FINANCIAL SERVICES FORUM

May 8, 2023

Via Electronic Mail: rule-comments@sec.gov

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

Re: Notice of Proposed Rulemaking on Safeguarding Advisory Client Assets (File No. S7-03-22)

Dear Ms. Countryman:

The American Bankers Association,[1] ABA Securities Association,[2] the Financial Services Forum,[3] and the Bank Policy Institute[4] (the "Signatories") appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on its proposed rule "Safeguarding Advisory Client Assets," published March 9, 2023 (the "Proposed

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[1] The American Bankers Association is the voice of the nation's $23.6 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard nearly $19.2 trillion in deposits, and extend $12.2 trillion in loans.

[2] The ABA Securities Association ("ABASA") is a separately chartered trade association and non-profit subsidiary of the American Bankers Association whose mission is to represent the interests of banks underwriting and dealing in securities, proprietary mutual funds and derivatives before Congress and the federal government. ABASA members are large financial institutions with significant capital markets businesses.

[3] The Financial Services Forum is an economic policy and advocacy organization whose members are the chief executive officers of the eight largest and most diversified financial institutions headquartered in the United States. Forum member institutions are a leading source of lending and investment in the United States and serve millions of consumers, business, investors, and communities throughout the country. The Forum promotes policies that support savings and investment, deep and liquid capital markets, a competitive global marketplace, and a sound financial system.

[4] The Bank Policy Institute is a nonpartisan public policy, research and advocacy group representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost two million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

Rule").[5] The Proposed Rule would significantly restructure, rework, and expand the current custody rule,[6] including the key relationship between a registered investment adviser ("RIA") and a qualified custodian in relation to the assets of an RIA client,[7] and the specific requirements that apply to qualified custodians that are banks.

The Signatories do not support the Proposed Rule and recommend that the Commission withdraw and re-propose it to more directly address specific instances where the current rule fails to ensure appropriate investor protection. The Proposed Rule suggests broad and complex changes that represent a fundamental departure from current industry practice, and, if finalized, would cause significant harm to investors and financial markets. Banks that provide custody services, or "custody banks," are among the most significant qualified custodians under the current rule, and play a critical, foundational role in the functioning of the global securities markets, ensuring broad operational efficiencies and high levels of investor protection. Custody banks have long offered safe, well-managed, and regulated custody services. The Commission has not identified any significant loss of traditional assets in custody that would warrant an extensive overhaul of the custody rules applicable to custody banks, as envisaged by the Proposed Rule. For reasons that are unclear, the Proposed Rule neither considers nor accommodates the bank custody model. In addition, the Proposed Rule does not articulate any deficiencies in the bank custody model that would warrant precluding clients of RIAs from utilizing custody banks absent the proposed changes to the operation of custody banks. And, as further described below, we believe the Proposed Rule's *de facto* regulation of custody bank operations and balance sheets exceeds the Commission's authority.

If, at a later date and with sufficient justification, the Commission resubmits for public review and comment an amended Proposed Rule that is more appropriately targeted to achieve the Commission's regulatory objectives, such an amended Proposed Rule (i) should not require banks to segregate client cash; (ii) should not hold custody banks liable for entities, such as central securities depositories ("CSDs"), or events, such as sub-custodian insolvency or *force majeure*, that are outside their control; (iii) should not require a custody bank to police RIAs' compliance with their investment mandates; (iv) should except or amend the custody requirement for asset classes that are impossible or infeasible to hold in custody; (v) should take into greater account any impacts the Proposed Rule would have on non-U.S. investments; (vi) should permit sensible, manageable, and comprehensive reporting; and (vii) should ensure it harmonizes with other regulatory requirements, such as those governing collective investment trusts ("CITs") and the Commission's own proposed rule on RIA outsourcing.[8] Any final rule must also allow for sufficient time to implement it, with the timing appropriate to its breadth and complexity.

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[5] SEC Release No. IA-6240, 88 FR 14,672 (March 9, 2023), *available at* https://www.federalregister.gov/documents/2023/03/09/2023-03681/safeguarding-advisory-client-assets.

[6] *See* 17 C.F.R. § 275.206(4)-2.

[7] When the term "client" is used in this letter, we refer to the investor whose assets are held in custody by the custody bank, not the RIA that has been engaged by the client to manage those assets.

[8] *See SEC* Release No. IA-6176, 87 FR 68816 (Nov. 16, 2022), available at https://www.sec.gov/rules/proposed/2022/ia-6176.pdf.

Prior to release of any revised Proposed Rule, the Commission should consult and engage with the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Board of Governors of the Federal Reserve ("Board") to ensure that any revised Proposed Rule is consistent, and does not conflict, with applicable federal banking laws and regulations. Finally, the Commission must complete a preliminary economic analysis and provide the public with a meaningful opportunity to comment. The preliminary economic analysis should take into account the impact of the Proposed Rule on RIAs, their clients, and qualified custodians, based on a more complete inventory of the effects that the Proposed Rule would have on all market participants. The preliminary economic analysis should also consider competition and the economy more broadly.

The Commission must allow at least 90 days for public comment for any re-proposal of the Proposed Rule in order to obtain sufficient and robust feedback. Given the breadth and complexity of the Proposed Rule, the following represents our most critical areas of concern relating specifically to banking operations, though there are numerous other aspects that the Signatories did not have sufficient time to address, some of which are referenced in summary form in Annex I to this letter. That the Signatories' request to the Commission for additional time to comment on the Proposed Rule was supported by fifteen industry associations demonstrates the wide range of concerns that the Proposed Rule raises, many of which implicate complicated issues that require careful examination by parties with the relevant expertise. Accordingly, the Signatories urge the Commission to evaluate the concerns raised by other commenters that address the impacts of the Proposed Rule, including comments submitted by the Securities Industry and Financial Markets Association, the Association of Global Custodians, the Futures Industry Association, the Managed Funds Association, Investment Adviser Association, and the International Swaps and Derivatives Association.

Overarching Concerns

The Signatories believe that, if the Proposed Rule were implemented as written, it would lead to a reduction in financial market access, provider choice, and operational efficiency. It would also lead to significant increases in custody fees and the risk profile of custody banks. All of these effects would harm investors, whether institutional or retail, with limited to no benefit in risk reduction.

The Proposed Rule does not sufficiently consider the bank custody model.

Banks have long been deemed "qualified custodians" under the Commission's custody rule. Custody banks are subject to stringent prudential mandates designed to ensure that their activities are conducted in a safe and sound manner. Furthermore, they are subject to ongoing, detailed supervisory oversight, including horizontal assessments of key facets of their operations in comparison to those of other similarly situated banks. In order to comply with both regulatory and supervisory expectations, custody banks have implemented and operate robust risk-management and control frameworks that address, among other matters, the monitoring of counterparty credit risk, asset-liability management practices, interest rate risk, and the oversight of third-party service providers.

Banks are uniquely capable of maintaining deposit accounts.[9] Unlike other types of qualified custodians, which must deposit customer funds in banks or invest them in non-cash assets, custody banks act as deposit-taking institutions for customer funds, using those funds to support related custodial services and other economic activities. This function serves both custodial clients, by permitting banks to provide custodial services at a low cost and at a scale across many markets, and the financial system more broadly, by permitting banks to extend credit and provide other banking services in support of their clients' day-to-day investment activities. Depositors are protected by the extensive regulatory framework relating to liquidity and capital that banks must comply with, and by the privileged position given to depositors in bank failures under the depositor preference statutes, which gives depositors (both insured and uninsured) a priority claim in a bank's insolvency, second only to administrative expenses of the bank's receiver.[10] Thus, although deposits represent obligations of the deposit-taking bank to its depositors, rather than discrete assets held as agent or intermediary, they are privileged obligations as compared to other types of creditors, protected by extensive regulation and entitled to the best position available to any creditor.

