Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

May 8, 2023

Via Email: rule-comments@sec.gov

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F. Street NE
Washington, DC 20549-1090

Re: Safeguarding Advisory Client Assets; File Number S7-04-23

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**SEC**" or "**Commission**") in response to the Commission's proposed amendments to, and redesignation of, the current custody rule as a new safeguarding rule under the Investment Advisers Act of 1940 (the "**Advisers Act**"), together with related amendments to the Advisers Act books and records rule and Form ADV (together, the "**Proposal**").[2]

We have significant concerns with the Proposal and its likely impact on investors and the financial market participants that serve them, including advisers, qualified custodians, independent accountants, and other market participants. The Proposal would disrupt critical financial markets, including credit markets, prime brokerage, over-the-counter ("**OTC**") derivatives markets, and commodities markets. It also would fundamentally alter the manner of transacting in these and other asset classes in ways that the Commission has not properly

1 MFA, based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

2 *See* Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672 (Mar. 9, 2023) (to be codified at 17 C.F.R. Pts. 275 and 279) ("**Proposing Release**"), available at: https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf.

1301 Pennsylvania Ave NW, Washington, DC 20004 | 546 5th Avenue, New York, NY 10036 | Rue d'Arlon 40, 1000 Brussels, Belgium |
14 Hanover Square, Mayfair, London, United Kingdom, W1S 1HT
ManagedFunds.org

considered—in fact, based on the discussion in the Proposing Release, in ways that the Commission has seemingly not considered at all.

Our members have long recognized the importance of safeguarding client assets subject to the custody rule, which currently includes client funds and securities. In proposing to expand equity-like safekeeping requirements to all asset classes, the Commission has not demonstrated any pervasive weaknesses or risks to advisory clients resulting from existing custodial practices for traditional asset classes, including privately placed securities, futures, swaps, security-based swaps, other bilateral contracts such as loans and repurchase agreements, and commodities. Despite this, the Proposal takes custodial practices developed for cash and publicly-traded securities and seeks to apply them to almost every type of investment, without regard to cost, benefit, or feasibility. As the Commission acknowledges, some of the custodial services the Proposal requires either do not exist or are not widely available, yet the Commission would require larger advisers to come into compliance within twelve months of the Proposal's adoption. The Commission does not appear to have consulted with participants in the many markets the Proposal would affect or to have coordinated with other regulators who might be surprised to find the markets they oversee being rewired to satisfy new investment adviser custody requirements. In fact, the overly broad nature of the Proposal will make continued investing in many traditional, long-standing asset classes difficult and more costly, and in some cases impossible.

Accordingly, the Proposal should be withdrawn. Then, only to the extent necessary and following an appropriate cost-benefit analysis, the Commission should, if appropriate, propose a tailored rule to address any gaps in market practices that the Commission identifies, focusing on the primary purpose of the custody rule: to reduce the risk that client assets will be lost, misused, stolen or misappropriated, or captured by the financial reverses of the adviser.

I. Executive Summary

The Proposal is overly broad, would have drastic implications for investors and for critical financial markets, and could shut down trading by advisers on behalf of clients in certain markets.

The requirements in the Proposal are not appropriately tailored to address actual or potential risks that client assets will be lost, misused, stolen or misappropriated, or captured by the financial reverses of the adviser. Although the analysis and discussion in the Proposing Release identifies certain risks in existing custodial practices and discusses the impact the Proposal would have on certain assets and markets (notably, crypto assets and markets),[3] the Commission has not demonstrated any pervasive weaknesses or risks with respect to custody of traditional asset classes. Nor has the Commission considered, as part of its economic analysis or otherwise, the major consequences that the Proposal would have on numerous asset classes and markets, as discussed below and in Annex A to this letter. In addition, the Proposal fails to

---

3 *See, e.g.*, Proposing Release at 14688-89 (applicability of the new "possession or control" requirement), 14742 (new requirements applicable to qualified custodians that are banks and savings associations), 14706 (change to the definition of privately offered securities).

consider the burdens associated with requiring the renegotiation of virtually all custody and trading agreements for the entire asset management industry. This would be a monumental undertaking for advisers, clients, custodians, and trading counterparties.

Given the expansive scope of the Proposal, we are also concerned that the comment period has not provided adequate time for either market participants (including asset managers, banks, and broker-dealers) or other regulators to undertake the complex and technical analysis necessary to evaluate the potential repercussions of the new rule, particularly in light of the Commission's numerous other overlapping regulatory initiatives.[4] This is especially troubling because the Commission's failure to sufficiently analyze the impact of the Proposal on various markets has effectively placed the burden on the asset management industry to undertake this analysis.

The Advisers Act does not authorize the Commission to adopt regulations that would have the effect of severely restricting investor access to entire classes of assets through registered investment advisers. Nor does the Advisers Act authorize the Commission to indirectly regulate qualified custodians by dictating the parameters pursuant to which advisers and advisory clients engage qualified custodians. The adoption of the Proposal would also represent arbitrary and capricious decision-making by the Commission, as the Commission has categorically failed to consider the impact the Proposal would have on critical asset classes and markets historically accessed by advisory clients.

Accordingly, the Proposal should be withdrawn and, to the extent necessary, re-proposed only after the Commission has conducted an adequate economic analysis considering the full costs and benefits of any new safeguarding requirements and has addressed the many fundamental flaws in the Proposal, including, but not limited to, the following unintended consequences that could result from the adoption of the Proposal:

- the temporary or permanent halting of trading by advisers on behalf of clients in certain markets that trade differently than public equity securities and bond markets;
- the significant increase in transaction costs and the potentially severe disruption of major markets, including equities trading, due to the inability to rehypothecate collateral (on which traditional prime brokerage relies);

---

[4] We, along with other industry groups, have separately expressed our concerns about the very short comment period for the proposed safeguarding rule given its expansive scope. *See* ABA Securities Association, Alternative Credit Council, Alternative Investment Management Association, American Bankers Association, American Investment Council, Association of Global Custodians, Independent Community Bankers of America, Investment Adviser Association, Investment Company Institute, LSTA, Managed Funds Association, Securities Industry and Financial Markets Association, SIFMA Asset Management Group, Request for Extension to the Comment Period for Safeguarding Advisory Client Assets Proposed Rule (Mar. 3, 2022), available at: https://www.aba.com/-/media/documents/comment-letter/jointextclientassets20230303.pdf?rev=3a6567371d634151b924385bff220d01.

- the creation of overlapping and confusing regulatory regimes where underlying assets are subject to oversight by other regulators;
- the significant disruption of markets for private securities and physical assets that trade regularly;
- uncertainty concerning the status of foreign financial institutions ("**FFIs**") as qualified custodians and limited or non-existent options for the custody of certain non-U.S. assets; and
- the exit of registered investment advisers and qualified custodians (including banks and broker-dealers) from certain markets and asset classes.

In addition to conducting an adequate cost-benefit analysis and addressing the fatal flaws discussed above, prior to adopting any version of the Proposal, the Commission should revise certain elements of the Proposal. Our key recommendations in this regard are that the Commission should:

- consider and adopt appropriately tailored parameters prior to extending safekeeping requirements to new asset classes, giving appropriate deference to well-established market practices;
- eliminate unnecessary requirements for qualified custodians, including (i) the asset segregation requirements for banks, savings institutions, and FFIs, and (ii) the financial strength requirement and enforceability of judgments requirement applicable to FFIs;
- not require advisers to renegotiate all custody and trading agreements to obtain reasonable assurances from qualified custodians that would impose simple negligence standards and would restrict the use of rehypothecation;
- allow futures commission merchants ("**FCMs**") to serve as qualified custodians for all client assets, in order to align the definition with the expanded scope of the Proposal and, in deference to the comprehensive CFTC regulation of FCMs, exempt FCMs from the other requirements for qualified custodians;
- following the traditional understanding of "custody," not impose onerous safekeeping requirements on advisers that only have discretionary trading authority but no authority to obtain client assets (for example, many separately managed account ("**SMA**") arrangements);
- restore a workable exception to the qualified custodian requirement for privately offered securities and apply it to physical assets as contemplated by the Proposal (as well as other types of investments that cannot feasibly be held with a qualified custodian);

- not adopt certain requirements related to the reporting of new detailed information regarding an adviser's custodial practices;

- exempt qualified custodians from the proposed outsourcing rule to avoid redundant regulations applicable to the adviser-custodian relationship; and

- provide an appropriate compliance transition period for all advisers.

II. Discussion

A. The Proposal would result in significant unintended consequences and would effectively preclude trading activity in certain asset classes. As a result, the Proposal should not be adopted.

The requirements set forth in the Proposal would be difficult, and in some cases impossible, to implement in practice. We are particularly concerned that the Commission has apparently not fully considered how custody requirements would apply to certain asset classes, such as bilateral OTC derivatives contracts, credit agreements, commodities, securities financing contracts, and underlying collateral subject to rehypothecation. Even where certain requirements could be implemented, they would be costly and burdensome for advisers and custodians, and such costs will ultimately be borne by investors.

The Proposal would extend the safekeeping requirements of the new rule to all client assets over which an adviser has custody, with "assets" defined to mean funds, securities or other positions held in the client's account.[5] The Proposing Release explains that the reference to "other positions" is intended to serve as a catchall for (i) assets that may not necessarily be recorded on a balance sheet for accounting purposes, such as short positions and written options; (ii) assets that may not clearly be "funds" or "securities," such as certain crypto assets, financial contracts held for investment purposes, and collateral posted in connection with swap contracts on behalf of a client; and (iii) physical assets, such as artwork, real estate, precious metals, and physical commodities.[6] The plain language of the proposed safeguarding rule, together with the foregoing statements in the Proposing Release, would therefore expressly extend safekeeping requirements to a significant universe of asset classes and positions, including security and non-security derivative contracts and underlying collateral, that have not historically been treated as being subject to the custody rule and for which custodial services may not feasibly be available.

This expansion of safekeeping requirements would have significant unintended consequences, including: (i) temporarily or permanently halting trading in markets where it is not clear how a qualified custodian could provide the requisite custody services; (ii) significantly increasing transaction costs, and potentially shutting down certain markets (such as prime brokerage) due to the inability to rehypothecate collateral; (iii) creating overlapping and confusing regulatory regimes where underlying assets are subject to oversight by other regulators; and (iv) significantly disrupting markets for private securities and physical assets that

---

5 Proposed safeguarding rule 223-1(d)(1).

6 Proposing Release at 14679.

trade regularly. The burdens of the Proposal could cause registered investment advisers and qualified custodians (including banks and broker-dealers) to exit markets where advisory client assets are implicated, leaving investors with limited choices and potentially greater exposure to unregistered advisers and unregulated entities.

