STATE STREET.

State Street Corporation

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May 8, 2023

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Via e-mail: rule-comments@sec.gov

**Re: Proposed Rule - Safeguarding Advisory Client Assets (File Number: S7-04-23)**

Dear Sir/ Madam:

State Street Corporation ("State Street") appreciates the opportunity to comment on the Securities and Exchange Commission's ("Commission") proposed Investment Advisers Act Rule 223-1 (the "Proposed Rule") which seeks to establish a new and significantly expanded regulatory regime for the safeguarding of assets on behalf of clients of Registered Investment Advisors ("RIAs"). State Street is concerned that the Proposed Rule, if adopted, will both significantly limit the ability of RIAs to secure custody services for a broad range of investment assets on behalf of their clients, including assets located in most, if not all, non-United States ("US") jurisdictions, while also substantially increasing the cost of services that a qualified bank custodian may be willing to continue to provide. The result will significantly reduce investment opportunities for RIA clients, greatly limiting the ability of both individuals and institutions to meet their financial goals, including retirement security.

Headquartered in Boston, Massachusetts, State Street is a global custody bank which specializes in the provision of financial services for institutional investor clients, such as asset owners, asset managers and official sector institutions. This includes investment servicing, investment management, data and analytics, and investment research and trading. With $37.6 trillion in assets under custody and administration and $3.6 trillion in assets

under management[1], State Street offers its clients the ability to transact and hold assets in more than 100 geographic markets globally.[2] State Street is organized as a US bank holding company, with operations conducted through several entities, primarily its wholly-owned state-chartered insured depository institution subsidiary, State Street Bank and Trust Company. As a bank holding company, we are subject to consolidated supervision by the US Federal Reserve System.

The Proposed Rule suffers from a number of material flaws which are addressed at length in various industry association comment letters. These include:

- The requirement for bank custodians to segregate client cash, as discussed in more detail below;
- The extension of the safekeeping obligation to broad categories of investment assets, such as derivatives, bank loans and foreign currency forwards that are not and cannot, as a practical matter be held in custody;
- The expansion of custodial liability to include subcustodians without limitation, and central securities depositories over which the qualified custodian does not exercise control, many of whom, particularly outside the US, will likely be unwilling to comply with the Proposed Rule;
- The imposition of expansive new contractual mandates for qualified custodians relative to RIAs and market participants in the chain of custody, including indemnification obligations which are unnecessary and unlikely to materially enhance investor protection; and
- The obligation to monitor on a pre-settlement basis the investment activities of RIAs to ensure compliance with client-imposed investment mandates and any applicable restrictions.

These various new obligations will create an RIA regulatory framework for custody services that for the most part simply cannot be met or, where they can be met, only with a significant increase in cost and a commensurate reduction in wealth accumulation, including retirement savings.

Our comments today focus on what State Street views as the most significant flaw in the Proposed Rule, at least with respect to custody banking, which is the mandate for the segregation of deposits held by qualified bank custodians for clients advised by RIAs.

[1] Assets under management as of March 31, 2023 includes approximately $59 billion of assets with respect to SPDR® products for which State Street Global Advisors Funds Distributors, LLC (“SSGA FD”) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.
[2] As of March 31, 2023.

## The Importance of Segregation in Custody Banking

To start, State Street fully supports the Commission's focus on the segregation of RIA clients' investment assets from the assets of a custodian. While cash is handled differently, full segregation of client securities and other non-cash assets from the potential bankruptcy of the custody bank is an underlying principle of custody banking.

Under current practice, securities (but not cash) owned by custody bank clients, including RIA-advised asset owners, are held in bankruptcy remote securities accounts, which typically make up over 95% of total client assets. The securities held in these accounts are fully protected from a custody bank insolvency, and are not available to creditors of a failed bank. While we have concerns with the suitability and possibility of the broadening of the scope of the RIA custody mandate to certain assets under the Proposed Rule for other reasons, to the extent financial assets other than cash are held in custody, they should be segregated from the proprietary assets of a qualified custodian.

With the exception of cash, we support the Commission's proposed change to condition a bank's qualified custodian status on holding RIA client assets in "an account designed to protect such assets from creditors of the bank in the event of the insolvency or failure of the bank…". This is a key element of the investor protection provided by the use of a bank custodian, and we support modifying the Commission's definition of qualified custodian to mandate such segregation.

## Current Custody Bank Approach to Cash Deposits

As described above, the vast majority of RIA client assets held by custody banks are securities, which are bankruptcy remote and fully segregated from the assets of the custody bank. Under the Proposed Rule, additional non-cash assets which a custody bank agrees to hold in custody would need to be held in similarly segregated accounts.

Each custody client, however, maintains a separate cash deposit account with the custody bank into which it deposits funds to be invested on its behalf by the RIA. These deposit accounts are largely operational accounts intended to support client investment activity, including payment and receipt of cash in connection with purchases and sales of securities, the receipt of dividends, income and corporate action or maturity proceeds, and the payment of expenses, each of which are integral to the securities settlement process. Like other deposit accounts, custodial cash deposit accounts become balance sheet liabilities of the custody bank, and, as noted in the Commission's Proposed Rule preamble, such accounts create a debtor-creditor relationship between the account holder and the custody bank.