The Proposed Rule fails to recognize critical aspects of the ways banks hold assets and includes several requirements that are unworkable in practice. The Proposed Rule seeks to impose requirements that are inconsistent with the very nature of bank deposits and may cause a number of banks to reconsider the provision of custodial services to clients advised by RIAs. Moreover, the requirements of the Proposed Rule relating to indemnification, the custodian's standard of care, and liability would not serve the Commission's goal of deterring misconduct because they would hold custody banks liable for circumstances that they cannot control and cannot avoid except by declining to provide custodial services in markets with a higher risk profile.

The Commission does not have the authority to regulate bank activities.

The Proposed Rule exceeds the Commission's authority. The Commission does not have authority to regulate custody banks. The Investment Advisers Act of 1940 (the "Advisers Act") contains no provision that delegates to the Commission the authority to alter sensitive aspects of the operations of custody banks, such as balance sheet structure and risk management, and courts have made clear an agency cannot regulate indirectly through rules governing private contracts where it lacks the authority to regulate directly. The Proposed Rule intrudes impermissibly into the regulatory framework governing the operation of custody banks, seeking to introduce requirements that would:

- affect those banks' deposit-taking activities and place the interests of RIA clients ahead of other depositors and even, potentially, the Deposit Insurance Fund;
- change the funding and liquidity profiles of those banks, requiring a greater reliance on wholesale market funding and other, riskier funding sources; and

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[9] 12 U.S.C. § 378.

[10] *See, e.g.*, 12 U.S.C. § 1821(d)(11); N.Y.B.L. § 166.

- shift risks that are rightly borne by RIAs and their clients to the banking system by requiring banks to assume responsibility for matters that they cannot and should not control, including the risks inherent to the assets in which the RIAs and their clients choose to invest.

All of these changes go well beyond the authority granted to the Commission, and, if banks were to seek to remain eligible to serve clients of RIAs, all would have a direct and significant effect on the regulation of banks, which are matters that are entrusted to the banking agencies.

Additionally, the Administrative Procedure Act (the "APA") requires that the Commission issue a rule only if it is the result of a thorough and well-reasoned decision-making process.[11] The Proposed Rule does not meet that standard. We note that the Commission has not presented any evidence of the need for such a monumental shift in the conduct of custody banks, nor has it offered a rationale to alter the custody rule for traditional assets. The Proposed Rule errs in its treatment of the operational and legal framework for custody services and would impose risks, costs, and inefficiencies to both the banking system and capital markets, which we identify throughout this letter and which the Commission has failed to address. Notably, the Proposed Rule's economic analysis—which is required by law and Commission policy—fails to consider the many likely effects of the Proposed Rule on the cost of providing custodial services and the resulting consequences for the availability of such services to investors, including custody banks multiplying their fees to recoup the costs and additional risks they would bear under the restrictions of the Proposed Rule, or ceasing to offer custodial services to these clients altogether, in order to satisfy prudential safety and soundness principles under which bank operations must be conducted. The Proposed Rule's failures clearly preclude the thorough and well-reasoned decision-making process required by the APA.

In the release for the Proposed Rule (the "Proposing Release"), the Commission points to the "significant developments with respect to crypto assets" as motivating in part its proposed revision of the existing custody rules.[12] Regardless of whether the challenges and complexities of custodial services for crypto assets merit revised regulation,[13] the Proposed Rule would affect all custodial services, including custodial services for traditional securities and cash. If one of the objectives of the Commission is to bring activities associated with crypto assets, in particular cryptocurrencies, into a sound regulatory framework, then the Commission should do so without upending the traditional markets and traditional model for securities, cash, and other assets. The Commission has not presented any concrete evidence sufficiently justifying the Proposed Rule's changes to the traditional operations of custody banks, which, if implemented,

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[11] In the Administrative Procedure Act, Congress instructed the courts to "hold unlawful and set aside agency action" that is "arbitrary," "capricious," or "an abuse of discretion." 5 U.S.C. § 706(2)(A).

[12] Proposing Release at 14,676; Testimony of Chair Gary Gensler Before the United States House of Representatives Committee on Financial Services at 8 (Apr. 18, 2023).

[13] We recommend that the Commission consider their Staff Accounting Bulletin No. 121 and the American Bankers Association, Bank Policy Institute, and Securities Industry and Financial Markets Association letter issued to the Commission on Staff Accounting Bulletin No. 121 Issued by the Staff of the Office of the Chief Accountant of the Securities and Exchange Commission (June 23, 2022), *available at* https://bpi.com/bpi-aba-and-sifma-comment-on-staff-accounting-bulletin-no-121/.

will disrupt a well-functioning and highly efficient market and result in harm to the investors and markets that the Commission seeks to protect.

Background on Custody Bank Services

Custody banks provide critical services to institutional investors that contribute to the efficiency and stability of global financial markets. These institutional investors include public and private pension plans, mutual funds,[14] insurance companies, private funds, hedge funds and other collective investment vehicles, endowments, and official sector institutions, such as local, state, and federal government agencies, as well as private wealth clients. In general, institutional investors select their custodians based on their own assessment of the costs, benefits, and risks of the custodial relationship. The primary goal institutional investors seek to accomplish when selecting a custodian is to safeguard their assets. At the same time, institutional investors must operate at scale in a cost-effective and efficient manner. Custody banks provide the necessary infrastructure, technology, expertise, and market access to enable institutional investors to do so. Custody bank services are designed to protect investor assets from misappropriation or loss while allowing for diverse and operationally efficient investing.

The OCC has observed that "[c]ustody relationships are contractual in nature and are essentially directed agencies."[15] The contract between a custody bank and its client shapes the services provided and sets forth the legal treatment of the safeguarded assets as property of the client, the scope of the services the custody bank will provide, the standard of care that the custody bank will exercise, and the limitations on the liability of the custody bank. In addition, the legal and regulatory framework of each relevant jurisdiction shapes the structure of the custody relationship. The laws of non-U.S. jurisdictions also impose specific requirements and conditions on custodians providing safekeeping of assets belonging to entities subject to those laws or providing safekeeping of securities issued in such a jurisdiction that are held for the benefit of investors in another jurisdiction such as the United States.[16] The Proposed Rule would inappropriately interfere with the contractual relationship between the investor and its custodian if the investor uses an RIA.

Despite contractual and jurisdictional differences, as a general matter, custody services traditionally consist of a combination of three main functions. These functions do not differ significantly when the custody bank's client is advised by an RIA, except that the client authorizes the custody bank to accept direction from the RIA on behalf of the client.

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[14] The investments of mutual funds and other registered investment companies are subject to a separate custody regime under the Investment Company Act of 1940 and are not within the scope of the Proposed Rule or this letter.

[15] OCC, *Custody Services Comptroller's Handbook* at 8 (2002), *available at* https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/custody-services/index-custody-services.html. Custody banks do not typically act in a fiduciary capacity, except in certain matters related to ERISA.

[16] *See Custody Services Comptroller's Handbook, supra* note 15, at 9-10. In part for this reason, when asked to provide custody for assets held in a non-U.S. jurisdiction, custody banks will typically contract with a sub-custodian local to or familiar with that jurisdiction, and the contract between the custody bank and its client will also often define the relationship between the custody bank and this sub-custodian.

First, a custody bank generally holds securities and "cash" in safekeeping on behalf of a client. Although the term "cash" is used, the client's asset is in fact a deposit that is treated as a bank liability to the client, either from the custodian itself, if the custodian is a bank, or from a third-party bank that receives the deposit. A custody bank may be willing to hold other assets as well, but securities and cash are predominant, in large part because a custody bank can exercise control of these types of assets, especially at scale.[17] The custody bank typically holds securities and cash through the simultaneous operation of two separate but related types of client accounts.