To illustrate the impracticality, costs, and burdens of extending safekeeping requirements to all asset classes without properly considering the implications and manner in which different asset classes could be custodied, below we discuss bilateral OTC (uncleared) derivatives contracts (as well as collateral posted in connection with uncleared derivatives), loan agreements and certain commodities. These are merely examples of the many asset classes that would be adversely affected by the Proposal.

1. *The application of the proposed safeguarding rule to bilateral financial contracts and collateral held in margin accounts would be impractical to implement and unduly burdensome.*

OTC derivatives contracts include swaps, security-based swaps, security options, and securities forwards, which are privately negotiated, bilateral contracts between an advisory client and a counterparty. Many of these transactions are not subject to mandatory clearing, but depending on the client and counterparty involved, a particular transaction may be subject to regulatory initial margin and variation margin requirements, and the counterparties may also exchange non-regulatory initial margin and variation margin. The contract itself will typically be held by the client off-balance sheet, the regulatory initial margin (if required) must be segregated and held by an independent custodian, the non-regulatory initial margin may or may not be segregated based on the underlying commercial arrangements, and the variation margin is not segregated and fully available for rehypothecation by the receiving party. In addition, dealers and other counterparties to OTC derivatives transactions are extensively regulated following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**") in the United States and through other prescriptive regulatory regimes globally.[7]

The implications of extending the proposed safeguarding rule's requirements to these instruments and the associated collateral are discussed below.

i. *The requirement to maintain a bilateral financial contract with a qualified custodian that would "maintain possession or control" over those contracts*

---

[7] The Dodd-Frank regulatory framework for derivatives markets includes: real-time reporting of trade information for swaps and security-based swaps; registration of swap dealers and major swap participants with the CFTC; registration of security-based swap dealers and major security-based swap participants with the SEC; limits on exposure to derivatives on certain physical commodities; required clearing through central counterparties and execution through regulated exchanges or electronic facilities; margin requirements for trades not centrally cleared; and capital requirements for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants. *See, e.g.*, 17 C.F.R. Ch. I, Pt. 23, Registration and Regulation of Swap Dealers and Major Swap Participants; 17 C.F.R. Ch. II, Pt. 240, Subpt. A, Registration and Regulation of Security-Based Swap Dealers and Major Security-Based Swap Participants.

> *will be practically difficult, if not impossible, to implement, and it is not clear that a qualified custodian will introduce meaningful protection from an investor perspective.*

To comply with the Proposal, an adviser would need to place a financial contract such as an off-balance sheet OTC derivative contract with a qualified custodian that would "maintain possession or control" over that contract. This possession or control requirement would mean the qualified custodian is required to participate in any change in beneficial ownership of that contract, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership. This requirement would be practically difficult, if not impossible, to comply with in the context of a bilateral agreement. For example, would the Commission require a custodian to become a party to the relevant International Swaps and Derivatives Association ("**ISDA**") agreements that typically govern OTC derivative transactions, either as a third party or as nominee for the adviser? And if so, what are the custodian's obligations and liabilities under such ISDA agreements? Or alternatively, where the ISDA agreement is between an advisory client and a counterparty that happens to be a qualified custodian, would that be sufficient for purposes of complying with the rule?

As noted above, the Proposing Release specifically discusses the applicability of the new "possession or control" requirement to crypto assets.[8] Strangely, however, the Proposing Release includes no indication of how an adviser could introduce a qualified custodian into a financial contract such as a bilateral OTC derivative. Further, it is not clear whether a counterparty to an OTC derivative that is a qualified custodian would need to agree, and whether such counterparty would in fact agree, to act in such capacity in connection with such a transaction, or if the Commission would take the view that a third party acting as qualified custodian must be introduced into the transaction. With respect to the former approach, OTC derivatives counterparties that happen to meet the definition of "qualified custodian" are unlikely to agree to take on custodial obligations and a negligence standard of liability relative to their financial contracts with advisory clients, given that their existing relationship to such clients is that of a counterparty, not that of a custodian or fiduciary. With respect to the latter approach, as noted above, it is not clear how a third-party qualified custodian could maintain "possession or control" of the OTC derivative as it is a notional principal agreement granting the counterparties the right to a future stream of cash payments or deliveries. For example, it is not clear under the Proposal whether such a third-party qualified custodian would be required to approve individual transactions under an ISDA agreement; if so, such a requirement would make swap trading unworkable, given the delays that third-party transaction-by-transaction approval would insert into the trade execution process.

---

8 Proposing Release at 14688-89.

In addition, financial contracts such as OTC derivatives do not pose any meaningful risk of loss, misuse, theft or misappropriation.[9] It is unclear, and the Proposal does not explain, how the adviser could use its authority to redirect the financial benefit of such contract to itself, because any payments made under the contract for the benefit of the client would, under the existing custody rule, need to be directed to an account under the control of the client or a qualified custodian of the client. Given the absence of any real risk of loss, misuse, theft or misappropriation, the utility of introducing a qualified custodian into agreements governing the underlying OTC derivative itself seems even more remote.

ii. The requirement to maintain collateral exchanged in connection with financial contracts and other transactions with a qualified custodian, and the attendant asset segregation requirements, will impose unnecessary and burdensome costs and does not account for the existing regulatory framework applicable to collateral usage, including in respect of broker-dealer margin accounts and by derivatives counterparties.

In addition to uncertainty with respect to the financial contract itself, extending safekeeping requirements to all underlying collateral, including collateral traditionally subject to rehypothecation, would result in significant costs to parties seeking to transact in OTC derivatives contracts, obtain prime brokerage services, or engage in transactions involving other collateral arrangements. The imposition of segregation requirements on collateral traditionally available for rehypothecation could make many widely used trading, hedging, and financing transactions unavailable to advisers, foreclosing the ability of advisory clients to engage in certain transactions. The Commission recognized the high cost of such segregation requirements when it declined to mandate individual segregation for non-cleared security-based swaps, noting that this would deprive security-based swap dealers ("**SBSDs**") of the use of collected collateral for re-hypothecation in related transactions, would raise SBSDs's costs of facilitating security-based swap transactions, and could reduce SBSDs's access to defaulting counterparties' collateral in typical default scenarios.[10] Similarly, in adopting margin segregation requirements

---

9 The Commission has historically treated securities evidenced by ISDA master agreements that cannot be assigned or transferred without the consent of the counterparty as privately offered securities exempt from the qualified custodian requirement. *See, e.g.*, Div. of Inv. Mgmt., SEC, IM Guidance Update No. 2013-04 (Aug. 2013), available at: https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf, at n.2. The Commission has not demonstrated any widespread issues arising out of this interpretation.

10 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. 163 (Aug. 22, 2019) (codified at 17 C.F.R. Pts. 200 and 240), available at: https://www.govinfo.gov/content/pkg/FR-2019-08-22/pdf/2019-13609.pdf, at 44027-28 ("The Commission has considered the costs and benefits of requiring segregation at a third-party custodian and prohibiting re-hypothecation. Based on its judgment and prior experience, the Commission determines that the potential benefits to financial stability do not justify the potentially considerable additional costs that would need to be borne by market participants under this alternative approach.").

for non-cleared, non-security based swaps, other regulators recognized the significant costs that would be incurred by market participants as a result of prohibiting rehypothecation.[11]

Specifically, the Proposal includes a new requirement that the adviser obtain reasonable assurances from the qualified custodian that "the qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities."[12] This requirement, which is not qualified by any ability of the client to authorize a different practice in writing, would seem to prohibit a broker-dealer acting as a qualified custodian from rehypothecating client assets, even when rehypothecation is otherwise permitted under applicable SEC regulations.[13] Margin financing by broker-dealers is currently an important funding source widely used by advisers on behalf of their clients, and effectively prohibiting rehypothecation in this manner will either make this financing unavailable to some clients or significantly increase the fees and rates charged by broker-dealers to clients for prime brokerage services (negatively impacting returns).

With respect to margin financing in particular, the Commission includes the following statement in the Proposing Release:

> For example, in a margin account, a type of brokerage account, a qualified custodian may lend cash to a client to allow the client to purchase securities. The qualified custodian's loan is typically collateralized by the securities purchased by the client, other assets in a client account, and cash, all of which are typically subject to a security interest in favor of the qualified custodian…. *The rule would not prohibit arrangements like these. Rather, the rule would require that the adviser obtain reasonable assurances from the qualified custodian that the client has authorized in writing any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors that would arise in connection with these arrangements or others.* While we recognize that these and similar arrangements involve some level of risk to client assets, we recognize that they can also be beneficial, and should be permitted when authorized.[14]

---

11 *See, e.g.*, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants and Capital, 81 Fed. Reg. 636 (Jan. 6, 2016) (codified at 17 C.F.R. Pts. 23 and 140), available at: https://www.govinfo.gov/content/pkg/FR-2016-01-06/pdf/2015-32320.pdf, at 688 ("The Commission understands that prohibition against rehypothecation will impose significant costs on market participants as this will increase their funding costs for margin.").

12 Proposed safeguarding rule 223-1(a)(1)(ii)(D).

13 *See* 17 CFR § 240.15c3-3.

14 Proposing Release at 14696 (emphasis added). Similarly, the Commission notes that the requirement that advisers segregate client assets is not intended to prohibit actions authorized by clients in writing, even when those actions result in client assets being commingled with adviser assets or subject to certain claims, including liens and security interests, in favor of the adviser. Proposing Release at 14714. The Commission notes, as examples, that clients' assets may be subject to a securities lending arrangement authorized by the client, and that clients may authorize margin financing arrangements. Proposing Release at 14714-15.

To the extent that it is the Commission's view that the new rule extends to collateral taken in connection with margin financing transactions only to require the above reasonable assurances, we urge the Commission to reiterate this and make similar allowances in the rule text and/or associated guidance if the new rule is adopted following re-proposal. It is otherwise not clear from the language in the proposed safeguarding rule and from other statements made in the Proposing Release that the rule's segregation requirements would not apply to margin accounts or otherwise effectively prohibit rehypothecation authorized by the client and permitted under other applicable laws.

