A Chart Book" (February 2022), https://www.sifma.org/wp-content/uploads/2022/02/SIFMA-Research-US-Repo-Markets-Chart-Book-2022.pdf. While we cannot size the precise impact for RIA managed Repo transactions, we believe that the impact would be material. If you disallow the reuse of those long assets by requiring segregation, the potential effect would be a significant portion of the following: $3.0 trillion in alternative financing required to support long side financing needs, meaningfully increasing the cost of financing U.S. Treasury positions. This would result in a material widening in outright UST levels (including new issue U.S. Treasury debt), U.S. Treasury futures and overall financing costs across the broader SFT landscape. With the segregation requirement, the market would experience a significant reduction in specific issue supply, impeding the

The inability to rehypothecate pledged securities and cash posted as margin in cleared and uncleared derivatives transactions would also restrict the flow of collateral through the system which today facilitates dealing and hedging activity. For example, today, a hedged market participant (such as a dealer) receives VM payments (inflows) for derivatives positions which are positive mark-to-market and pays out VM (outflows) on that position's hedge, or vice-versa. This is essentially a liquidity redistribution within the system. However, if the securities or cash posted as VM cannot be rehypothecated, then the hedged participant would need to fund the VM outflow. This could be detrimental to the market overall as it would increase the demand for cash and liquid assets to use as collateral, particularly during times of market volatility, as experienced during the March 2020 "dash for cash."[35]

e. **The Proposed Rule's Reasonable Assurances Requirement Unreasonably Expands QC Liability for Losses Outside of a QC's Control and Could Result in Reduced Services and Limited Market Access.**[36]

The Proposed Rule would require a QC to provide written assurances that "the existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client."[37]

Investors, along with their advisers, select an investment strategy based on their investment objectives and overall risk appetite, among other things. This may include investing globally in multiple markets and across multiple asset classes. In choosing the markets to invest in, investors consider the risks inherent to those investment choices (including those that are heightened in less regulated or more volatile emerging markets). These risks can include country risk, market risk, currency risks, tax risk, legal risk, and political risk, but also general infrastructure risks associated with safekeeping assets in that market (e.g., by CSDs and sub-custodians). QCs offer access to a large number of markets to allow investors to execute on their investment strategy. This includes selecting a third-party custodian in markets where the QC does not have a local presence after conducting extensive due diligence and on-boarding. There is a negotiated contractual relationship between the QC and the sub-custodian, and sub-custodians are monitored by the QC through ongoing due diligence.

To allow local market access, a QC must connect, either directly, or indirectly, to the local CSD, which serves as the official registrar of securities locally issued and as the settlement platform. CSDs are highly regulated financial market infrastructures whose terms are governed by a rulebook and uniform participant agreements. Participants have extremely limited control over these CSDs and have no ability to negotiate participation terms. As such, it cannot be meaningfully said that the QC "chooses" or "delegates" its custody obligations to CSDs. CSDs are market infrastructures, and the risk of loss due to the CSDs is part of the risk profile of investing in that market.

Although the language is not clear, the Proposed Rule could be interpreted to unreasonably expand the QC's assumption of liability to losses it has no ability to prevent or control, including those

market's ability to facilitate short covering as the market would no longer have access to a large pool of bonds to repo out to cover short positions. The resultant combination of increased fails and increased short carry costs (i.e., increased "specialness") would impact a range of market functions, most notably a Primary Dealer's ability to provide liquid two-way markets in USTs.

[35] Basel Committee on Banking Supervision Committee on Payments and Market Infrastructures Board of the International Organization of Securities Commissions, "Review of Margining Practices" (September 29, 2022), https://www.bis.org/bcbs/publ/d537.pdf.

[36] Please refer to comment letters from the following trade associations for more detail: ABA/BPI/SFS, AFME/AGC-EBF (for discussion of impact on FIFs), AGC, FIA, and SIFMA.