The securities accounts that are used for safekeeping client assets include not only traditional equity and debt securities, but also shares and other ownership interests in mutual funds and other funds, asset-backed securities, and various alternative investments. These investments are held in custody for, and beneficially owned by, the clients. In nearly all cases, securities are warehoused or "dematerialized" in a CSD,[18] such as the Depository Trust and Clearing Corporation ("DTCC") in the U.S., which are highly regulated public market infrastructures servicing the entire market, and which custody banks have no control over or ability to select. Custody banks hold and transfer the overwhelming majority of client securities in book-entry form, either directly or indirectly through a CSD. Because clients retain the beneficial property interest in the assets credited to securities accounts held by custody banks (so long as the custodian complies with applicable legal and operational requirements),[19] these investments are not included within the property of the custody bank, nor are they reflected on the custody bank's balance sheet.

Cash balances may be held by custody banks in many different currencies, reflecting the broad range of global markets to which custody banks provide their customers access. Although a custody bank could deposit these funds at a separate institution, a custody bank will agree in almost all instances to hold cash deposits as banker.[20] Like other deposits, such cash balances are reflected as a liability on the custody bank's balance sheet, and the custodial client has a claim against the custody bank coequal with the claims of the bank's other

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[17] In contrast, bilateral contracts, including many forms of derivatives, would likely require a custody bank to be added as a party in order to exercise control. Other assets also may be less suited to custodial arrangements because of the risks that they pose, the expertise required to hold them in safe keeping, or for other reasons.

[18] CSDs are discussed in more detail below. In general, securities are housed in a CSD located in a jurisdiction in which the securities were issued or offered, excepting privately placed securities where beneficial ownership is recorded directly by the issuer or transfer agent.

[19] *See, e.g.*, U.C.C. § 8-503(a) (1994).

[20] A custodian typically also provides cash management services, such as end-of-day balance reporting and sweep arrangements and short-term investment products, which, as an alternative to depositing client cash balances, allow such balances to be reinvested in securities, including interests in money market funds or other investment vehicles. *See* The Clearing House, *The Custody Services of Banks* (July 2016), *available at* https://www.theclearinghouse.org/advocacy/articles/2016/07/20160728-tch-issues-white-paper-on-custody-services-of-banks. The securities in which the cash is invested are then held in the customer's securities account, like other securities held in custody for that customer. A portion of the cash balance may be used to fund an operating account to support the client's ongoing securities activities. Investment managers are responsible for managing these balances using their own risk-management processes and operational deposit needs.

depositors. Deposits held by a custody bank for a custodial client, like other deposits, generally benefit from the priority given to depositors in the event of a bank's insolvency. For example, with respect to depository institutions insured under the Federal Deposit Insurance Act, deposit liabilities are preferred over all other liabilities of the bank in the event of insolvency, except for the administrative expenses of the receiver.[21] In other words, deposit liabilities — whether insured or uninsured — rank ahead of all general creditors and other liabilities of the bank, other than the expenses of the bank's liquidation, without the need for any special agreement or arrangement.

The second main function of custody banks is facilitating the settlement of securities transactions by delivering or receiving securities and the related cash consideration at the direction of their clients (or, in the case of a client advised by an RIA, at the direction of the RIA), using the cash account maintained for the client as an operating account. Clients do not generally prefund trades; rather, they depend on custody banks to provide intraday liquidity to offset buy and sell transactions and to allow investor instructions to settle on time, whether or not the necessary funds are available in the relevant client's account at a given time. Such clients then usually fund any end-of-day overdraft of their account with the custody bank or may wire out, or invest, any surplus end-of-day net balance. The resulting balances or overdrafts are operational in nature.

Although not obligated to do so, custody banks typically advance any shortfall in funds necessary to process trade purchases, unless the custody bank is concerned about the client's credit.[22] These short-term credit extensions, many of which are intra-day but a portion of which are overnight, are typically secured by an equivalent security interest in the assets in the client's securities account. A custody bank may also offer what is referred to as "contractual settlement," meaning that, on a trade's contractual settlement date, it will credit the client's account with the proceeds of securities that the client has sold, regardless of whether those funds have actually been received.[23] These settlement services are critical to the operation of the securities market by permitting the orderly settlement of trades and preventing trades from failing.[24] Custody banks can afford to offer these services because the necessary cash flows are treated as general deposits, allowing custody banks to utilize the cash flows to fund the credit extensions while accounting for the activity as credits and debits to a client's cash deposit account.

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[21] *See* 12 U.S.C. 1821(d)(11).

[22] In the vast majority of cases, these advances are intraday credit extensions, which are outstanding for less than a day, or overnight credit extensions, which are outstanding for less than two days. These advances are typically secured by a security interest in the assets held in the client's securities account, as well as by a lien upon the specific securities settled using the advance (*i.e.*, a broker's lien).

[23] If the securities or proceeds have not been received by an agreed-upon date, the transaction will typically be reversed. *See Custody Services Comptroller's Handbook, supra* note 15, at 72.

[24] Congress recognized the importance of these extensions of credit by including "any extension of credit for the clearance or settlement of securities transactions" in the universe of "securities contracts" entitled to safe harbor protection under the Bankruptcy Code. *See* 11 U.S.C. § 741(7)(A)(v); 12 U.S.C. § 1821(e)(8)(D)(ii)(VI).

Third, a custody bank facilitates the exercise of other rights associated with ownership of such securities, such as voting on corporate actions, the receipt of proceeds from maturing fixed income securities, income payment processing, and tax reclamations.[25]

Many custody banks offer custody services across international markets, facilitating non-U.S. investment by U.S. investors. The OCC observes that, in order to "understand and comply with local laws and regulations" in non-U.S. markets, a custody bank "will typically rely on a sub-custodian" that is a bank local to the non-U.S. market and may not be an affiliate of the custody bank.[26] This practice reflects the importance of contracting with a bank with the requisite expertise in the local market. In some non-U.S. markets, only one local sub-custodian may be authorized or available. By selecting and monitoring sub-custodians, and interacting with CSDs, the custodian creates a network that facilitates smooth international investment.

The custody chain, or the use by investors of intermediaries such as custodians, sub-custodians, and CSDs to hold securities, is a fundamental building block of capital markets. It provides a way of managing a "many-to-many" problem, namely, the problem of how to connect multiple issuers (tens, if not hundreds, of thousands) to multiple investors (tens, if not hundreds, of millions). The custody chain benefits capital markets by minimizing the number of individual connections that are necessary to connect issuers to investors. Custody networks thereby facilitate investment in securities, including cross-border investment in securities.

Custody services already operate within a robust statutory framework developed to govern the relationship between a custody bank and its client with respect to the property held in custody. In addition to long-standing law governing the treatment of customer property in a bank insolvency, Article 8 of the Uniform Commercial Code (the "UCC")[27] establishes clear rules regarding the treatment of customer property held by a custody bank (or other securities intermediary).

Revenues for custody services are primarily driven by fees, which have been kept very low by a highly competitive marketplace, and by net interest income. Any significant

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[25] Often, custody banks will offer other, ancillary services as well, such as fund accounting, fund administration, transfer agency services, outsourcing services, and reporting. See *The Custody Services of Banks*, *supra* note 20, at 7. Custody banks also provide clients the opportunity to engage in foreign currency transactions and participate in securities lending. Although those ancillary services may also be affected by some elements of the Proposed Rule, they are not the principal focus of this letter.

[26] *Custody Services Comptroller's Handbook*, *supra* note 15, at 9-10; 13. Each CSD has its own membership requirements and qualifications. "In certain well-established markets, U.S. custodians are direct members of the local CSD through a physical presence in the market, either in the form of a branch of their U.S. bank or another subsidiary bank, or in the form of a locally incorporated subsidiary. These direct memberships are generally known as 'self-custody' arrangements. In numerous other markets, however, custodians do not have a physical presence and prefer to access a CSD through the appointment of a sub-custodian." *The Custody Services of Banks*, *supra* note 20, at 13. In some cases, a U.S. custodian is unable to establish a subsidiary in the relevant country, and has no choice but to access the CSD through an unaffiliated sub-custodian.