2. *The Proposal does not properly account for the application of safekeeping requirements to loan agreements and syndicated loan markets.*

Similar to the issues identified above with respect to OTC derivatives, the Proposal does not address the impracticalities of extending safekeeping requirements to loan agreements that are used in the syndicated loan market and other credit markets. Loan transactions occur within a well-developed, and well-understood, trading and settlement infrastructure, and loan agreements already include transfer controls that mitigate the risk of misappropriation by an adviser. It would likely be unworkable to introduce a third-party qualified custodian into a loan agreement, which is merely a contract between borrowing and lending counterparties, for similar reasons as those noted in the context of OTC derivatives. Even in a common arrangement where the loan agreement includes one or more banks as administrative agent and/or lender, it is not clear that any such banks would also agree to serve as qualified custodian with respect to the loan agreement itself, or whether the custodial arrangements with a bank serving in such role would be sufficient for purposes of complying with the rule.

In addition, because loan agreements are not physical assets and are unlikely to be securities under current law,[15] advisers and clients would seemingly not be able to rely on the exception for privately offered securities and physical assets unable to be maintained with a qualified custodian. This could effectively preclude advisory clients from participating in the syndicated loan market and other credit markets. The syndicated loan market is an expansive and critical component of the U.S. financial markets more generally.[16]

3. *The proposed safeguarding rule would disrupt critical commodities markets.*

The Proposal would fundamentally disrupt the orderly functioning of critical commodities markets and force regulatory requirements on market participants that conflict with

---

[15] Although certain debt instruments are securities, this section of our discussion is focused on loan agreements that would not be considered securities and would therefore fall outside of the exception for privately offered securities.

[16] As of April 28, 2023, the par amount of U.S. leveraged loans outstanding was $1.4 trillion. *See, e.g.*, Morningstar LSTA US Leveraged Loan Index, available at: https://indexes.morningstar.com/indexes/details/morningstar-lsta-us-leveraged-loan-index-FSUSA084ZT?tab=overview. Leveraged loans are a crucial source of financing for private companies, many of which do not have investment grade credit ratings and are unable to obtain financing in the public equity or debt markets.

requirements imposed by other federal agencies and foreign regulatory regimes that have exclusive jurisdiction over these markets. Specifically, elements of the Proposal are unworkable with respect to commodities markets that involve frequent trading, and the Proposal would create a regulatory layer in addition to, and potentially in conflict with, existing oversight of commodities markets by other federal agencies.

The Proposal would require an investment adviser to implement certain procedures for clients' physical assets that cannot be maintained with a qualified custodian.[17] These procedures provide, among other things, for: (i) the adviser to enter into a written agreement for an independent public accountant to verify any purchase, sale, or other transfer of beneficial ownership of such assets; (ii) the adviser to notify the accountant of any such transaction within one business day; and (iii) the accountant to promptly verify the transaction and to notify the Commission within one business day upon finding any material discrepancies.

This requirement is unworkable for certain commodities markets. For example, the daily and monthly natural gas markets consist of thousands of participants transacting at numerous locations in the continental United States and Canada, at times within moments by telephone and internet. Many of these locations are not stand-alone structures but segments of individual pipelines or locations where pipelines interconnect with other pipelines or local distribution companies. The requirement that an independent accountant verify all these transactions and receive and give notice of any discrepancies would impose significant costs (including potentially as a result of accountants needing to hire and train new personnel) and add another layer of complexity and friction to the commodities markets, which could slow down trading and materially increase the cost of commodities borne by end users, including the general energy-consuming public. Given the volume of trading in these markets, market participants subject to the proposed safeguarding rule may simply stop trading rather than incur the additional costs and burdens associated with transaction verification.

A number of physical assets are regulated pursuant to other federal statutory frameworks, often by agencies to which Congress has given exclusive jurisdiction, or are subject to interstate administrative or common law requirements and regimes. The U.S. energy industry is one example where possession, control, custody, transfer, and shipment of physical assets is already regulated by a complex framework of federal and state administrative and common law. These frameworks apply to classes of physical assets including both commodities and physical plants and equipment.

For example, interstate possession and control of natural gas is regulated by the Federal Energy Regulatory Commission ("**FERC**"). Existing regulations set forth complex standards around pipeline and storage capacity utilization and title transfer. The Proposal would impose an additional burden, and likely add confusion to existing processes of title analysis, particularly at the federal level. Under the Natural Gas Act and FERC regulation, shippers on natural gas pipelines are required to have title to the gas being shipped on the pipeline capacity. Adding new

---

[17] Although we focus on commodities markets in this section, the prompt verification requirements in the Proposal would be costly and burdensome to implement and would be generally disruptive to existing trading practices across many other markets as well. See our discussion in Part II.B.7 below.

auditor verification requirements to the FERC title requirement would be an unnecessary additional burden and would confuse pipeline tariff and scheduling administration for a substantial number of physical market participants who interact with investment advisers operating in the space, thereby raising costs to the broader market.

Other industries with "physical assets" outside of the Commission's competence and authority include agriculture, chemicals, mining, timber, vintage and antique items and art. The proposed safeguarding rule could cause other market participants to pause, or even avoid, transacting in these commodities with investment advisers, thereby reducing market liquidity and harming the interests of investment adviser customers seeking returns derived from the commodities markets.

Finally, it is not clear how advisers could, under the Proposal, transact in intangible commodities, such as renewable energy credits or carbon credits, which are neither eligible for custodial services as contemplated by the Proposal nor physical assets. The Commission should not prevent advisory clients from participating in these important markets.

4. *The Commission has failed to consider the impact of the Proposal on certain markets and has not conducted an adequate cost-benefit analysis regarding the effect the Proposal could have on certain asset classes.*

The Commission does not provide evidence in the Proposing Release that extending safekeeping requirements to commodities and financial instruments—including, but not limited to, OTC derivatives contracts, credit agreements, and securities lending agreements—and related collateral is necessary to address a pattern of harm to investors or to otherwise promote investor protection. Indeed, the Proposing Release fails to address the potential ramifications of the new safeguarding rule to these asset classes and market transactions in any meaningful way. Although the Commission devotes several paragraphs to discussing the potential costs associated with expanding the scope of assets subject to the rule to include crypto assets, the Commission does not address at all the potential costs associated with expanding the scope of assets to include regularly traded commodities, syndicated loans, derivative contracts, and securities financing agreements, among many other asset classes.[18] These asset classes represent trillions of dollars of assets outstanding in the U.S. financial markets—with respect to the credit markets alone, the Commission reported in October 2020 that there were $1.2 trillion of syndicated leveraged loans outstanding in the United States.[19] Investors in syndicated loans and participants in securities lending transactions include banking organizations, pension funds, insurance companies, business development companies, and mutual funds.

Given the Commission's failure to address the costs that the Proposal would impose by extending safekeeping requirements to various asset classes, we have undertaken a preliminary analysis of the potential impacts the Proposal would have for certain asset classes, which is

[18] Proposing Release at 14741-42.

[19] Div. of Econ. and Risk Analysis, SEC, U.S. Credit Markets: Interconnectedness and the Effects of the Covid-19 Economic Shock (Oct. 2020), available at: https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf. *See supra* note 16.

attached to this letter as Annex A. The scope of the analysis was necessarily limited by the time constraints of the comment period and does not cover all asset classes that would be subject to the safeguarding rule if adopted as proposed. However, we believe it is useful in demonstrating the significant potential consequences that the Proposal could have for certain asset classes and transactions—consequences which we believe, in many cases, are unintended and have not been fully considered by the Commission.

Costs associated with the expanded safekeeping requirements contemplated by the Proposal include, but are not limited to, costs associated with renegotiating virtually all trading and custody agreements for the entire asset management industry, the impact of lost liquidity in markets newly impacted by the rule (such as OTC derivatives markets, prime brokerage markets, syndicated loan markets and certain commodities markets), increased costs of obtaining custody services (both as a result of custodians needing to provide services for new asset classes and as a result of custodians needing to comply with new requirements set forth in the Proposal), and the impact of lost access to certain non-U.S. markets. On the other hand, the potential benefits associated with the vast expansion of safekeeping requirements under the Proposal are less clear. The Commission has not demonstrated a pattern of risk or harm to investors (outside of recent examples involving crypto assets), fund investors have historically relied on (and will continue to rely on) audited financial statements to receive comfort regarding their holdings,[20] and there does not seem to be any meaningful benefit of adding a qualified custodian to certain asset classes, such as those that involve bilateral contracts. In failing to consider the potential impacts to markets and investors, the Commission has not conducted an adequate cost-benefit analysis of the implications of the expansion of the rule's safekeeping requirements. Accordingly, the Commission should undertake a cost-benefit analysis that considers all of the consequences of the safeguarding rule prior to re-proposal of the rule.

B. In addition to the fatal flaws described above that necessitate the withdrawal of the Proposal, if the Proposal is ultimately adopted following re-proposal, the Commission must make significant changes to better tailor the rule and mitigate impractical burdens and undue costs.

If the Commission does move forward to adopt a safeguarding rule after addressing the fatal flaws discussed in Part II.A. above, a number of significant changes should be made to better tailor the rule and mitigate impractical burdens and undue costs.

---

20 The Commission justifies new custodial requirements and the imposition of these requirements on new asset classes in significant part by reference to the "integrity" of custodial account statements, which the Commission describes as "critical." Proposing Release at 14675. However, investors in commingled funds relying on the audit exemption in the existing custody rule do not (and will not under the Proposal) receive custodial statements. The Proposal does not identify deficiencies with respect to the protections provided to fund investors by existing audit practices, nor does it indicate why additional safekeeping requirements are necessary to achieve the investor protection goals of the custody rule with respect to fund investors.