[37] Proposed 17 C.F.R. § 275.223-1(a)(1)(ii)(C).

resulting from acts or omissions of third parties that it has no role in selecting but is nevertheless required to utilize. QCs cannot be expected to bear the risk that a client assumes (for a potentially higher return) by investing in certain markets. Requiring custodians to remain responsible for activity occurring at sub-custodians or CSDs that are outside their control would unavoidably be viewed as taking on the risks traditionally borne by investors and not QCs. This could lead to an increase in fees and/or QCs exiting certain markets and potentially limiting markets for these RIA-advised investors.

f. The Proposed Rule's Indemnification and Insurance Requirement Is Unnecessary, Unworkable, and Will Likely Result in Increased Costs for Clients.[38]

The Proposed Rule would require a QC to provide written assurance that it "will indemnify the client (and have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the qualified custodian in the event of the qualified custodian's own negligence, recklessness, or willful misconduct."[39]

We support the Proposed Rule's position that a QC should have some level of liability for direct losses to a client based on the acts or omission of such service provider. Given the highly negotiated nature of these relationships, the level and detail of such liability should be left to the parties. The requirement would also require significant repapering of custodial agreements. In addition, compliance with the insurance requirement may be infeasible given the potential lack of such insurance available in the market today. Even if such insurance were available, it would impose a significant and prohibitive financial burden on the QCs. The resulting burden on QCs would ultimately fall on clients in the form of increased fees for the custodial services they receive or a reduction of the custodial services available to them.

This requirement would have a particularly adverse impact on FCMs. The number of FCMs has been decreasing in recent years as a result of reduced profitability and heavy regulation.[40] The insurance requirement, on top of the indemnification requirement—which FCMs typically do not provide—would add additional burden and may induce more FCMs to exit the business. FCMs are already subject to robust customer protection rules under the CEA and CFTC, and the Commission has not demonstrated the need for these additional requirements. Additionally, the obligation for FCMs to indemnify accounts associated with RIAs undermines the equal treatment provided to all clients of the FCM.[41] In the event of an FCM's bankruptcy, all customers in a regulatory category are treated identically and paid out pro-rata, and it would seem an unintended consequence to potentially treat self-traded accounts (including those of retail clients) in a less favorable manner than accounts traded by an RIA.

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[38] Please refer to comment letters from the following trade associations for more detail: ABA/BPI/SFS, AFME/AGC-EBF (for discussion of impact on FIFs), AGC, FIA, and SIFMA.

[39] Proposed 17 C.F.R. § 275.223-1 (a)(1)(ii)(B).

[40] *See* FIA comment letter for detailed discussion.

[41] 17 C.F.R. Part 190.

g. The Proposed Rule's Requirement to Specify an RIA's Level of Authority to Effect Transactions Will Likely Reduce Market Efficiency, Increase Settlement Risk, and Result in Worse Outcomes for Clients.[42]

The Proposed Rule imposes a written agreement between an RIA and a QC that "specifies [the RIA's] agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations, and permits [the RIA] and the client to reduce that authority."[43] The Commission's stated reason for the 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".[44]

A QC processes settlement instructions solely at the direction of its client, or its RIA when the client is advised by an RIA, and verifies that the RIA is duly authorized to instruct settlement. The QC cannot and does not verify whether these settlement instructions sent by the RIA are in line with the agreement between the client and the RIA detailing the RIA's authority. Even if the QC has access to the agreement, it does not have the necessary information, expertise, or authority to fully comprehend the context of such trading activity. Exercising investment authority requires an understanding of the context and interpretation of the financial situation, which the QC does not have.

This provision of the Proposed Rule appears to require a QC to review each RIA instruction ahead of settlement to verify whether that instruction is within the RIA's investment authority and also mistakenly assumes RIA's authority can be clearly specified for all types of trades in the new written agreement. However, the Proposed Rule fails to consider situations in which there is ambiguity as to whether a specific RIA instruction falls within the scope of the agreed-upon authority. One example would be where an RIA recommends a particular hedge trade for its client and the QC makes a conservative determination (given the potential liability it could face for unauthorized trades) to hold up settlement or simply reject it. This would disrupt the RIA's investment strategy and prevent the client from obtaining the best outcome for its investment. In addition, QCs settle tens of thousands of transactions per day, which makes it operationally infeasible to review each instruction. This requirement cannot be practically achieved without a radical change to the STP of QCs, leading to substantial delays in settling open trades and creating counterparty settlement risk and increased market risk for clients. This would be inconsistent with the Commission's objective to reduce the standard settlement cycle for U.S. securities to T+1.