[27] Article 8 of the UCC has been enacted in every state. *See* https://www.uniformlaws.org/committees/community-home?CommunityKey=f93a92b2-020f-4bfa-880b-5f80d24d018d.

change in the operational and economic model for custody banks will make custody services much more expensive for investors than they are today. The OCC observed that the growth of the investment industry led to an increase in assets under custody (as of the end of the fourth quarter of 2022, the twelve largest custodians collectively held nearly $250 trillion in assets under custody[28]), and, even 20 years ago, the OCC noted that "competition for custody … has been fierce, causing profit margins to shrink."[29] As the Proposing Release observes, economies of scale, low profit margins, and the importance of reputation has led to a small number of banks, mostly large U.S. financial institutions, dominating the custody services industry.[30] Given the size and scale of systems, processes, and people required to provide investors with the ability to invest in a wide array of markets and assets, in most cases only large-scale financial institutions are able to make the significant technological investments required to provide custody services that keep markets moving smoothly, including the provision of intraday or overnight extensions of credit. Given that custody bank fees are compressed, a custody bank's ability to earn net interest income arising from client deposits and client lending is crucial to supporting the provision of services to investors at low cost, and to fund the ongoing, large-scale development of custodial infrastructure and technology that such services require.

Custody banks are subject to stringent prudential regulation. A custody bank may be subject to regulations covering capital, liquidity, stress testing, and other financial resiliency requirements; cyber security and other operational resiliency obligations; recovery and resolution planning mandates (including related requirements to provide for additional liquidity to material operating entities in times of stress); and anti-money laundering and financial crimes regulation. Moreover, custody banks are subject to ongoing supervisory oversight and review by dedicated teams of on- and off-site examiners. To comply with both regulations and supervisory expectations, custody banks have implemented and operate robust risk-management and control frameworks which address, among other matters, the monitoring and management of capital and liquidity, counterparty due diligence practices, information systems and controls, third-party risk management, and the maintenance of AML and other financial crimes compliance infrastructure. The robust regulatory framework within which banks operate, which is well understood by institutional investors and regulators alike, makes them among the safest locations for asset safekeeping and contributes to their primacy as providers of custody services.

Although other custodians and intermediaries, such as broker-dealers and futures commission merchants ("FCMs"), provide services that may be similar in many respects, there are also significant differences. As a starting point, only banks may accept deposits. Although broker-dealers maintain credit balances, and FCMs also hold cash for use in customer trading, both broker-dealers and FCMs must hold their cash either directly as deposits in banks, or with clearing FCMs or clearing organizations that in turn must hold their cash, typically at a bank.[31] Banks, as noted above, accept deposits and reflect the deposits as liabilities on their own balance sheets. When a broker-dealer accepts cash as a financial asset to be held in custody, the financial

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28 Global Custodians, Custodians by assets under custody and administration, Q4 2022 Rankings, *available at* https://www.globalcustodian.com/custodians-assets-under-custody/.

29 *See Custody Services Comptroller's Handbook, supra* note 15, at 1.

30 Proposing Release at 14,739.

31 See 17 C.F.R. § 240.15c3-3(e) (broker-dealers) and 17 C.F.R. § 1.20 (FCMs).

asset is a claim against a bank[32] — a claim that can be distinguished from other claims that the broker-dealer may have against a bank. When a custody bank accepts cash to be held in custody, the financial asset is a claim against that bank; there is no specific asset underlying that claim — it is a general claim against the assets of the bank itself.

Discussion

I. The treatment of cash deposits in the Proposed Rule is unworkable in practice and, where technically possible, impractical, highly inefficient and costly to market participants.

The Proposed Rule would add a new requirement that a custody bank, in order to meet the definition of a qualified custodian with whom RIAs may custody assets, including cash, must "hold[] the client assets [including cash] in an account designed to protect such assets from creditors of the bank […] in the event of the insolvency or failure of the bank[.]"[33] The Commission explains that a custody bank must hold such assets in "an account in which client assets are easily identifiable and clearly segregated from the bank's assets."[34] With respect to non-cash assets held in a securities account by a custody bank, this requirement is already embedded in the regulatory expectations and requirements,[35] and UCC Article 8 provides expressly that assets held in this manner are not property of the bank and that a custody bank has a duty to promptly obtain and properly maintain assets it holds in custody.[36] Accordingly, with respect to non-cash assets, these requirements are already met, and the Proposed Rule is unnecessary. With respect to cash, however, the Proposed Rule would create novel problems.

Inequitable Treatment of the FDIC and Retail Depositors. The Commission states that a primary objective of the Proposed Rule is to protect retail investors.[37] However, even assuming that a custody bank were able to insulate funds held for such advised investors from the failure of the bank such that the claims of these advised investors would be paid ahead of the claims of other depositors — including retail depositors — in the event of a bank insolvency, then other bank depositors, including employers with payroll accounts and entities with

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32 The fact that cash must ultimately reside at a bank as a deposit is only one reason that the Signatories believe that banks must continue to be eligible to serve as qualified custodians. In response to the Proposing Release's Question 19, the Signatories believe the Proposed Rule should continue to recognize banks as qualified custodians. Question 23 asks whether the proposed requirements for qualified custodians should apply only to those banks that are not federally insured or OCC-supervised banks. Proposing Release at 14,685. There are a variety of bank and trust company entities that have safely and successfully provided custody for a substantial period of time but are not federally regulated or insured. Accordingly, the Signatories oppose any narrowing of the definition of bank, whether by reference to the regulatory regime applicable to such bank or otherwise.

33 Proposed 17 C.F.R. § 275.223-1(d)(10)(i).

34 Proposing Release at 14,683.

35 *See, e.g.*, *Custody Services Comptroller's Handbook*, *supra* note 15, at 14 ("[A] custodian's accounting records and internal controls should ensure that assets of each custody account are kept separate from the assets of the custodian and maintained under joint control.").

36 UCC § 8-503(a); UCC § 8-504(a).

37 Proposing Release at 14,694.

significant operating accounts, as well as the FDIC, as insurer of retail deposits, and the Deposit Insurance Fund, would all be subordinated to the clients of RIAs. This would be a dramatic change to the existing bank resolution framework. Elevating the claims of clients of RIAs in this manner would raise the risk that the FDIC (as subrogee of the insured depositors), the Deposit Insurance Fund, and other depositors will be left short in an insolvency. The Commission's failure to address conflicting aspects of the existing legal framework for bank insolvency would render the Proposed Rule arbitrary and capricious under the APA if finalized.

If the Commission were to succeed in achieving its goal, it would both give better treatment to clients of RIAs than to ordinary depositors and the FDIC and raise the cost of resolving a failed depository institution. The Proposed Rule would ensure that, for custody banks, the assets of clients that utilize an RIA, which, in the vast majority of cases, are institutions with considerable assets, are better protected than the checking account of a retail depositor or small investor, a highly inequitable result.

Impracticality of Special Deposit Accounts. The Proposed Rule requires banks to "hold the 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."[38] The Proposing Release suggests that the Commission expects banks to achieve this end by holding client cash in "an account in which client assets are […] clearly segregated from the bank's assets" and recites language from a banking treatise referring to the concept of a "special deposit."[39]

Although special deposits may have characteristics that differentiate them from general deposits, as a practical matter, a bank that holds cash — even in a special deposit — has a deposit liability to its client. As noted in the Proposing Release, this deposit liability is a general claim against all the assets of the bank, not a claim to particular cash held by the bank. Deposit liabilities are entitled to priority over other creditors in the event of the bank's failure.[40] In most states, both "general" and "special" deposits are liabilities of the depository institution, backed by all the assets of the depository institution.