1. *The Commission should consider and adopt appropriately tailored parameters prior to extending safekeeping requirements to new asset classes, giving appropriate deference to well-established market practices.*

As discussed in Part II.A, the Commission has not properly considered how various asset classes would be affected if the Proposal were adopted, and the Proposal is simply unworkable for certain asset classes. Prior to any determination to re-propose a new safeguarding rule, the Commission should appropriately tailor the rule's requirements to the underlying assets proposed to be covered.[21] For example, the Commission should not extend custody requirements to financial contracts and instruments which are not subject to existing mandatory clearing and/or segregation requirements and which are entered into with or posted to arm's-length counterparties (such as bilateral OTC derivatives, credit agreements, and securities lending, repurchase and reverse repurchase agreements, among other types of bilateral contracts). Advisers acting on their clients' behalf customarily enter into these contracts and other instruments with banks, broker-dealers, swap dealers and SBSDs, and other counterparties, but it is not feasible (1) for these counterparties to agree to serve as qualified custodian in accordance with the requirements of the rule or (2) to involve a third-party qualified custodian to maintain possession or control over contracts and associated collateral.[22] As discussed in Part II.A.1.i, the Proposing Release does not provide any indication of how qualified custodians would be introduced into these types of financial contracts, and it is not clear that qualified custodians would be in a position to serve in that capacity. The imposition of qualified custodian requirements on these positions and related collateral is effectively regulation of counterparty credit risk, which falls outside the Commission's statutory authority in this area and is not necessary to protect investors given existing, comprehensive regulation of dealers and other relevant counterparty types.

In addition, in order to facilitate the continuation of existing market practices in respect of rehypothecation, the Commission should expressly exclude collateral posted in support of financial transactions from asset segregation and custody requirements.[23] The failure to make these allowances would significantly and in many cases prohibitively increase costs associated with entry into such transactions, including potentially eliminating the ability of clients to rely on margin financing. Although the Proposing Release indicates that margin financing would continue to be available when authorized in writing by the client,[24] it is not clear to us that other

21 See the discussion Section 2.C. below noting how the Proposal seeks to regulate the custody, segregation, and safekeeping of certain asset classes that are within the purview of other federal regulators, such as commodities and non-security derivatives (which fall under the orbit of the CFTC) and energy products (which fall under the orbit of FERC).

22 For example, in the case of a counterparty to a trade agreement acting in a dual capacity as qualified custodian, that party may not be willing to agree to a negligence standard of liability if it is also required to act as a qualified custodian under the contract. In the case of a trade agreement that is entered into among counterparties plus a qualified custodian, it is impractical to interpose the qualified custodian into the relevant transactions.

23 *See supra* Part II.A.1.ii.

24 Proposing Release at 14696, 14714-15.

aspects of the proposed safeguarding rule (*e.g.*, the requirement that custodians and advisers segregate client assets from their own proprietary assets) would actually permit the continuation of these and other arrangements relying on rehypothecation in practice.

The Commission should also expressly exclude commodities traded in markets that are subject to regulation and oversight by other governmental agencies, such as the electricity and natural gas markets.[25] For these types of commodities, there is an existing regime that governs ownership (including transfer of ownership) by market participants, making an additional regulatory layer unnecessary and likely to cause confusion and harm.

However, we believe many of these asset classes can be subject to surprise examination or, if applicable, the requirement to obtain and deliver audited financial statements that address these positions. This safeguard has served clients and investors well since it was adopted by the Commission, and the Commission has presented no evidence in the Proposal of any shortcoming or investor protection concern related to these assets or the protections afforded by existing audit practices.

Accordingly, the Commission should conduct further analyses to determine appropriately tailored parameters prior to extending safekeeping requirements to additional asset classes, which parameters should contemplate the exclusion of certain asset classes (including certain financial contracts, underlying collateral, and certain commodities) from custody requirements where existing risk mitigants obviate the need for additional regulation and where a regulatory safekeeping requirement is likely to be impractical, unduly burdensome, unnecessary, or confusing to implement in practice.[26]

2. *The Commission should eliminate unnecessary requirements that would apply to banks and savings institutions acting as qualified custodians.*

The Proposal would make significant changes that impact the conditions under which banks and savings institutions may serve as qualified custodians of client assets. For a bank or savings association to serve as a qualified custodian, the institution would be required to hold client assets, including cash deposits, "in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association."[27] This requirement could limit the number of banks and savings associations eligible or willing to serve as qualified custodians, while potentially limiting the

---

25 *See supra* Part II.A.3.

26 Depending on the parameters ultimately adopted by the Commission, it may also be appropriate to consider expanding the definition of "qualified custodian" to facilitate compliance with the rule in asset classes that have not traditionally been subject to safekeeping requirements. This could include, as examples, capturing registered swap dealers and SBSDs that are not otherwise covered by the existing definition of "qualified custodian." In addition, it may be appropriate to expand the exception for privately offered securities and physical assets to include other asset classes identified by the Commission that cannot feasibly be custodied as required by the rule.

27 Proposed safeguarding rule 223-1(d)(10)(i).

quality and choice that advisers and their clients currently enjoy with respect to qualified custodians.

A requirement for banks and savings associations to establish segregated accounts for client deposits would represent a substantial departure from such institutions' current operational models, resulting in significant costs and burdens borne by not only advisers and clients but also the banking industry. For example, banks providing custody services rely on their general deposits to provide the intra-day and overnight liquidity necessary for the efficient settlement of client transactions. Requiring segregated accounts for advisory client deposits would remove advisory client funds from the bank custodian's pool of general deposits, with the result being that trades would need to either be prefunded or subject to delayed settlement until funds become available. In addition, the application of the segregated account requirement to client deposits could significantly reduce bank custodians' net interest income, with the result being that custody fees would need to increase significantly to offset the lost income, or banks may exit the custody business altogether.[28] The requirement would also appear to result in advisory clients being placed ahead of other general depositors in the event of a bank's insolvency. The Commission does not properly explain how the application of the segregated account requirement to client deposits would fit into the existing insolvency regime applicable to federally insured banks and savings associations, or provide justification for why advisory clients should be given priority over other types of depositors.[29]

In proposing that banks and savings associations must hold advisory client assets in the segregated accounts described in the Proposing Release, the Commission points to "a growing number of state-chartered trust companies and other state-chartered, limited purpose banking entities entering the custodial market,"[30] which the Commission subsequently explains are "offering custodial services for crypto assets."[31] However, the proposed safeguarding rule would not limit the requirement to utilize these segregated accounts only to the state-chartered entities identified by the Commission in its commentary—the new rule would require *all* banks and

---

[28] The traditional banking model relies on the ability of banks to earn net interest income on funds deposited by bank customers. *See, e.g.,* Robert DeYoung and Tara Rice, How do banks make money? A variety of business strategies, Research Department of the Federal Reserve Bank of Chicago (2004), available at: https://www.chicagofed.org/publications/economic-perspectives/2004/4qtr2004-part4-deyoung-rice ("Some banks employ traditional banking strategies, attracting house-hold deposits in exchange for interest payments and transaction services and earning a profit by lending those funds to business customers at higher interest rates.").

[29] The Commission states in the Proposing Release that the protections afforded by requiring segregated accounts under the proposed safeguarding rule "would be limited to the clients of those qualified custodians that would not be subject to the resolution processes deployed by the FDIC or by the OCC or have not developed and deployed comprehensive custodial service agreements governing their relationships with their custodial customers." Proposing Release at 14743. However, the plain text of the new rule does not support or explain the Commission's narrow interpretation of the segregated account requirement, which by its terms would apply to all banks and savings associations.

[30] Proposing Release at 14742.

[31] *Id.*

savings associations acting as qualified custodians to create a segregated account structure for advisory clients.

Importantly, as the Commission itself emphasizes in the Proposing Release, the "core purpose" of the custody rule has historically been, and remains, "protecting client assets from loss, misuse, theft, or misappropriation by, and the insolvency or financial reverses of, *the adviser*."[32] The custody rule has never been intended to protect advisory clients from the insolvency or financial reverses of the qualified custodian.

Accordingly, the Commission should not adopt the asset segregation requirement for banks and savings associations, particularly to the extent it would require the segregation of client deposits. It is imperative that the safeguarding rule, if adopted, not lead banks and savings institutions to discontinue offering custodial services on commercially reasonable terms.

3. *The Commission should eliminate the unnecessary requirements that would apply to FFIs acting as qualified custodians.*

The Proposal would also impose extensive new conditions on FFIs serving as qualified custodians. As with banks and savings associations above, these requirements could limit the number of FFIs eligible or willing to serve as qualified custodians, potentially further limiting the market for qualified custodians and creating barriers to non-U.S. markets where eligible custodians are not available. Indeed, as discussed below, the Commission explicitly acknowledges in the Proposing Release that the new requirements applicable to FFIs could limit access to foreign markets by U.S. advisory clients.[33]

Consistent with our comments above regarding the segregated account requirement applicable to banks and savings associations, we are similarly concerned about the asset segregation requirements for FFIs.[34] In addition, the requirement that an FFI have "the requisite financial strength to provide due care for client assets"[35] is subjective and presents substantial risk of second-guessing by the Commission. Moreover, as has been made apparent recently, a U.S. or non-U.S. financial institution that by all metrics appears to have financial strength can become suddenly and unexpectedly impaired. It is unreasonable to expect that an adviser could effectively predict such an occurrence, which leaves the adviser at risk of non-compliance in hindsight.

We are also concerned by the requirement that the adviser and the Commission must be able to enforce judgments, including civil monetary penalties, against the FFI. The enforceability of rights and remedies among advisers, clients and custodians is properly addressed in commercial arrangements between counterparties and should not be a regulatory requirement that causes some institutions to wholly refrain from participating in the market for safekeeping

---

32 *Id.* at 14776 (emphasis added).

33 *Id.* at 14744 n.489.

34 Proposed safeguarding rule 223-1(d)(10)(iv)(D).

35 Proposed safeguarding rule 223-1(d)(10)(iv)(E).

U.S. advisory client assets. It is also not clear from the Proposal what civil monetary penalties and other judgments the Commission might seek to enforce against FFIs, or how such enforcements would relate specifically to the custody of client assets.[36]

Further, the Proposal does not address, in any meaningful respect, the likely impact of these extensive new requirements applicable to FFIs on the availability of qualified custodial services outside the United States. Our members have significant concerns that these new requirements may limit the availability of qualified custodians that allow members to trade in instruments in non-U.S. markets in compliance with the rule. The Commission acknowledges in the Proposing Release that, if advisers maintain client assets in a country where no FFIs would qualify under the proposed safeguarding rule, clients will incur costs associated with divestiture of foreign assets, potentially at a loss, and the Commission further acknowledges that it does not have data on the number of client accounts and the quantity of assets that could be affected.[37]

Accordingly, if the Commission does adopt additional requirements applicable to FFIs serving as qualified custodians, it should not adopt the specific requirements described above regarding account segregation, requisite financial strength (or, at the very least, provide a clear and objective threshold for what constitutes the requisite financial strength), and enforceability of judgments by the adviser and the Commission. In addition, we urge the Commission to conduct further analyses regarding the potential impacts of the new FFI requirements on the availability of custodians outside the United States and to further tailor the requirements for FFIs prior to adopting any rule to ensure that advisers can continue to invest client assets in foreign markets. It is essential that the Commission ensures that any adopted rule not preclude trading in non-U.S. markets.

