Via Electronic Submission

Venessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: **File Number S7-04-23**
Investment Advisers Act Release No. 6240, Safeguarding Advisory Client Assets[1]

HSBC Securities (USA) Inc., on behalf of itself and its affiliates worldwide (collectively, **HSBC**), appreciates the opportunity to comment on the Securities and Exchange Commission's (the **Commission**) above-captioned rule proposal (the **Proposed Rule**).

HSBC is one of the world's leading international banks. Through our Markets and Securities Services (**MSS**) business, HSBC provides global custody, direct custody and clearing services to institutional clients[2] with approximately $8.4 trillion in total custodied assets. Through our global custody network, HSBC's institutional clients and their underlying investors can access multiple asset classes in 96 markets worldwide. Additionally, HSBC launched a U.S. prime brokerage platform in 2022 that provides execution, financing and custody services to investment funds and advisers.

Given the international nature of our MSS business, we are especially concerned that the Proposed Rule would inappropriately limit the ability for investors acting through U.S. registered investment advisers (**RIAs**) to invest in markets outside of the United States (**Non-U.S. Markets**) by making it impracticable for them to transact in and hold cash and non-cash assets located outside of the United States (**Non-U.S. Assets**).[3] Investing in Non-U.S. Markets helps such investors (**RIA Investors**) to diversify their risks and returns, including by accessing higher growth emerging markets.

Of course, the different legal, operational, and business conventions in Non-U.S. Markets can expose RIA investors to different custodial and other risks than when they invest in U.S. Assets. RIAs weigh these potential risks and returns, negotiate for appropriate contractual and other protections with relevant U.S. and non-U.S. custodians, and provide full and fair disclosure

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

[2] Institutional clients include sovereign wealth managers, governments/states, pension funds, asset managers, insurance companies, other custody banks and broker-dealers.

[3] Conversely, the term "**U.S. Assets**" is used throughout to refer to both cash and non-cash assets located inside the United States.

to their clients about the risks and benefits of investing in Non-U.S. Markets, all taking into the RIA's fiduciary duty to those clients.

The Proposed Rule would interfere with this RIA responsibility by imposing *de facto* limits on permissible investments through overly prescriptive safekeeping requirements. In particular, there are three aspects of the Proposed Rule that could potentially make certain Non-U.S. Markets effectively off-limits to RIA Investors: (1) the requirement that RIAs ensure all client assets placed with the foreign financial institution (**FFI**) are held in bankruptcy-remote accounts that would provide comparable protections to those assets as if they were held in the United States (the **FFI Comparability Requirement**);[4] (2) the requirements for a custodian to provide a broad indemnification to, and for the RIA to obtain written assurances from, the custodian that the existence of any sub-custodial or securities depositary arrangement will not excuse the custodian's obligations to the client (the **Custodial Liability Requirements**);[5] and (3) the requirement for cash segregation by banks (the **Bank Cash Segregation Requirement**).[6]

Below we provide some background addressing the characteristics of Non-U.S. Markets that inform our comments before summarizing our concerns with these three requirements.[7]

1. Investing in Non-U.S. Markets Requires Interaction with Local Market Infrastructures, Legal Systems, and Market Conventions

Our comments are informed by our experience offering custody and clearing services for Non-U.S. Assets to RIA Investors either directly (*e.g.*, as global custodian, or direct local

[4] Proposed 17 C.F.R. § 275.223-1(d)(10)(iv)(A) and (D); 88 Fed. Reg. 14,684, 14,744 (the Commission proposes to adopt "an additional segregation requirement for FFIs" designed to provide protections "that are more comparable to those [the Commission] [is] proposing for [U.S.] assets held with U.S.-regulated bank or savings association qualified custodians.").

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

[6] Proposed 17 C.F.R. § 275.223-1(a)(1)(ii)(D), (a)(3), (d)(10)(i) and (d)(10)(iv)(D).