In addition, as applied to derivatives and SFTs, the requirement would force QCs to perform this monitoring pre-trade, as no effective unwind is possible for these transactions. This would introduce substantial trade delays, reduce market efficiency, and harm RIA-advised clients.[45]

III. Recommended Alternatives.

While we have attempted to fully identify the markets impacted and potential repercussions, given the expansive nature of the Proposed Rule we are concerned that the 60-day comment period has not been sufficient for market participants, the Commission, and other regulators to fully evaluate the scope of the Proposed Rule's impacts and potential unintended consequences.

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[42] Please refer to comment letters from the following trade associations for more detail: ABA/BPI/FSF, AGC, and SIFMA.

[43] Proposed 17 C.F.R. § 275.223-1(a)(i)(D).

[44] *Id.*

[45] *See supra* footnote 25.

We strongly believe the Commission should re-propose a rule that is more appropriately targeted to achieve the Commission's regulatory objectives, after a complete analysis of alternatives that would be less disruptive to traditional markets. If one of the Commission's primary objectives is to bring RIA activities associated with crypto assets, in particular cryptocurrencies, into its regulatory framework, then the Commission should consider doing so without upending the traditional markets.

In the absence thereof, we offer the following critical suggestions for amendments to the Proposed Rule:

a. Cash Segregation.

JPMorgan recommends that the Commission remove the Proposed Rule's requirement for banks and savings associations to segregate cash in bankruptcy remote accounts.

b. Scope of the Proposed Rule.

At a minimum, we recommend that the Commission either maintain the "all other positions" language but add a list of asset types and activities to be scoped out, or replace "all other positions" with the term "crypto assets," including a definition of "crypto assets" in the final adopting release.

It is important to note that given the limited time to fully analyze the impact of the Proposed Rule, the list provided below may not be exhaustive. We therefore recommend that the Commission further consult with the industry in determining the right scope of the Proposed Rule.

The non-exhaustive list of assets/activities to be scoped out includes:

- financial contracts held for investment purposes
- OTC derivatives (options, forwards, swaps and security-based swaps)
- collateral posted in connection with OTC derivatives on behalf of the client
- cleared derivatives (futures, options on futures, swaps and security-based swaps)
- SFTs (including repurchase agreements/reverse repurchase agreements, securities lending)
- FCMs
- commodities
- MBS (including CMOs and "to-be-announced" obligations)
- loans,[46] and
- any other assets and positions, as needed.

Alternatively, if the Commission would prefer to insert a definition of crypto assets, we would be ready to assist in these efforts and provide suggestions, leveraging the work done by other regulatory authorities and industry associations.

c. Standard Level of Custodial Liability.

JPMorgan supports a minimum standard of liability for a client's loss of assets due to a QC's own actions or omissions or due to its failure to exercise reasonable skill, care or diligence in its

[46] Please refer to the comment letter from MFA and SIFMA for discussion of loans. Please note the industry is still evaluating specific impacts on loans and will submit a supplemental comment as appropriate.

selection or monitoring of a sub-custodian, in all cases subject to existing law or regulation applicable to such QC. The Proposed Rule should be clarified such that it is consistent with the following principles:

1. In no event should a QC be liable for any acts or omissions of a CSD.
2. In no event should a QC be liable for any acts or omissions of a sub-custodian unless, with respect to a sub-custodian the QC has selected, the QC has failed to comply with the minimum standards noted above.
3. In no event should a QC be liable for losses due to events outside the QC's control, such as those related to force majeure and/or country risk.
4. Any standard of care should be in accordance with the standards prevailing in the relevant market in which the QC or sub-custodian operates.

d. Specification of Agreed-Upon Level of RIA Authority.

JPMorgan recommends the Commission withdraw the sections of the Proposed Rule that would require QCs to perform a pre-settlement review of an RIA's trade instructions for the reasons stated above.

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JPMorgan appreciates the opportunity to comment on the Proposed Rule and provide our views on potential risks and recommendations on the topic of safeguarding client assets. We would be pleased to provide any further information or respond to any questions that the Commission or the staff may have. We look forward to continuing to engage with the Commission on this topic.

Very truly yours,

/s/ Teresa Heitsenrether

Teresa Heitsenrether
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Global Head of JPM Security Services

/s/ Troy Rohrbaugh

Troy Rohrbaugh
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JPM Head of Global Markets

Cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime Lizárraga, Commissioner
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