4. *The Commission should not require advisers to renegotiate all custody and trading agreements to obtain reasonable assurances from qualified custodians that would impose simple negligence standards and would restrict the use of rehypothecation.*

The Proposal would require that advisers obtain "reasonable assurances" in writing from each qualified custodian that the custodian will comply with certain requirements, and advisers would be required to "maintain an ongoing reasonable belief" that the custodian is complying with these requirements.[38] Among other things, the adviser would need to obtain reasonable assurances that a qualified custodian will (1) indemnify the client (and will 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 and (2) clearly identify the client's assets as such, hold them in a custodial

---

[36] The Proposing Release suggests that enhanced custody of safeguards for client assets held outside the United States is being driven by recent events in the crypto markets but, again, the Commission does not discuss or appear to consider the need for, or potential impact of, imposing these safeguards on FFIs that provide custody for other asset classes. Proposing Release at 14684.

[37] Proposing Release at 14744 n.489.

[38] Proposed safeguarding rule 223-1(d)(1)(ii).

account, and segregate all client assets from the qualified custodian's proprietary assets and liabilities.

The reasonable assurances requirement would necessitate the renegotiation of all trading and custody agreements across the asset management industry with no clear benefit to advisory clients. Clients are already protected by the obligations that custodians have to them under their direct agreement. Requiring advisers to extract their own assurances from custodians does not offer clients any meaningful additional protections.

The imposition of a simple negligence standard on qualified custodians aligns with other recent Commission rulemakings that propose this standard, which has been sharply criticized by many advisers, investors, and service providers. We have expressed our concern regarding the use of the negligence standard in recent comment letters.[39] We again express our disagreement with the Commission's use of a simple negligence standard, which is actually counterproductive to the Commission's investor protection goals. As acknowledged by the Commission in the release,[40] requiring a custodian to provide indemnification (and maintain insurance) for simple negligence would likely represent a substantial departure from existing market practices. This could have the effect of reducing the number of firms willing to serve as qualified custodians, and, at a minimum, would significantly increase the cost of those services, which costs will be borne by investors.

In addition, as discussed above, the requirement that qualified custodians segregate client assets from the custodian's own assets and liabilities would appear to prohibit rehypothecation of collateral and other customary transactions pursuant to which custodians provide margin financing to customers, including prohibiting a broker-dealer that is acting as a qualified custodian from engaging in permissible rehypothecation of client assets. This requirement would materially adversely affect standard prime brokerage and banking services, resulting in increased costs to clients and reducing the amount of liquidity available to advisers and their clients. Broker-dealers are permitted to rehypothecate customer assets subject to limits imposed under Commission broker-dealer regulations, which are designed to protect customers of the broker-dealer.[41] In addition to increasing costs and potentially restricting access to margin financing, additional asset segregation requirements also would not afford better protections to advisory clients because, in a broker-dealer's insolvency, they would remain subject to *pro rata* distribution of customer assets alongside other customers whose assets are not subject to these

---

39 *See* Managed Funds Association, Comment Letter on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Apr. 25, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20126631-287270.pdf; Managed Funds Association, Comment Letter on Reopening of Comment Period for Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (June 13, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20131144-301341.pdf; Managed Funds Association, Comment Letter on Outsourcing by Investment Advisers (Dec. 20, 2022), available at: https://www.sec.gov/comments/s7-25-22/s72522-20153177-320682.pdf.

40 Proposing Release at 14746.

41 *See* 17 CFR § 240.15c3-3.

segregation requirements. Therefore, the Commission should not extend asset segregation requirements to activities permitted by existing regulations, such as rehypothecation by broker-dealers.

Accordingly, the Proposal's requirement that advisers obtain reasonable assurances from custodians should not be adopted. The costly undertaking of renegotiating every custody and trading agreement would provide little benefit, if any, to advisory clients. If the Commission does proceed with the reasonable assurances requirement, at a minimum, it should tailor the requirement to avoid unintended consequences and the imposition of significant costs and burdens on qualified custodians, which would substantially increase costs incurred by advisers and their clients and could limit the number of qualified custodians available in the market. Specifically, the Commission should not apply a simple negligence standard to qualified custodians and should exclude activities permitted by existing regulations from the requirement for asset segregation. These changes are imperative to ensure a large and competitive market for qualified custodial services.

5. *The Commission should allow FCMs to serve as qualified custodians for all client assets, to align the definition with the expanded scope of the Proposal and, in deference to the comprehensive CFTC regulation of FCMs, exempt FCMs from the other requirements for qualified custodians.*

FCMs currently are permitted and, in some instances, required to custody client assets in connection with a wide range of cleared derivatives transactions, including not only commodity futures and options thereon and security futures products, but also cleared swaps and, in certain instances, security-based swaps.[42] In providing these custody services, FCMs are subject to comprehensive regulation by the CFTC affecting such matters as asset segregation, client agreements, account statements, and independent audits. Several aspects of the Proposal would duplicate or, in some instances, conflict with these CFTC requirements. FCMs should be permitted to hold advisory client assets as qualified custodians that are subject to the customer protection regime under the Commodity Exchange Act and CFTC's regulations, rather than the Proposal's requirements, many of which are redundant and unnecessary in light of the regulatory requirements already applicable to FCMs.

If it proceeds to expand the scope of positions subject to the safeguarding rule, the Commission should take steps to recognize the widespread use of FCMs by advisory clients and defer to CFTC regulation of FCM custody practices. Specifically, the Commission should permit an adviser to use an FCM in lieu of a qualified custodian for the full range of instruments and collateral held by FCMs for customers, *i.e.*, commodity futures and options thereon, security futures products, cleared swaps, and cleared security-based swaps.[43]

---

[42] The Commission permits certain security-based swaps to be carried by an FCM when portfolio margined with cleared swaps.

[43] Current custody rule 206(4)-2(b)(1) and proposed safeguarding rule 223-1(b)(1) allow investment

Alternatively, the Commission should revise the FCM prong of the definition of "qualified custodian" to provide that FCMs are qualified custodians not only with respect to funds, security futures, securities incidental to commodity futures and options thereon, but also to other derivative products that are cleared through FCMs, including commodity futures, cleared swaps and cleared security-based swaps. This change would align with the expansion of the rule to capture all client assets, including "positions," in addition to funds and securities, and would also take into account developments in the types of transactions that are permitted to be accessed through FCMs.[44] In addition, the Commission should exempt registered investment advisers from the proposed safeguarding rules 223-1(a)(1) and (a)(3) when an FCM holds their clients' assets, effectively exempting FCMs from the redundant written agreement, reasonable assurances, and segregation requirements.

6. *The Commission should follow the traditional understanding of "custody" and not impose onerous safeguarding requirements on advisers that only have discretionary trading authority but no authority to obtain client assets.*

The Proposal would significantly impact clients that hire advisers to manage their assets through SMAs, specifically by including discretionary trading authority within the revised definition of "custody." While this change would impose significant burdens, it would not provide a new benefit to SMA clients.

As a result, advisers would be required to follow all of the rule's requirements relating to SMAs for which advisers have discretionary trading authority, including: (i) entering into a written agreement with the client's custodian, (ii) ensuring that the custodian has custody of any trading agreements, including collateral posted in connection therewith, that the adviser enters into on behalf of the SMA, and (iii) potentially, engaging an independent public accountant to conduct an annual surprise examination. These requirements would impose significant new operational and compliance burdens on investment advisers, especially smaller advisers, with respect to their SMA clients, which we do not believe is justified in all instances in light of the investor protection concerns the Commission seeks to address.

Specifically, many SMA clients are sophisticated institutional investors that utilize the SMA product in order to tailor investments to their own preferences, including the selection of the services providers that will be used for the account, including the client's custodian. These SMA clients have direct relationships with their custodians and accountants, and it is not necessary or appropriate to insert advisers into such relationships for the benefit of the investor. In addition, the scope of the definition of "custody" in the existing rule (as modified to apply to client assets) would provide sufficient protection to SMA and other clients, as it would apply to circumstances where the adviser can withdraw assets from the client's account or where (as in the case of fund clients) that adviser or its affiliates or supervised persons have legal ownership of or access to client assets. Redirecting client assets to the adviser or adviser-controlled entities

---

advisers to use a transfer agent in lieu of a qualified custodian with respect to shares of a mutual fund. The Commission could similarly allow investment advisers to use an FCM in lieu of a qualified custodian with respect to client assets that are held incidental to transactions cleared by FCMs.

44 Proposing Release at 14679.

through discretionary trading authority is already addressed by the Advisers Act restrictions on principal and cross transactions and does not need to be separately addressed in the proposed safeguarding rule.

Accordingly, the Commission should not extend the safekeeping requirements of the Proposal to circumstances where the adviser would have custody solely by virtue of its discretionary trading authority, or at the very least, exempt for these purposes SMAs managed for institutional investors that have engaged their own custodians and dictated their preferences regarding engagement of independent accountants.

7. *The Commission should restore a workable exception to the qualified custodian requirement for privately offered securities and apply it to physical assets as contemplated by the Proposal.*

The proposed exception for privately offered securities and physical assets includes extensive new and burdensome conditions that could make the exception effectively unusable. The Proposal introduces stringent requirements that will need to be met in order for the exception to be available, reflecting the Commission's view that "[i]deally, a robust market for custodial services would develop for [all] physical assets and privately offered securities"[45] and would likely result in an exceedingly narrow exception. The exception, as revised, is problematic for a number of reasons, and we do not believe that introducing a qualified custodian into these transactions is necessarily protective.