Special deposits had great importance in the days in which banks more often held physical currency on premises — in the form of bank notes, coins, and precious metals.[41] However, as physical currency has largely been replaced by electronic balances on the books of Federal Reserve, the concept of holding "cash" in bailment has become confused and uncertain.[42] The law differs from state to state, and sometimes from court to court within a state,

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38 Proposed 17 C.F.R. § 223-1(d)(10).

39 Proposing Release at 14,683. 5C Michie on Banks and Banking, Deposits section 339 (Sept. 2022); Banking Law, section 134.05.

40 12 U.S.C. § 1821(d)(11)(A)(ii). This priority is limited to deposits maintained with domestic offices of the failed bank, and those that are "dually payable" by both the U.S. and non-U.S. offices of the bank.

41 *See generally* Joseph H. Sommer, *Special Deposits*, 76 Bus. Law. 841, 844-848 (Summer 2021). When a customer delivered physical cash to a bank, the bank agreed to hold that physical cash in bailment and not use it in its business, and the bank and the customer agreed that a "special deposit" was established, the customer was indeed viewed as a bailor or trustor, and not as a creditor of the bank.

42 The difficulty does not arise from a change in the ability of banks to hold assets in bailment, but rather from a change in the nature of cash, from a physical asset to an intangible asset ultimately representing balances

and where these deposits are recognized, their significance has generally related more to determining the rights of the bank vis-à-vis its customer, rather than the rights of the customer vis-à-vis other creditors of the bank.[43] There is one relatively recent case in which the court did determine that a deposit was a "special deposit" and therefore entitled to "full recovery and priority over uninsured deposit claims,"[44] but the FDIC has strongly objected to this conclusion and some courts in other relatively recent cases have not recognized the existence of a special deposit in similar circumstances.[45] At best, the legal status of special deposits is unclear. Moreover, the concept of special deposits may not exist in some jurisdictions, particularly outside the U.S., at all.[46]

The Commission's reliance on a legal doctrine that is outdated, ambiguous, and inoperative in multiple U.S. and non-U.S. jurisdictions does not represent the due consideration Congress requires for agency rulemaking.

Reliance Upon Third-Party Banks. Although, in theory, a custody bank could place client funds that it holds in custody with another commercial bank in an account held for the benefit of that client, this approach would not insulate the client from the threat of bank insolvency.[47] The insolvency risk could merely shift from the custody bank that the client selected to the third-party bank selected by the custody bank. Besides failing to eliminate the risk of bank insolvency, this approach would also expose the client to the risk of the third-party bank, which may be greater than that of the custody bank, *without* the client necessarily having a direct contractual relationship with that third-party bank. Indeed, this approach might make it difficult

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at a Federal Reserve bank. Banks can, of course, hold "trust deposits," but (1) a custodian is an agent of its customer, not a trustee, and (2) trust deposits remain liabilities of the depository bank, albeit subject to collateralization requirements in some jurisdictions. Please see the discussion of collateralization below.

43 *See, e.g.*, *In re Brittenum & Assocs., Inc.*, 868 F.2d 272, 276 (8th Cir. 1989) ("[F]unds are outside the bank's right of setoff, when the bank is put on notice of a third-party's interest in the deposited funds, for example, when the funds are held in a special account."); *Spears v. FDIC*, 793 F.2d 270, 273 (10th Cir. 1986) (finding special deposit as species of escrow that is not amenable to setoff).

44 *Merrill Lynch Mortg. Cap., Inc. v. FDIC*, 293 F. Supp. 2d 98, 110 (D.D.C. 2003) (under N.Y. law that account was a special deposit, entitling Merrill Lynch to priority over uninsured deposit claims).

45 *Fed. Home Loan Mortg. Corp. v. FDIC*, No. 85-39, 1985 WL 17367, at *3–4 (E.D. Ky. May 17, 1985) (concluding that disputed account was not a special deposit), and *Snyder v. RTC*, 35 F.3d 557 (4th Cir. 1994) (per curiam) (same).

46 *Id.* at 854. Recognizing both the confusion in the existing law, and the potential utility of special deposits in a variety of circumstances, the National Conference of Commissioners on Uniform State Laws has undertaken a project to develop a uniform law on special deposits. However, (1) this project has not yet been completed, (2) when it is completed, it will not affect any state's law until it is enacted by the relevant legislature, and (3) the current draft of the proposed law rejects the notion that a "special deposit" is a bailment. See Special Deposits Act (Discussion Draft for the March 31, 2023 Meeting) § 12 Off. cmt. 1 ("Some existing case law suggesting that the bank holding the funds deposited holds it in 'custody' and the relationship is in the nature of a bailment is rejected. In modern commercial practice, no financial institution takes funds from a customer and holds it in custody. This bailment concept is anachronistic and not feasible in modern banking practice.").

47 Although a bank may place the funds on deposit in its master account at a Federal Reserve Bank, the Federal Reserve Banks do not permit the establishment of multiple master accounts nor accounts held for the benefit of customers.

for a client to even *identify* the third-party bank where the client's cash is ultimately held on deposit. This approach gives a client less control, and more risk, than it would have with the current general deposit structure whereby the client selects and has a direct relationship with the bank where the client's cash is held on deposit. Alternatively, if a client selects the third-party bank, then the client would still be exposed to the credit risk of that third-party bank, as well as subject to a number of burdensome administrative responsibilities, such as holding multiple accounts with multiple banks, potentially in multiple currencies, and independently managing cash and foreign currency activity. Of course, clients select custodians in significant part to avoid these logistical burdens. Lastly, the clients would have to manage any deposit risk on the third-party bank themselves.

Arrangements with third-party banks would also add substantial operational complexity to the process of ensuring that cash is transferred back to the custody bank to be available to effectuate transactions, such as trade settlement, and then back to the third-party bank, potentially even before daily transactions have been reconciled.[48] These arrangements would negatively impact the use of Straight-Through Processing,[49] because the custody bank would be required to interface with the third-party bank and set up cash clearing arrangements between the custody bank, the third-party bank, the CSDs, and the local central bank as part of the settlement process.[50] The global nature of markets and currencies supported by custody banks compounds this complexity; the end of day for a bank in Asia is generally the beginning of the day for a bank in the United States.

The Proposed Rule would also impose cash segregation requirements on foreign financial institutions.[51] It is unclear if the Proposed Rule is meant to require cash segregation across all entities in the custody chain, including sub-custodians, to prevent insolvency risk from any intermediary. If so, then cash segregation would be ultimately required up to the level of the local central bank.

Collateralization. Conversations with Commission staff have raised the possibility that collateralizing client cash deposits might satisfy the Commission's desire to insulate clients from custody banks' credit risk if segregation is not possible in practice.

However, most banks are not permitted to collateralize general deposits because doing so would allow banks to prefer certain depositors or creditors at the expense of others in ways that are at odds with the general bank resolution scheme devised by Congress in the

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48 Despite all of these contortions to comply with the Proposed Rule, the client would still be subject to intra-day risk against the custody bank.

49 Straight-Through Processing is an automated process that is employed in millions of transactions per day conducted purely through electronic transfers with no manual intervention involved. The Proposed Rule's requirement for cash segregation, combined with its requirement that custody banks monitor an RIA's investment authority, would render Straight Through Processing impossible, leading to longer settlement times. These increased settlement times would create counterparty and market risks greater than whatever risks the Commission is trying to address in the Proposed Rule.

50 For example, some custody banks self-clear cash transactions processed at the CSD level by leveraging their master cash account at their central bank.