[7] In addition to the concerns set out in this letter, we also share the broader concerns with the Proposed Rule that have been expressed within the submissions of the American Bankers Association (**ABA**), the ABA Securities Association, the Bank Policy Institute, the Financial Services Forum, the Association of Global Custodians, the Association of Financial Markets in Europe, the European Banking Federation, Futures Industry Association, and the Securities Industry and Financial Markets Association, among others. In particular, we reiterate the point articulated by several commenters that the Proposed Rule's segregation requirements effectively prohibit rehypothecation of client assets by qualified custodians, including by prime brokers. This directly conflicts with the Commission's own customer protection and segregation rules for broker-dealers and security-based swap dealers, which allows for certain amounts of securities collateral to be de-segregated and rehypothecated. Similar conflicts are raised vis-à-vis uncleared swaps margin rules adopted by the Commodity Futures Trading Commission and Prudential Regulators. Rehypothecation is critical to the practice of prime brokerage, including extensions of credit and the facilitation of liquidity through margin lending, as well as swap and security-based swap dealing. The prohibition on rehypothecation by prime brokers and swap and security-based swap dealers would materially reduce liquidity, for both U.S. and Non-U.S. Assets, available to investment funds acting through RIAs and would significantly increase costs and risks for the investors in these funds.

custodian, to the investor) or indirectly (*e.g.*, as sub-custodian to the global custodian acting for the investor).

In both scenarios, our custody services facilitate RIA Investor access to the relevant non-U.S. financial market infrastructure (**FMI**) used to hold, transfer, and settle transactions in Non-U.S. Assets. For example, if an RIA Investor intends to purchase or sell a non-U.S. security, the custodian will facilitate access[8] to, as relevant, the issuer/registrar, the securities settlement system (typically operated by central securities depositories (**CSDs**) or international central securities depositories (**ICSDs**)), the clearing system (typically operated by a central clearing counterparty (**CCP**)), the payment system (typically operated by or in cooperation with a national central bank) and local tax and regulatory authorities.

In most Non-U.S. Markets, there is typically only one or a very small number of FMIs that service all Non-U.S. Assets in that market, meaning that investors in that market must submit to the legal and operational framework of those FMIs. Most non-U.S. FMIs also limit direct membership/access to local financial institutions. As a result, RIA investors need a non-U.S. custodian to facilitate access to non-U.S. FMIs and, in turn, Non-U.S. Markets. In other words, RIA Investors cannot access Non-U.S. Markets without taking on the risks of using local FMIs and custodians.

The use of a given local FMI and custodian, and the effectiveness of the local regulatory/insolvency regimes and ability to enforce court judgments locally, are accordingly all aspects of the "country risk" associated with foreign investment. The same is true of the risks arising out of the regulation and operation of other entities and infrastructures within those jurisdictions. We would expect such country risk to be relevant to the decision of an RIA Investor or RIA to participate and invest in a given Non-U.S. Market.

As described below, however, the Proposed Rule would take this decision out of the hands of RIA Investors and RIAs by either: (i) preventing non-U.S. custodians from being able to provide custody services for Non-U.S. Assets; or (ii) increasing the costs to RIA Investors in obtaining custody services for Non-U.S. Assets.

2. The FFI Comparability Requirement Would Prevent RIA Investors from Accessing Certain Markets

Legal and regulatory frameworks and market practices for the custody and protection of client assets vary globally. While in many markets, local rules and market practice are aligned with the International Organization of Securities Commissions (**IOSCO**) standards for the protection

[8] In facilitating such access, the core services of the custodian will include safeguarding and recordkeeping services, asset servicing (including income and tax, corporate action and collateral processing and valuation and reporting), transaction processing and settlement and associated banking services, such as payment and liquidity services (including the extension of intraday and overnight credit and liquidity and foreign exchange services).

and custody of client assets,[9] this may not always be the case due to, among others, differences between U.S. and non-U.S. custody along with varying depositor/investor protection schemes and bankruptcy/insolvency regimes.