First, we are concerned that the condition that an adviser reasonably determine that ownership cannot be maintained with a qualified custodian would require extensive ongoing analysis and documentation by the adviser. It is unclear how advisers could reasonably undertake to prove a negative as required by this element of the Proposal. Further, there is a substantial risk of second-guessing by SEC examination and enforcement staff. The Proposing Release states that such a determination would be based on "facts and circumstances" and would evolve over time as assets and the custodial industry change.[46] Such a vague framework leaves little for advisers to comfortably rely on when making this determination. Moreover, the Proposing Release points to the advisers' fiduciary duties in selecting a qualified custodian, creating a significant tension for advisers that may be forced to choose between selecting a newer or lower quality firm in markets that have not traditionally been served by qualified custodians or potentially failing to comply with the rule. The Proposal also does not account for situations where qualified custodians may charge unreasonably high fees in underserved markets (*e.g.*, markets not traditionally served by qualified custodians and markets that experience significant custodian exits as a result of the Proposal's requirements), which would create a similar tension for advisers in choosing between high-cost custody services for their clients or forgoing client exposure to relevant markets.

Second, the requirements to notify an independent public accountant engaged to perform transaction verifications within one business day of each transaction involving an asset exempt

[45] Proposing Release at 14705.

[46] *Id.* at 14707.

from the proposed safeguarding rule and to then have such public accountant promptly verify each such transaction is onerous and unnecessary. This aspect of the Proposal would impose meaningful new obligations on advisers and their accounting firms, although the Commission appears to take the view that these obligations could be assumed relatively efficiently.[47] To the contrary, effectively requiring real-time verification of exempt transactions would have a significant negative impact on market liquidity for a wide range of assets due to the expensive and highly manual nature of the verification process. The added layer of complexity and friction in affected markets could slow down trading and materially increase the costs borne by end users, with delayed trading cycles exposing advisory clients to counterparty risk and market reverses.[48] As described above, these changes could have significant adverse effects on certain markets where there is extensive intraday trading activity, such as the markets for electricity and natural gas. The Commission has pointed to no evidence that existing safeguards, such as the annual surprise examination and audited financial statement requirements, have failed or that real-time verification of assets would correct an existing gap in investor protection.

Third, the requirement that each privately offered security or physical asset not maintained with a qualified custodian be verified as part of a surprise examination or financial statement audit is unduly costly and burdensome for both advisers and independent accountants. The Commission acknowledges that this would be a departure from the way most surprise examinations or audits are currently conducted, as they typically rely on a representative sample of assets under custody selected by the accountant.[49] Further, the Commission discusses in the Proposing Release how this aspect of the Proposal (as well as the broadened scope of assets covered by the Proposal) could reduce the available capacity of accountants and therefore increase the overall costs for accounting services.[50] On the other hand, the Commission does not identify a material benefit to investors that would necessarily result from imposing this new

---

[47] The Commission states its view that the notice from the adviser to the accountant "would not be challenging for any adviser to provide to the independent public accountant, especially considering the limited nature of the requirement relative to the more involved aspects of many of the closings related to privately offered securities or physical assets such as the preparation or review of closing memos, confirmation of receipt of funds, execution of signature pages, and many other more time consuming tasks related to closings for these types of assets." Proposing Release at 14708. The Commission goes on to note, "[b]ased on our experience with the audit provision in the current rule, we understand that independent public accountants are familiar with a wide variety of transaction verification and tracing transaction activity as this is a normal audit procedure." *Id.*

[48] Indeed, seeking to mitigate risks associated with market volatility, the Commission recently adopted a rule amendment to shorten the standard settlement cycle for most routine securities trades from two business days after the trade date to one business day after the trade date. *See* Shortening the Securities Transaction Settlement Cycle, 88 Fed. Reg. 13872 (Mar. 6, 2023) (codified at 17 C.F.R. Pts. 232, 240, and 275), available at: https://www.govinfo.gov/content/pkg/FR-2023-03-06/pdf/2023-03566.pdf.

[49] Proposing Release at 14705.

[50] *Id.* at 14742, 14752.

requirement.[51] The current practice of the accountant selecting the representative sample sufficiently balances the need for independent verification with concerns of cost and practicality.

Accordingly, the Proposal should be modified to ease the conditions for the exception for privately offered securities and physical assets to avoid effectively eliminating the availability of the exception altogether.[52] Specifically, the Commission should not adopt requirements that (1) an adviser reasonably determine that ownership of the asset cannot be maintained with a qualified custodian, (2) each transaction involving an exempt asset be verified promptly, (3) an adviser notify an independent public accountant within one business day of a transaction involving an exempt asset, and (4) the existence of each exempt asset be verified in a surprise examination or financial statement audit.

With respect to the requirement that an adviser reasonably determine that ownership cannot be maintained with a qualified custodian, this requirement should not be adopted given the practical difficulty of proving a negative and the significant risk of an adviser's determination being second-guessed in hindsight. At the very least, this requirement should be eliminated for the types of private securities that have historically been exempt under the custody rule (including limited partnership agreements and limited liability company agreements), and the Commission should place reasonable limits on the analysis required of advisers (*e.g.*, annual review) and provide confirmation that an adviser's reasonable, documented determination will not be second-guessed. If this requirement is adopted, it should also be clear in the rule text or SEC guidance that an adviser must only determine that ownership cannot be maintained with a qualified custodian on commercially reasonable terms, to avoid the risk that advisers must engage a qualified custodian when one is available, regardless of cost or terms imposed by the prospective custodian.

With respect to the requirement that each transaction involving an exempt asset be verified promptly and the requirement that the existence of each exempt asset be verified in a surprise examination or financial statement audit, maintaining the current practice of accountants selecting a representative sample of exempt assets in surprise examinations and financial statement audits would avoid subjecting investors to unnecessary market and counterparty risks associated with delayed settlement cycles and would continue to ensure investor protection while preventing unnecessary costs and burdens that would ultimately fall on investors.

---

51 *See* Proposing Release at 14752 (explaining that the magnitude of the benefit will depend on other factors, such as the extent to which sampling techniques are effective or the extent to which loss or theft of client assets tends to occur in assets that do not meet the materiality threshold, but failing to point to any concrete data suggesting that actual benefits will be realized).

52 In addition, as discussed in note 26 above, in connection with any re-proposal of the rule, it may be appropriate to expand the exception for privately offered securities and physical assets to include other asset classes identified by the Commission that cannot feasibly be custodied as required by the rule.

8. *The Commission should not adopt new Item 9.B, nor certain amendments to 9.C(1) of Form ADV.*

The Proposal includes amendments to Form ADV, which would amend Part 1A (and corresponding sections of Schedule D) to require new information corresponding to proposed safeguarding rule 223-1.[53] Among other new reporting requirements, advisers would be required to report detailed information regarding client assets and the number of clients falling into each category of custody (*i.e.*, direct or indirect), and to provide certain identifying and other information about the qualified custodians maintaining client assets and the independent accountants auditing them.

The Form ADV amendments would add a new Item 9.B, which would require an adviser to publicly disclose whether it is relying on any exceptions to the proposed safeguarding rule and, if so, on which exceptions the adviser is relying.[54] In addition, proposed amendments require other-than-annual updates to Form ADV if there are changes regarding the adviser's reliance on exceptions to the proposed rule. We do not believe that the burdens of these new requirements are justified, as the SEC staff can obtain this information in connection with its examinations of advisers, and it is not clear what benefit real-time public disclosure of this information would provide to investors.

We are also concerned about elements of the proposed amendments to Item 9.C(1) which would require disclosure of information about qualified custodians, as well as the number of clients and amount of client assets maintained at each custodian.[55] Specifically, requiring advisers to publicly disclose the contact information for an individual at the qualified custodian who can receive regulatory inquiries places a burden on advisers to monitor personnel changes at the custodian, and it is not clear that custodians and their employees would want this information to be publicly available when any purpose achieved by providing this information to investors can be addressed by either including contact information in the custodial agreement or making the information available upon request.

In addition, the number of clients and amount of client assets maintained at a qualified custodian is potentially competitively sensitive information with respect to the custodian's business, as investors and other interested parties would be able to evaluate which custodians are more or less prominent in the market for particular custodial services.[56] Advisers compete to identify and negotiate terms with financing counterparties, and the disclosure of the amount of assets held at each qualified custodian would compromise competitive advantages of advisers and reveal important information about their businesses. Public knowledge of the distribution of large advisers' client assets among custodians could also be particularly sensitive—and

---

[53] Proposing Release at 14756.

[54] *Id.* at 14730.

[55] *Id.* at 14789-792.

[56] We expressed similar concern in our comment letter on Outsourcing by Investment Advisers about the risks of requiring advisers to publicly disclose their third-party service providers. Comment Letter on Outsourcing by Investment Advisers, *supra* n.37, at 12-13.

potentially destabilizing—in times of market stress.

Accordingly, the Commission should not adopt certain elements of the Form ADV amendments that are part of the Proposal. Specifically, the Commission should not adopt new Item 9.B or the proposed amendments to 9.C(1) that would require disclosures regarding qualified custodian personnel and the volume of the qualified custodian's business.

9. The Commission should exempt qualified custodians from the proposed outsourcing rule to avoid redundant regulations applicable to the adviser-custodian relationship.

The Proposing Release does not sufficiently address how the Proposal would interact with the proposed outsourcing rule. In a footnote of the Proposing Release, the Commission "remind[s] advisers that as additional financial institutions become available to custody assets, advisers must continue to exercise their fiduciary duties to clients in connection with selection and monitoring of the qualified custodian."[57] However, there is a lack of clarity regarding whether custody would be considered an outsourced function under the proposed outsourcing rule, and as a result, whether advisers would need to follow the regulations set forth by both proposals with respect to their engagement of qualified custodians. As Commissioner Uyeda pointed out in his statement on the Proposal, there appears to have been little consideration for how these proposals impact each other.[58]

Accordingly, if the Commission moves forward with the Proposal, it should exempt qualified custodians from the proposed outsourcing rule, in order to avoid redundant regulations on the adviser-custodian relationship. At a minimum, the Commission should provide further guidance on how it views the interaction between these two proposals as they relate to the adviser-custodian relationship.