51 Proposed 17 C.F.R. § 275.223-1(d)(10)(iv)(D).

Federal Deposit Insurance Act.[52] For example, OCC guidance states, "National banks generally are prohibited from pledging assets to secure private deposits."[53] National banks may only collateralize "fiduciary deposits," which include those for which the bank is acting in a fiduciary capacity,[54] and deposits for governmental or similar customers whom policymakers have deemed it desirable to prefer as a matter of public policy. Only a small number of states permit their state-chartered banks to collateralize general deposits.[55] As noted above, custody banks generally are not acting in a fiduciary capacity and, as a result, would not in the normal course of business be permitted to collateralize deposits held as custodian. Accordingly, collateralization is not a feasible or legal method to satisfy the Commission's concern.

Furthermore, the Commission should recognize that collateralization would not provide *direct* rights to individual clients, unless every deposit were backed by a separate collateral account in which the client has a security interest. Given that cash balances fluctuate constantly as a result of settlement and asset-servicing activities, the collateral amounts would also need to be adjusted continuously and bespoke reporting mechanisms would need to be created for that purpose. This approach is not operationally feasible.

Collateralizing each client cash deposit would also dramatically increase the costs of providing custody services and contribute to custody banks either ceasing to provide custodial services or to pass on the significant increase in cost to custodial clients. Indeed, collateralization on such a scale is likely to create an artificial increase in the demand, and therefore the cost, of acceptable collateral, and these additional costs would also be passed on to custodial clients. Finally, holding additional collateral would also complicate and negatively affect banks' already complex and costly liquidity requirements. These costs and complexities make collateralization impractical as a method of achieving the Commission's goals.

Effects on Trade Settlement. The segregation of cash held in custody would upend normal-course custody bank activities that ensure the efficiency of settlement and the smooth operation of financial markets. Cash treated by a custody bank as a general deposit offers the

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52 The FDIC recently issued a report outlining potential approaches to deposit insurance reform. *See* FDIC, *Options for Deposit Insurance Reform* (May 1, 2023), p. 49, *available* at https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf. This report evaluates a range of approaches, including the feasibility of collateralizing large uninsured deposits. The FDIC's analysis, which identifies a number of factors likely making collateralization infeasible, demonstrates the importance of allowing the FDIC, as the prudential banking regulator entrusted with authority over bank deposit insurance, to evaluate the best means to ensure banks' ability to satisfy their deposit obligations.

53 OCC, *Activities Permissible for National Banks and Federal Savings Associations*, Cumulative, 2017 Edition, p. 43, *available at* https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-activities-permissible-for-nat-banks-fed-saving.pdf.

54 "Fiduciary capacity means: trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gifts to minors act; investment adviser, if the bank receives a fee for its investment advice; any capacity in which the bank possesses investment discretion on behalf of another; or any other similar capacity that the OCC authorizes pursuant to 12 U.S.C. 92a." 12 C.F.R. §9.2(e). In general, custodians do not act in a fiduciary capacity because they are not carrying out any of these functions.

55 Nebraska, Maine and Illinois permit collateralization of non-fiduciary deposits.

liquidity necessary for credit extensions and contractual settlement when clients lack necessary funds at the precise moment of settlement. First, by eliminating custodial clients' funds from banks' sources of liquidity, the Proposed Rule could cause most, if not all, custody banks to limit or eliminate these settlement options for the clients subject to the Proposed Rule. Clients would either need to pre-fund trades or custody banks would need to delay settlement until an account is fully funded, resulting in increased burden on, and risk to, the settlement process and to clients advised by an RIA. These impacts would lead to a more complex structure, a buildup of settlement risk, and general market inefficiency. Second, the liquidity provided by cash held in custody as a general deposit generates net interest income for custody banks, enabling them to offer custodial services for substantially lower fees than would otherwise be economically viable. Banks subject to already low profit margins for custody services would raise fees significantly to address the loss of net interest income caused by cash segregation, and higher custody costs would introduce friction into economically beneficial financial activity. Without these revenues from net interest income, the provision of custody services may cease to be economically viable for many custody banks, leading those banks to exit the market, creating even more concentration risk. These effects would also raise the risks inherent in the Commission's recent decision to move the securities settlement cycle for U.S. equities to a T+1 basis in 2024, and thereby fail to "reduce latency, lower risk, and promote efficiency as well as greater liquidity in the markets,"[56] as increased friction and fails would make it difficult for the markets to achieve this level of efficiency.

Effect on Asset Servicing and Tax. The segregation of cash would have profound effects on the way in which asset servicing is conducted and render the provision of tax services extremely complex. Asset-servicing events, such as income payments or corporate actions with a cash component, are handled by the custodian, using client general deposit accounts. A custody bank or its sub-custodian, in their capacity as tax withholding agent, deducts from an issuer's coupon or dividend payment the required amount of withholding tax for payment to a relevant tax authority before it credits the investor with the net amount. If a custody bank or its sub-custodian must collateralize these assets, then this process would become extremely complex. If the associated cash needs to be segregated, then the bank cannot withhold the relevant tax payment, and clients would need to prefund any event requiring cash. As noted above, this impact would prohibit Straight-Through Processing of corporate actions.

Increasing Risk to Bank Funding Stability. If banks must segregate the funds held for custodial customers, then by definition some banks would have to obtain funding for their normal-course activities from other sources, including the wholesale funding markets (*e.g.,* repo transactions and other short-term money market transactions). These sources of funds are both more expensive and more volatile, and increasing banks' dependence on these sources of funds is inconsistent with the banking agencies' policy goal of reducing banks' reliance upon less stable funding. Increasing the exposure of banks to the capital markets would also make the banking system more brittle in times of financial crisis. These delicate risk-management considerations illustrate that bank liquidity and management of balance sheet assets are fundamentally issues for bank regulation and not within the authority of the Commission.

56 SEC, *SEC Finalizes Rules to Reduce Risks in Clearance and Settlement* (Feb. 15, 2023), *available at* https://www.sec.gov/news/press-release/2023-29.

Current Protections and Tools to Manage Client Deposit Risks at Custody Banks. The detrimental outcomes described above are unjustified in view of the other mechanisms that custody banks currently provide, and that clients actively use, to limit their credit risk exposure to banks. Clients receive intraday reports on their cash balances and any changes to them. Furthermore, the financial industry has a variety of tools, including end-of-day sweep services, to move client cash to other banks or to short-term investment vehicles. For example, clients can wire out money to other banks, intraday and end-of-day, for placement in time deposits, high-yield accounts, and other products, and most custody banks offer services such as automated sweeps of cash into money market funds. A number of custody banks also offer collateral management services that allow clients to invest cash in other assets such as repurchase agreements. These services help clients manage bank credit risk without the costly disadvantages of mandatory segregation of cash into stand-alone accounts. When a client is advised by an RIA, the RIA can make use of all these options.

The availability of industry-offered protections is not the only reason that client cash is often swept into non-deposit assets. Most large custody banks are required under the Liquidity Coverage Ratio (the "LCR"), which is based on the framework established by the Basel Committee on Banking Supervision, to maintain portfolios of "high-quality liquid assets" ("HQLA") to ensure sufficient liquidity over a thirty-day period. Under the LCR framework, custody deposit balances that cannot be classified as "operational" are given no liquidity benefit and therefore must be offset by applicable HQLA. As such, the LCR requirement applicable to non-operational deposits incentivizes large custody banks to limit the non-operational deposits held on their books, aligning with the Commission's desire to limit advised clients' credit exposure to banks. When viewed in line with market practice and the lack of evidence that the bank custody model for traditional assets has failed to protect clients of RIAs, additional requirements would be redundant in terms of the protections offered to clients of RIAs, but additive in terms of costs and complexities.

For the reasons stated above, the Commission should withdraw the sections of the Proposed Rule that aim to protect client cash deposits from the credit risk of the custody bank.[57]

II. The Proposed Rule shifts legal liability to custody banks, holding them accountable for actions well beyond their control.