Custody deposit accounts form the foundation for the banking services provided by custody banks. Client deposits are invested by the custody bank in a conservative portfolio of assets, primarily highly liquid central bank deposits and short-term debt, but are also used to fund custody-related banking services. These services include intra-day and overnight credit in support of securities settlement activity, which is critical to the smooth functioning of the securities markets. Custody-related banking services also include credit facilities to mutual funds and exchange-traded funds ("ETFs"), which provide a flexible liquidity source which can be draw upon in times of excessive fund outflows. Like all banks, such funding of balance sheet assets comes from client deposits.

Custody bank clients have ample opportunity and options to actively manage their credit risk to their custody bank and increase their investment yield on cash. Clients typically manage the level of their non-operational deposits on a daily basis by sweeping end-of-day cash balances outside of the custody bank, primarily through money market fund sweeps and repurchase agreements. While clients need to maintain sufficient cash balances with the custody bank to meet forecasted cash flow from settlement and other activity, the management of cash beyond the day's operational need is fully at the discretion of the client or a fiduciary, such as an RIA, acting on the client's behalf.

With respect to RIAs specifically, as the Commission points out in the Proposed Rule release, "advisers must continue to exercise their fiduciary duties to clients in connection with the selection and monitoring of the qualified custodian," which presumably includes prudent management of client cash.

**The Commission's Proposal**

The Commission has proposed a radical change in the treatment of cash managed by RIAs held at bank custodians. Under the Commission's proposal, cash held at custodians must, like financial assets, be held in accounts "designed to protect such assets from the creditors of the bank in the event of insolvency or failure of the bank …" The Commission seems to be envisioning the use of some kind of special deposit account, akin to holding cash in the bank's safe.

To put it simply, the Commission's proposal is unworkable and fundamentally at odds with how banks – including custody banks --- provide banking services to clients.

**Negative Impacts of the Proposed Rule**

The Commission's cash segregation proposal for custody banks, if adopted, would require a significant and untenable restructuring of the custody bank business model for those banks choosing to service RIA-managed investment accounts. If expanded, as suggested by a question from the Commission in the Proposed Rule, to other SEC-regulated entities, such as Registered Investment Companies, the consequences would be even more severe.

First, and most importantly, the Commission's proposed cash segregation mandate will significantly degrade the banking services available to custody clients, creating significant operational challenges and damage for investors. Under the current custody banking model, the custody bank balance sheet is funded by client deposits. Most of this funding is invested in highly liquid assets (such as central bank placements and short-term debt), but the custody bank's balance sheet also provides funding for lending to custody clients, primarily for day-to-day operational needs such as intraday and overnight credit.

As currently practiced, custody banks use this credit capacity to smooth the settlement of securities transactions and other client investment activity. Credit is extended to fund various client cash disbursements, such as securities purchases, in advanced of corresponding client cash receipts, such as securities sales. Absent this banking service provided to custody clients, all client disbursements would need to be fully pre-funded, slowing securities settlement and other investment activities, and creating the high risk of securities trading fails which may involve penalties and even the suspension of trading authority under various settlement failure regimes. The resulting increase in failed trades and lack of custody-related credit extensions will significantly disrupt RIA-advised investment activity, and limit investment strategy options for investors.

Second, the Commission's Proposed Rule will dramatically increase costs to investors. As in other types of banking, cash on deposit at a custody bank is invested by the bank in income producing assets, resulting in net interest income ("NII") to the bank. While custody bank revenue is typically weighted more heavily toward fees than other banking business models, NII is still a critical element of the custody bank business model, often representing 20% or more of total revenue. Under the Proposed Rule, custody banks would be denied the ability to make use of RIA client cash deposits, and the lost revenue would need to be recovered through increased fees charged and elimination of interest paid to clients.

In addition to the loss of NII, custody banks would also need to recover from their RIA clients the cost of obtaining alternative sources of funding, most likely in the wholesale market, and the substantial expenses need to completely overhaul existing internal custody, payment and accounting systems to meet the requirements of the Proposed Rule.

Finally, given the limited substantive discussion and lack of detail in the Commission's release, it is extraordinarily uncertain how an RIA is expected to identify a qualified bank custodian that meets the cash segregation requirements of the Proposed Rule. Does the bank custodian need to segregate cash at end of day, or is the cash account somehow required to be segregated throughout the day? Can an RIA place client cash at a bank other than the custodian, taking on credit risk to that bank instead of the custody bank? If so, does moving cash to another bank impose the qualified custodian segregation mandate on that bank as well? How does the Commission's new segregation approach interact with the Federal Deposit Insurance Corporation's depositor preference rules? The Commission provides no technical detail or guidance in the Proposed Rule, and seems to assume bank deposit structures to accomplish its cash segregation mandate are commonly used and well understood, which is not correct. Should the Commission intend to propose an entirely new approach for managing cash related to RIAs, it needs to provide significantly more detail and analysis.

**Recommendation**

As noted above, State Street has numerous significant concerns with the Proposed Rule, as captured in industry association comment letters to the Commission. At a high level, we recommend that the Commission withdraw the Proposed Rule, better articulate its policy goals, and, if needed, re-propose a new rule better targeting investor protection and other policy mandates.

With respect to the Commission's cash segregation proposal specifically, State Street recommends that any new segregation requirement adopted as part of the Commission's definition of a qualified bank custodian explicitly provide an exception for cash on deposit with the custody bank.

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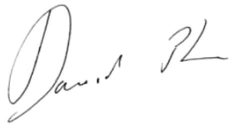
**Conclusion**

Thank you once again for the opportunity to comment on the important matters raised within the Proposed Rule, particularly as it relates to the requirement to segregate RIA client cash deposits.

Sincerely,



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