10. The Commission should provide an appropriate compliance transition period for all advisers.

The Commission has proposed a compliance transition period following adoption of the rule of one year for large advisers, or 18 months for advisers with under $1 billion in regulatory assets under management.[59] Given the significant changes envisioned by the Proposal and the extensive analysis advisers, qualified custodians, independent accountants and others will need to do to implement these changes and come into compliance with the Proposal (not to mention the qualified custodian services that would need to develop for new markets and asset classes where none exist today), we do not think the proposed compliance transition period is

---

57 Proposing Release at 14683 n.91.

58 Commissioner Mark T. Uyeda, Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets (Feb. 15, 2023), available at: https://www.sec.gov/news/statement/uyeda-statement-custody-021523.

59 Proposing Release at 14732. We believe the size-based distinction is unnecessary because the Proposal envisions operational changes that would need to be implemented across the custody ecosystem irrespective of whether the custodial service is used by large or small advisers.

appropriate. In comparison, the CFTC's January 2016 rule on margin requirements (which introduced fundamental changes to how market participants must manage collateral in connection with covered derivatives transactions) had a multi-year phase in process for the initial margin requirement.[60] If the proposed safeguarding rule ultimately changes the landscape for custody of client assets in the drastic way contemplated by the Proposal, a similarly lengthy period must be allowed for the transition of market participants into compliance with the new rule.

C. <u>If adopted, the Proposal would exceed the Commission's statutory authority and would be arbitrary and capricious.</u>

The Proposal, if adopted substantially as proposed, would exceed the Commission's statutory authority. The Commission invoked its authority under Sections 206(4), 211(a), and 223 of the Advisers Act, but none of those provisions authorizes the full scope of the proposed rule.

Section 206(4) authorizes the Commission to promulgate rules that are "reasonably designed to prevent . . . fraud[], decept[ion], and manipulat[ion]."[61] Yet aspects of the Proposal target negligent business practices rather than fraud, deception and manipulation.[62] To the extent the Proposal contains rules designed to prevent behavior that is not fraudulent, deceptive, or manipulative, it exceeds the Commission's statutory authority under Section 206(4) and should not be adopted.

Section 211(a) in relevant part authorizes the Commission to issue rules consistent with statutory functions and powers otherwise conferred on the Commission. Although the Commission cites Section 211(a), it does not provide any explanation or analysis for its applicability here. Section 211(a) does not provide the Commission with the power to promulgate rules that affect markets and market participants outside the scope of the Commission's existing authority.

Finally, Section 223 of the Advisers Act authorizes the Commission to adopt rules prescribing "steps" a registered investment adviser must take "to safeguard client assets over

---

60 *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (codified at 17 C.F.R. Pts. 23 and 140), available at: https://www.govinfo.gov/content/pkg/FR-2016-01-06/pdf/2015-32320.pdf; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 89 Fed. Reg. 229 (Jan. 5, 2021) (codified at 17 C.F.R. Pt. 23), available at: https://www.govinfo.gov/content/pkg/FR-2021-01-05/pdf/2020-27736.pdf.

61 15 U.S.C. § 80b-6(4), § 80b-3(d).

62 *See, e.g.*, Proposing Release at 14694 ("[T]he proposed indemnification requirement would likely operate as a substantial expansion in the protections provided by qualified custodians to advisory clients, in particular because it would result in some custodians holding advisory client assets subject to a simple negligence standard rather than a gross negligence standard").

which such adviser has custody."[63] The scope of the proposed safeguarding rule is so expansive, and would have such a significant and far-reaching impact on financial markets and market participants, that the rule extends beyond the authority granted to the Commission by Congress in three critical ways.

First, the Commission's authority under Section 223 is textually limited to regulating adviser safekeeping practices—*i.e.*, "steps to safeguard client assets." Yet the Proposal would not only regulate those practices but would more generally regulate investor access to entire asset classes and markets. As described in this letter, the Proposal would significantly disrupt certain critical financial markets (including the credit markets, the OTC derivatives markets, the commodities markets, and the markets for prime brokerage services) and could drive advisory clients out of these markets, as well as certain non-U.S. financial markets, unless the clients determine to conduct their activities without the involvement of a registered investment adviser. The scope of the Proposal, which the Commission stated expressly is designed to "remain evergreen," would force significant shifts in existing market practices in numerous asset classes in ways that are not appropriately designed to facilitate the safekeeping of advisory client assets. This would be a "transformative expansion" of the Commission's regulatory authority under the sections of the Advisers Act cited by the Commission in the Proposing Release.[64]

Second, the Commission's authority under Section 223 is textually limited to the practices of "investment adviser[s] registered under [the Advisers Act]." However, the Proposal would not only regulate registered investment advisers but would also serve to indirectly regulate qualified custodians through prescribed contractual provisions and reasonable assurances requirements, imposing, among other obligations, a negligence standard of liability on custodians that is not contemplated by any statutory authority and is not appropriately imposed on market participants by the Commission. Under the proposed safeguarding rule, custodians will not be eligible to serve as "qualified custodians" unless they enter into written agreements with advisers and provide reasonable assurances to advisers, including that the custodian will indemnify the client (and will 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.[65]

---

[63] 15 U.S.C. § 80b-18b.

[64] *See, e.g.*, *West Virginia v. EPA*, 142 S. Ct. 2587, 2595 (2022) (determining that the Clean Power Plan proposed by the Environmental Protection Agency represented a transformative expansion of the agency's authority under the Clean Air Act because the plan pursued "a broader, forward-thinking approach to the design of Section 111 regulations that would improve the overall power system, rather than the emissions performance of individual sources, by forcing a shift throughout the power grid from one type of energy source to another") (internal citations omitted).

[65] Requirements applicable to actors historically outside the scope of relevant statutory authority were struck down by a federal appeals court reviewing the Department of Labor's "Best Interest Contract Exemption" ("**BICE**"). *See U.S. Chamber of Commerce v. U.S. Dep't of Labor*, 885 F.3d 360, 382 (5th Cir. Mar. 15, 2018) ("[T]he [BICE] 'exemptions' actually subject most of these newly regulated

Third, the Commission's authority under Section 223 is textually limited to "client assets" over which the adviser has "custody." Yet the Proposal would apply to "positions" over which the adviser never has custody in any real sense, and to assets over which the adviser does not retain custody for the life of the transaction. As noted above, the Commission explains in the Proposing Release that the reference to "other positions" in the proposed rule is intended to serve as a catchall for, among other things, positions that may not necessarily be recorded on a balance sheet for accounting purposes, such as short positions and written options, and assets that may not clearly be "funds" or "securities," such as financial contracts held for investment purposes and collateral posted in connection with swap contracts on behalf of a client.[66] However, certain "positions" that would appear to be captured by the Proposal (*e.g.*, off-balance sheet contracts and arrangements) may not be "assets" and may not be in the adviser's "custody" and cannot practically be placed in the custody of a third party.[67] Similarly, it is unclear how a custodian could maintain custody over assets over which neither the client nor the adviser has custody for the life of the relevant transaction (*e.g.*, collateral posted in connection with a client's financial contract when the collateral is subject to rehypothecation) without significant market disruption. The Proposal also seeks to regulate the custody, segregation and safekeeping of certain asset classes that are within the purview of other federal regulators, such as commodities and non-security derivatives (which fall under the orbit of the CFTC) and energy products (which fall under the orbit of FERC).

At a minimum, given the sweeping consequences described in this letter that are likely to arise if the Proposal is adopted, the Commission must identify a clear statement from Congress authorizing its actions.[68] For any one of the foregoing three reasons, it cannot do so.

In addition to exceeding its statutory authority, the Commission has acted arbitrarily and capriciously in proposing a rule that would substantially impact markets and asset classes that were apparently not considered by the Commission in its evaluation of the Proposal's economic impact. As discussed above, although the Commission devotes several paragraphs to discussing the potential costs associated with expanding the scope of assets subject to the rule to include crypto assets, the Commission does not address in any meaningful respect the potential costs associated with expanding the scope of assets to include regularly traded commodities, syndicated loans, derivative contracts, and securities financing agreements, among many other asset classes.

---

actors and transactions to a raft of affirmative obligations. Among the new requirements, brokers and insurance salespeople assume obligations of loyalty and prudence only statutorily required of ERISA plan fiduciaries.").

66 Proposing Release at 14679. As discussed in this letter, it is questionable whether a qualified custodian could even be introduced into certain client "positions" (*e.g.*, bilateral contracts) in a manner that would allow the custodian to have custody in compliance with the rule.

67 As discussed in this letter, it is questionable whether a qualified custodian could even be introduced into certain client "positions" (*e.g.*, bilateral contracts) in a manner that would allow the custodian to have custody in compliance with the rule.

68 *West Virginia*, 142 S. Ct. 2587.

Accordingly, if enacted, the Proposal would exceed the Commission's statutory authority and would be arbitrary and capricious. For these and other reasons stated in this letter, the Proposal must be withdrawn and re-proposed with a more limited scope, following an appropriate cost-benefit analysis of any existing gaps in practices relating to the safekeeping of advisory client assets.

* * * * *

In conclusion, while MFA and its members fully recognize the importance of safeguarding client assets, we do not believe the requirements set out in the Proposal are necessary or appropriately tailored to actual or potential risks that client assets will be lost, misused, stolen or misappropriated, or captured by the financial reverses of the adviser. We are concerned that the Proposal is overly broad, not appropriately tailored to accomplish the Commission's investor protection goals, and would have significant unintended consequences that we believe the Commission has not fully considered. For these reasons, we believe the Proposal should be withdrawn and, to the extent necessary re-proposed, only after the Commission has addressed the many fundamental flaws in the Proposal discussed above.

MFA appreciates the opportunity to provide comments to the Commission on the Proposal. If you have any questions about these comments, please do not hesitate to contact Matthew Daigler, Vice President & Senior Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/S/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs

cc: The Hon. Gary Gensler, Chairman
The Hon. Hester M. Peirce, Commissioner
The Hon. Caroline A. Crenshaw, Commissioner
The Hon. Jaime Lizárraga, Commissioner
The Hon. Mark T. Uyeda, Commissioner
Mr. William Birdthistle, Director, Division of Investment Management

Annex A

Safeguarding Rule Proposal: Asset Analysis

This Annex A is a brief summary of certain implications of the Proposal on a range of asset classes in which investment advisers may transact on behalf of their clients. The analysis in this Annex is preliminary, does not include all asset classes in which investment advisers transact, and cannot replace the thorough cost-benefit analysis that the Commission should undertake before any determination to re-propose a new safeguarding rule. The analysis in this Annex is focused on, among other things, the theoretical availability of qualified custodians and implications for collateral with respect to various asset classes but does not purport to address all of the flaws or difficulties that would follow from the Proposal, many of which are described in the body of the letter to which this Annex is attached. For example, the likelihood that custodians would exit certain markets (including by refusing to provide the contractual terms or assurances required by the Proposal) or provide custodian services only on uneconomic terms is not included among the implications of the Proposal summarized in this Annex.