The Proposing Release states that the Commission "seeks to create a minimum floor of custodial protection for investors."[58] The Proposed Rule requires an RIA to obtain reasonable assurances in writing from a custody bank that the custody bank will comply with

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[57] The fact that cash must ultimately reside at a bank as a deposit is only one reason that the Signatories believe that banks must continue to be eligible to serve as qualified custodians. In response to the Proposing Release's Question 19, the Signatories believe the Proposed Rule should continue to recognize banks as qualified custodians. Question 23 asks whether the proposed requirements for qualified custodians should apply only to those banks that are not federally insured or OCC-supervised banks. Proposing Release at 14,685. There are a variety of bank and trust company entities that have safely and successfully provided custody for a substantial period of time but are not federally regulated or insured. Accordingly, the Signatories oppose any narrowing of the definition of bank, whether by reference to the regulatory regime applicable to such bank or otherwise.

[58] Proposing Release at 14,694.

various requirements, including that, as a qualified custodian, it "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 custodian in the event of the qualified custodian's own negligence, recklessness, or willful misconduct."[59] Additionally, the Proposed Rule would also hold custody banks "to a simple negligence standard rather than a gross negligence standard"[60] for all client assets.

Holding custody banks liable for their own errors, including errors related to the appointing and monitoring of sub-custodians, is a sensible "minimal floor of custodial protection." The Signatories support a liability regime that holds custody banks liable to clients for loss of the client's assets caused by a custody bank's own negligence, recklessness, or other willful misconduct, including when a custody bank was negligent in selecting a sub-custodian that later caused such a loss. However, there are three fundamental issues with the liability and standard of care elements of the Proposed Rule in its current form.

First, a custody bank simply cannot control or manage the risk of a market infrastructure entity such as a CSD. When the Proposed Rule uses the term "arrangement" to classify a custody bank's interactions with a CSD, it fails to recognize that these interactions are non-discretionary and do not consist of a delegation of custody. A CSD is a fundamental aspect of the local market infrastructure, completely distinct from and outside the control of a custody bank. As noted above, CSDs are the repository for recording securities ownership, and a custody bank cannot hold or settle transactions in book-entry form unless a CSD ultimately provides a corresponding entry. A custody bank's interactions with a CSD do not parallel a discretionary contract with a vendor; a CSD will not negotiate its terms, conditions, and operations with individual members or participants. Interactions with CSDs are a necessary, non-optional, and fundamental aspect to operating in financial markets globally, regulated by the relevant supervisory authority in the relevant jurisdiction (*e.g.,* the Commission, for CSDs in the United States). If an end investor, or its RIA, chooses to invest in securities whose ownership is recorded in a particular CSD, the custody bank's only options are to refuse to accept the security into custody or to accept the CSD as it stands. The Proposed Rule would force a custody bank to assume liability for the misconduct of an aspect of market infrastructure that it cannot control and cannot avoid. That the Proposed Rule fails to recognize the operations of fundamental market infrastructure indicates that it would not meet the standard for well-reasoned decision-making required by the APA if finalized.

Second, a custody bank does not control a client's country of investment, and, for similar reasons, should not be liable for the circumstances stemming from a client's choice of a particular market. "Realistically, the decision to enter a market is driven by the customer's desire to invest there."[61] Clients would be exposed to the risk of those markets even in the absence of a particular custody bank. At a minimum, custody banks should not be held responsible for actions that are beyond anyone's practical control; the Proposed Rule should make clear that custody banks are not responsible for *force majeure* events and similar country risks that are inherent to

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[59] Proposed 17 C.F.R. (a)(1)(ii)(B).

[60] Proposing Release at 14,694.

[61] *See Custody Services Comptroller's Handbook*, *supra* note 15, at 13.

the choice of investing in the relevant country. Additionally, the negligence standard that governs a custody arrangement is generally evaluated based on local law and market practice, which facilitates non-U.S. investment by according it with complementary but non-U.S. standards. The Commission should not therefore impede non-U.S. investment by mandating that RIAs only contract with custodians that follow the Commission's particular playbook.

Third, the Proposed Rule would also hold custody banks "to a simple negligence standard rather than a gross negligence standard"[62] for all client assets, even when the circumstances and risk profile of the custody services demand tailoring of the negligence standard.

The Commission should support the ability of all parties in the traditional custody model to agree to terms tailored to the risks of a particular market. The Commission should allow custody banks and their clients to negotiate a standard of care and liability that reflects the dynamics of the particular situation – the particular RIA, end investor, trading strategy, assets, and jurisdictions involved – instead of imposing specific provisions by decree into all contracts regardless of appropriateness. The types of institutional investors served by the custody banks represented by the Signatories are fully able to negotiate contractual terms with custody banks, including liability and standard of care. Indeed, liability is one of the most negotiated parts of custody contracts, and investors and custodians are careful to achieve an appropriate balance between costs and risks. It is inappropriate for the Commission to put its thumb on the scale in favor of one party to these contracts.

Moreover, other than generalized "observations" by its own staff, the Commission has not identified *any* specific instances demonstrating problems with the protections custodians currently provide. Furthermore, the Commission acknowledges in the Proposed Rule that this requirement would represent a substantial and costly expansion in the protections provided by banks to advisory clients.[63] Such a significant shift to the risk-management practices of banks requires sufficient justification under the APA, and the Commission's failure to provide this justification would render this section of the Proposed Rule arbitrary and capricious if finalized.

The Proposed Rule would also likely reduce the number of firms willing to offer access to certain markets or serve as qualified custodians altogether, and thereby reduce the scope of markets available to RIA clients, given the substantially increased risk to the custody bank. Without sensible limits on liability, custody banks may simply refuse to contract with sub-custodians. This effect would force investors either to abandon a particular market or to contract with those entities directly as custodians, eliminating significant network effects of the custody chain that are critical to well-functioning securities markets. The Proposed Rule would also upend current contractual relationships without sufficient justification under the APA.

At a minimum, the Proposed Rule would significantly increase the cost of custody services. In particular, there is currently no market for insurance that would ensure a custody bank could indemnify a client and multiple other parties for their losses. As a general matter, banks use capital, not insurance, to manage the risk exposures of their banking activities, so the

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[62] Proposing Release at 14,694.

[63] Proposing Release at 14,746.

premiums for the "insurance arrangements" that the Proposed Rule mandates custody banks have in place could be exorbitant, given the lack of an existing market and the breadth of indemnification contemplated by the Proposed Rule. These costs add to those previously discussed, compounding the harms to investors, who would suffer these costs as increased fees or as limited or no choices for custody services in certain markets.

Therefore, the Commission should withdraw the sections of the Proposed Rule that require custody banks to assume liability for the actions of other parties.

III. The Proposed Rule's requirement for custodians to monitor RIA authority to effect transactions would reduce market efficiency, create settlement failures, work against T+1 settlement, and increase cost for investors.

The Proposed Rule would require a written agreement between an RIA and a custody bank that "specifies [the RIA's] agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations, and permits [the RIA] and the client to reduce that authority."[64] The Proposing Release expresses the Commission's concern that custody banks are "reluctant to modify or customize the level of authority investment advisers have with respect to customer accounts" because such modification or customization would "increase[] [custody banks'] need to monitor customer accounts, and to accept liability, for unauthorized transactions by an adviser and its personnel."[65] The Proposing Release goes on to state that the reason for the new requirement is to reduce the "risk that a custodian may follow an instruction with respect to client assets presuming authority that the adviser does not have under its advisory contract with the client."[66]

The prescriptive provision in the Proposed Release appears to be intended to require a custody bank to review each trade settlement instruction before settlement to determine whether that instruction is outside the investment authority of the RIA.[67] Congress gave the Commission the authority to supervise RIAs but not the authority to use the banking system to fulfill that responsibility. Deputizing custody banks to fulfill the Commission's own responsibilities to protect investors from RIA malfeasance exceeds the Commission's authority; it also would have a number of negative practical effects.