While custodians (non-U.S. and U.S. alike) often can provide clients with assurances that they will comply with all local laws, regulations, and market practices in the jurisdictions they operate—including those related to client asset protection— they typically cannot provide clients with assurances that the local custody regime for Non-U.S. Assets provides protections comparable to what would be available for U.S. Assets because they do not control the relevant legal and regulatory frameworks or market practices. Differences in rules and market practice are an inherent risk of an investment in the relevant Non-U.S. Market and are relevant to the decision of an RIA Investor or RIA to engage in that market. The custodian cannot control and should not be asked to assume this risk.

The existence of differences in custodial protections does not mean that Non-U.S. Markets are entirely without protections. Rather, these differences simply affect the investment risk/return analysis for RIAs and RIA Investors. It would be inappropriate for the Commission to prohibit RIA Investors from accessing Non-U.S. Markets simply due to the presence of different legal and regulatory frameworks for custodians in those markets.

3. The Custodial Liability Requirements Would Conflict with Global Regulatory Standards and Market Conventions

The Custodian Liability Requirements could result in the custodian being held liable for losses beyond its control (including for the actions, or insolvencies, of CSDs/ICSDs and other sub-custodians and for force majeure events). This requirement is inconsistent with existing global regulatory standards and market practice for the oversight of sub-custody and depositary arrangements today. Typically, custodians accept responsibility for exercising all due skill, care and diligence in the selection, appointment and periodic review of any party they appoint or utilize for the holding and safekeeping of client assets[10] and do not accept responsibility for the actions

[9] *See* IOSCO, Recommendations Regarding the Protection of Client Assets, Final Report FR01/14 (January 2014) (**IOSCO Clients Assets Protection Recommendations**), *available at*: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf, and IOSCO, Standards for the Custody of Collective Investment Scheme Assets (**IOSCO CIS Custody Standards**), Final Report FR25/2015 (November 2015), available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD512.pdf.

[10] *See, e.g*., Principle 3(3) IOSCO Client Assets Protection Recommendations, Standard 5 IOSCO CIS Custody Standards, UK Financial Conduct Authority's (**FCA**) Rule CASS 6.3.1R (regarding depositing safe custody assets with third parties), available in Chapter 6 of the Client Assets sourcebook in the FCA Handbook ("**FCA Custody Rules**") *available at*: https://www.handbook.fca.org.uk/handbook/CASS/6/?view=chapter and Article 3(1) of the European Union's European Commission Delegated Markets in Financial Instruments Directive (EU) 2017/593 ("**MiFID Delegated Directive**"), *available at*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02017L0593-20221122.

of any sub-custodian or depositary they appoint or utilize which are outside of their control.[11]

If custodians (U.S. and non-U.S. alike) are required to accept liability for losses caused by sub-custodians and CSDs/ICSDs that they do not control, we would expect those custodians either to stop providing custody services in certain Non-U.S. Markets to RIA Investors and/or to increase their fees for doing so. This, in turn, impacts the ability of RIA Investors to access those Non-U.S. Markets, particularly ones where there are a limited number of custodians to choose from.

4. The Bank Cash Segregation Requirement is Not Practically Feasible and Could Require Prohibitively Costly Pre-Funding and Limit the Availability of Credit for Settlement Purposes.

The Bank Cash Segregation Requirement would require bank custodians to segregate and hold cash for RIA Investors "in an account designed to protect such assets from creditors of the bank … in the event of the insolvency or failure of the bank."[12] Such a requirement would be infeasible for bank custodians to implement. Holding cash off-balance sheet with third parties rather than on deposit as banker would disrupt the ability of custodians to provide RIA Investors with other core banking services, such as providing credit and facilitating payments.