	Asset Class	**Description of Assets/Transactions**	**Collateral**	**Implications of Proposal**
1.	Bilateral OTC Derivatives, including Security Options, Securities Forwards, Security-Based Swaps, and Swaps and Other Non-Securities Derivatives	Privately negotiated, bilateral derivatives contracts. One or more third-party custodians may be involved in the transaction to hold collateral in certain cases.	In general, for swaps and security-based swaps, clients whose average notional amount calculation is above $8 billion must collect and post regulatory initial margin above a $50 million threshold.[69] Regulatory initial margin must be segregated and held by a custodian that is independent of the counterparties. Clients may also post non-regulatory initial margin, such as an "independent amount."	The proposed extension of the rule's requirements to "other positions held in a client's account," along with statements in the Proposing Release, would apply the rule's requirements to assets held off balance sheet, including financial contracts held for investment purposes. The proposed asset segregation requirements would appear to restrict the rehypothecation of collateral currently available for that purpose. It is unclear how an adviser could maintain an OTC contract with a qualified custodian in accordance with the requirements of the Proposal (*i.e.*, the qualified custodian

[69] Certain differences exist if trading with a nonbank dealer subject to SEC margin rules.

	Asset Class	Description of Assets/Transactions	Collateral	Implications of Proposal
			The independent amount may or may not be subject to segregation at a third-party custodian, depending on the client's election and commercial considerations. Clients generally also exchange variation margin. Variation margin is typically available for hypothecation by the receiving party unless posted by a registered fund or similar client subject to asset segregation requirements.	maintaining "possession or control" over the contract). Also, the asset segregation requirements would impose considerable costs not considered by the Commission in the Proposing Release. *See* Comment Letter Sections II.A.1.i and II.A.1.ii.
2.	Cleared Security-Based Swaps	Security-based swaps that clear and settle through a central clearing house. The clearing house is the counterparty to the transaction. Clients are typically not members of the clearing house and access through a broker-dealer ("**B-D**") / futures commission merchant ("**FCM**") under portfolio margin relief granted by the SEC.	Central counterparty sets collateral requirements. Collateral is typically posted/received through a customer account maintained by the client's B-D/FCM (usually, as a portfolio-margined position in an FCM cleared swap account).	The Proposal would leave a gap in the ability of FCMs to act as qualified custodians with respect to these contracts and related collateral. FCMs are permitted by SEC portfolio margin exemption to clear transactions in single-name credit default swaps (and custody securities incidental thereto). *See* Comment Letter Section II.B.5.

	Asset Class	Description of Assets/Transactions	Collateral	Implications of Proposal
3.	Cleared Swaps	CFTC-regulated swaps that clear and settle through a central clearing house. The clearing house is the counterparty to the transaction. Clients are typically not members of the clearing house and access through an FCM.	Central counterparty sets collateral requirements. Collateral is typically posted/received through a customer account maintained by the client's FCM.	The Proposal would leave a gap in the ability of FCMs to act as qualified custodians with respect to these contracts and related collateral. FCMs are permitted to clear CFTC-regulated swaps (and custody securities incidental thereto). *See* Comment Letter Section II.B.5.
4.	Listed Commodity Futures and Futures Options	Listed/exchange-traded commodity futures contracts, or options on such a future. The exchange / clearing house is the counterparty to the transaction. Clients are typically not members of the clearing house and access through an FCM.	Exchanges set collateral requirements. Collateral (initial and variation margin) is typically posted/received through a customer account maintained by the client's FCM. Positions generally settle daily through the posting/receipt of variation margin directly to the client's account with an FCM.	The Proposal would leave a gap in the ability of FCMs to act as qualified custodians with respect to these contracts while permitting FCMs to act as qualified custodians with respect to the related collateral. *See* Comment Letter Section II.B.5.
5.	Listed Security Futures Products	Listed/exchange-traded futures contracts on a single non-exempt security or narrow-based security index, or options on such a future. The exchange / clearing house is the counterparty	Exchanges set collateral requirements. Collateral (initial and variation margin) is typically posted/received through a customer account maintained by the client's B-D/FCM. Positions generally settle daily through the	No material change anticipated because security futures and related collateral are maintained through a B-D/FCM that can serve as a qualified custodian for purposes of the rule.

	Asset Class	Description of Assets/Transactions	Collateral	Implications of Proposal
		to the transaction. Clients are typically not members of the clearing house and access through a B-D or FCM.	posting/receipt of variation margin directly to the client's account with a B-D/FCM.	
6.	Listed Securities Options	Listed/exchange-traded option on a security or index of securities. The exchange / clearing house is the counterparty to the transaction. Clients are typically not members of the clearing house and access through a B-D.	Exchanges set collateral requirements. Collateral (initial and variation margin) is typically posted/received through a customer account maintained by the client's B-D.	No material change anticipated because the option and related collateral are maintained through a B-D that can serve as a qualified custodian for purposes of the rule.
7.	Securities Financing Transactions	Securities lending/borrowing contracts, repurchase agreements and reverse repurchase agreements. One or more third-party custodians can be involved in the transaction to hold collateral in certain cases.	Securities can be posted as collateral for the transaction.	The proposed extension of the rule's requirements to "other positions held in a client's account," along with statements in the Proposing Release, would apply the rule's requirements to assets held off balance sheet, including financial contracts held for investment purposes. The proposed asset segregation requirements would appear to restrict the rehypothecation of collateral currently available for that purpose. It is unclear how an adviser could maintain a securities financing contract with a qualified custodian in accordance with the requirements of the Proposal (*i.e.*, the qualified custodian

	Asset Class	Description of Assets/Transactions	Collateral	Implications of Proposal
				maintaining "possession or control" over the contract). In addition, underlying collateral currently is subject to rehypothecation by firms facilitating these transactions in many cases, and the asset segregation requirements of the Proposal could substantially increase costs of securities financing transactions or make margin financing unavailable. *See infra* "Depository Eligible Securities."
8.	Depository Eligible Securities	A security that is freely tradeable pursuant to U.S. securities laws and is otherwise qualified to be held at a depository (*e.g.*, DTC) and serviced.	None.	The asset segregation requirement would appear to restrict a B-D acting as a custodian from rehypothecating client assets, which is permitted subject to limits imposed under SEC B-D regulations. Prohibiting rehypothecation would either significantly increase the fees and rates charged by B-Ds to clients (negatively impacting returns) or make margin financing unavailable to some clients. *See* Comment Letter Section II.A.1.ii.
9.	Non-Depository Eligible Securities	Private securities that are not freely tradeable and are ineligible to be held at a depository, as well as other securities held directly on the books of the issuer or transfer agent.	None.	The Proposal would substantially limit the availability of the exception for these types of securities. It is unclear how advisers could properly determine that ownership of the securities cannot be recorded and maintained in a manner that permits a qualified custodian to maintain possession or control. Transaction and asset verification requirements would impose significant additional costs and could drive some advisory clients away from these

	Asset Class	Description of Assets/Transactions	Collateral	Implications of Proposal
				securities. *See* Comment Letter Section II.B.7.
10.	CDs and other transferable bank-issued instruments	Cash-like instruments issued by banks, such as CDs.	None.	The Proposal would require banks and savings associations to hold client funds in special accounts designed to protect those assets from creditors in the event of insolvency of the financial institution. A requirement to establish such accounts would represent a substantial departure from banks' current operational models. See Comment Letter Section II.B.2.
11.	Loans	Loans and related instruments, such as borrowing arrangements involving the client or client interests in loan participations.	Loans may be secured by underlying collateral, including securities and physical assets.	The Proposal would extend safekeeping requirements to all loans and loan participations (beyond debt instruments treated as securities and subject to the current custody rule). It is unclear how an adviser could maintain a loan agreement with a qualified custodian in accordance with the requirements of the Proposal (*i.e.*, the qualified custodian maintaining "possession or control" over the contract). In the Proposing Release, the SEC suggests that a qualified custodian would be required to participate in transactions involving the acquisition or transfer of interests in loans, which may not be commercially feasible. *See* Comment Letter Section II.A.2.
12.	Physical Commodities	Physical commodities such as gold, art, oil	None (although certain commodity transactions, such	The Proposal would extend safekeeping requirements to physical commodities.

	Asset Class	**Description of Assets/Transactions**	**Collateral**	**Implications of Proposal**
		barrels, crops, etc.	as forwards or loans, may be collateralized).	Depending on the nature of the asset, advisers may be able to rely on the exception for physical assets unable to be maintained with a qualified custodian, but would have to determine that no custodian is available. Transaction and asset verification requirements would impose significant additional costs, particularly for commodities that are traded frequently/on an intraday basis. It is unclear how the Proposal would interact with other regulatory regimes governing transfer and custody of certain physical assets, and whether SEC has jurisdiction to dictate custody requirements for these assets. *See* Comment Letter Section II.A.3.
13.	Intangible Commodities	Intangible commodities such renewable energy certificates (RECs) and other environmental commodities.	None (although certain commodity transactions, such as forwards or loans, may be collateralized).	The Proposal would extend safekeeping requirements to intangible commodities. It is unclear how all intangible commodities could be held with a qualified custodian.
14.	Digital Assets	Assets recorded on a blockchain.	None (although certain digital asset transactions, such as loans or derivatives, may be collateralized).	The Proposal would extend safekeeping requirements to all digital assets. It is likely that none would be able to rely on the private securities / physical assets exemption because digital assets are publicly recorded on a blockchain and custodians are able to maintain possession and control of the private key.
15.	Fiat Currencies	Government-issued currency that is not	None.	The Proposal would require banks and savings associations to hold client funds in special

	Asset Class	**Description of Assets/Transactions**	**Collateral**	**Implications of Proposal**
		backed by a commodity.		accounts designed to protect those assets from creditors in the event of insolvency of the financial institution. A requirement to establish such accounts would represent a substantial departure from banks' current operational models. *See* Comment Letter Section II.B.2.