For example, as other commenters have noted, the Bank Cash Segregation Requirement could lead custodians to require pre-funding of transactions by, and increase the costs of credit they offer to, RIA Investors to facilitate the settlement of transactions.[13] As a result, the Proposed Rule would make it impractical for RIA Investors to participate fully in certain Non-U.S. Markets where either the cost of credit, or, in the absence of credit, the cost to pre-fund a specific transaction (such as wire fees to make payment in a foreign market or local currency), or the opportunity costs

[11] Consistent with the MiFID Delegated Directive and the FCA Custody Rules, bank custodians will undertake due diligence, as part of their ongoing review of their network of third party sub-custodians and local CSDs/CCPs, on at least: (i) the expertise and market reputation of each third party; and (ii) any local legal requirements and market practices related to the holding of non-cash assets that could adversely affect a client's rights to those assets. However, as is common in the market, bank custodians typically also will review: (1) the third party's performance of its services to the bank custodian; (2) the arrangements the third party has in place for the holding and safeguarding of non-cash assets (*e.g.*, by reviewing account structures, recordkeeping arrangements and legal agreements); (3) industry standard reports/assurance reports on internal controls (*e.g.*, ISAE 3402); (4) the capital or financial resources of the third party (*e.g.*, audited accounts); (5) the credit-worthiness of the third party; and (6) whether the third party has the appropriate regulatory permissions in the local market.

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

[13] Segregation would make it impossible to integrate cash accounts into bank custodians' core settlement and asset servicing processing systems and would create delay in settlements. If a client wants to engage in a transaction (*e.g.*, to purchase securities) at the custodian bank but cash is held at a third-party bank pursuant to the Bank Cash Segregation Requirement, the custodian bank must check and block balances on the account at the third-party bank. After settlement, the funds would be debited from that account. To make the process faster, clients' only option would be to pre-fund transactions, increasing the upfront cost of engaging in transactions, which can be substantial when multiplied over all transactions involving custodial cash accounts.

from the loss of straight-through processing (STP), can exceed the value of the proposed transaction.

The Bank Cash Segregation Requirement would also increase the total custody costs paid by RIA Investors without providing any meaningful additional protections. The risks to RIA Investors arising from the insolvency of any party holding its cash assets would remain even if the Commission proceeded with the Bank Cash Segregation Requirement. Rather than mitigate or eliminate this risk, the Proposed Rule simply shifts it from the risk of insolvency of the bank custodian to the risk of insolvency of the third-party bank with whom the client's cash was deposited. And in some Non-U.S. Markets, the risk of insolvency of such other third-party banks in that market could be greater than the risk of insolvency of the bank custodian.[14] The Bank Cash Segregation Requirements could thus lead to increases in custody fees for RIA Investors (*e.g.*, to offset the net interest income banks ordinarily derive from client cash deposits and cover the additional operational and settlement risk that would arise from the loss of liquidity and/or STP). The risk of custody fee increases is particularly acute for Non-U.S. Assets due to the complexities inherent in cross-border settlement operations.

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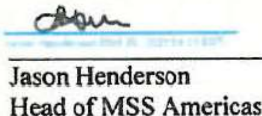
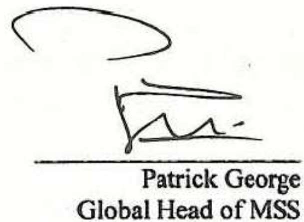
Thank you for your attention to HSBC's comments on the Proposed Rule. We would be pleased to provide further information or assistance at the request of the Commission or its staff. Should you have any questions or require any further information, please contact the undersigned at your convenience.

Sincerely,





Jason Henderson
Head of MSS Americas

Patrick George
Global Head of MSS

[14] The Bank Cash Segregation Requirement also potentially could lead to a concentration of cash deposits belonging to RIA Investors with one or two local banks in certain Non-U.S. Markets, with the result for RIA Investors being an increase in market concentration risk and possibly limited options to mitigate that risk in stressed market conditions (*e.g.*, by depositing relevant cash with the custody bank outside the local market, with that custodian bank instead assuming any credit risk associated with the deposits placed in the local market).