First, requiring a custody bank to monitor trades, which it does not have the ability to do, and then subjecting it to liability for the misconduct of an RIA would not simply harm the custody bank but the clients of RIAs, because RIAs would not be accountable for their own misconduct. Rather than protecting investors, the Proposed Rule might create a moral

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64 Proposed 17 C.F.R. § 275.223-1(a)(i)(D).

65 Proposing Release at 14,699.

66 *Id.*

67 In its discussion of "a qualified custodian's participation in a change of beneficial ownership" related to determining that the custodian has "possession or control" of a given asset as required by the Proposed Rule, the Proposing Release states that "beneficial ownership may occur at different points in the transaction lifecycle based on the type of asset involved," pointing to both trade date and trade settlement. This suggests that the Commission may be seeking to hold a custody bank responsible for the integrity of a transaction across its lifecycle. Proposing Release at 14,688 n.118.

hazard that increases investor risk. The Proposed Rule would effectively use bank balance sheets to underwrite the failures of some less reputable RIAs to comply with their investment authority. Custody banks are typically large financial institutions that are likely to be targeted for litigation when clients seek recompense for RIAs acting outside their investment authority.

Second, monitoring RIA instructions to confirm they fall within an RIA's investment authority would lead to a significant increase in the costs and complexity of providing custody services, which again would be passed onto RIAs and their clients. Review of trades by custody banks, pre-settlement, could not be practically achieved without radical changes to order processing that would result in significant settlement delays, the buildup of counterparty risk, and, ultimately, a dramatic increase in failed transactions.

As discussed, a custody bank settles trades solely at the direction of its client, or its RIA when the client is advised by an RIA. The custody bank does not exercise any discretion over the disposition of client assets under custody. In cases where a client is advised by a RIA, the custody bank will not have access to the agreement between the investor and the RIA detailing the RIA's authority and thus would have to rely upon the description of that authority included in the proposed custody contract with the RIA. Even if the custody bank did have access to the agreement, the custody bank does not have the information, expertise, or authority to determine the reasons, dynamics, or context of trading activity. Exercising investment authority requires an understanding of the context and interpretation of the financial situation, and an investment agreement may have various limits on certain kinds of investment, countries of investment, or investments over a certain percentage that apply conditionally or only in circumstances that a custody bank cannot assess. The Proposed Rule would force a custody bank to review and "second guess" each instruction. The need for interpretation of context and ultimate judgment as to whether an instruction falls under an RIA's investment authority means that this review could not be automated. These additional costs and complexities would be reflected in significantly higher prices for custody services.

Finally, by requiring a custody bank to monitor trades, the Proposed Rule would aggravate risk in the financial markets by increasing operational uncertainty and trade fails. A custody bank settles thousands of trades in a day, a scale that makes it operationally unfeasible to review each trade against the relevant investment advisory agreement, even if the custody bank somehow had access to the agreement and a full understanding of the RIA's investment relationship with its customer.[68] Therefore, the custody bank cannot, as a practical matter, determine if a trade sufficiently deviates from an investment agreement or customary practice such that the RIA is misusing or misappropriating investor funds. Put simply, a custody bank cannot police conduct that it is unable to assess.

If a custody bank were to be made liable for the malfeasance of the RIA, custody banks would, at the least, seek to delay settlement to perform oversight, making it difficult to achieve timely settlement, an essential precondition to the efficient operation of the financial markets. Accelerated settlement reduces counterparty risk during the period between trade

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[68] Custody banks contributed to the settlement process for a substantial portion of the 643 million listed U.S. securities that DTCC settled in 2021. DTCC, *Settlement & Asset Services*, *available at* https://www.dtcc.com/settlement-and-asset-services.

execution and settlement, but, alongside the Proposed Rule's cash segregation requirement, this delay would frustrate the Commission's efforts to move to a more secure T+1 settlement period. If forced to make a rapid decision, custody banks would likely refuse to settle a significant number of trades out of an abundance of caution and in the absence of sufficient information to avoid liability in case a transaction is later alleged to have been a misuse of investor funds. Such delays would also create disputes with RIAs and clients that may be costly to resolve. These settlement fails and disputes among financial market participants would undermine, rather than support, the Commission's objective to create secure and effective securities markets and would harm investors.

Accordingly, the Commission should withdraw the sections of the Proposed Rule that would require review of instructions by custody banks.

IV. The Proposed Rule raises significant question as to how a custody bank would provide custody and segregation of assets with respect to assets that are not cash or securities.

The Proposed Rule would require RIAs to establish custodial arrangements for assets that currently cannot be held in custody by a custody bank or that a custody bank will not accept for custody without imposing exorbitant fees. The Proposed Rule requires RIAs to establish custodial arrangements pursuant to which a custodian has "possession or control" not just for "funds" and "securities" but for "other positions held in [the adviser's] client's account."[69] Under the Proposed Rule, a custody bank would have sufficient "possession or control" when it "is required to participate in any change in beneficial ownership of those assets, 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."[70] The definition in the Proposed Rule is duplicative and unnecessary in light of other operative legal frameworks, such as UCC Art. 8 and other state laws. This requirement of the Proposed Rule also fails to recognize the infeasibility, and at times the impossibility, of holding several prominent categories of client assets in custody. The Proposed Rule also fails to recognize that custody banks may simply be unwilling to custody assets that pose too much risk, no matter what price the market would bear for those custody services, or undergo a fundamental shift to their instruction authority by interposing them between an RIA and the sell side.

Positions a Bank Cannot Custody. As a general principle, whether it is even possible for a bank to hold an asset in custody depends on whether the bank can exercise control of that asset.[71] A bank can exercise control of a security by holding the physical security itself or by the marking of its books and records in accordance with the ownership record of a CSD. By

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69 Proposed 17 C.F.R. § 275.223-1(d)(1). Proposed 17 C.F.R. § 275.223-1(b)(2) excepts certain privately offered securities or physical assets from the requirement to be held with a qualified custodian, if the adviser meets certain conditions.

70 Proposed 17 C.F.R. § 275.223-1(d)(8).

71 This approach reflects the Uniform Commercial Code (UCC), which has been adopted in most states. States have also begun to adopt Article 12 which allows *a custody bank* to hold a crypto asset in custody if that asset can be controlled.

contrast, a bank cannot exercise control, in a commercially or legally feasible manner, of cleared derivatives carried by an FCM, or over-the-counter derivatives structured as contracts between a client and a third party. Custody banks, as a rule, do not become parties to transactions on behalf of their clients. Such an approach would subject the custody bank to counterparty risk that it would be reluctant, if not unwilling, to accept. Furthermore, participating in a large number of contracts between two other parties is not feasible at scale. The Commission does not articulate how a bank could be put into the chain of control for an asset that is contractual in nature without making it a party to the contract or why doing so would add value for the client.[72]

As is the case with over-the-counter derivatives, a custody bank cannot hold in custody bank loans and foreign currency forward transactions because these assets are structured as contracts between a client and a third party. This is particularly the case when an RIA executes transactions as agent for its advised clients, and allocates those transactions among its advised accounts. In that case, the RIA may be able to change the allocation of the transactions among its clients without the custody bank's knowledge, and, as a result, these investments will fail to meet the "control" requirement necessary to be held in custody in compliance with the Proposed Rule.

The Proposed Rule requires a significant quantity of asset classes to be held in custody that are currently impossible to custody. Its failure to meaningfully discuss the methods by which a custody bank could fulfill this requirement would render this section of the rule, if finalized, arbitrary and capricious under the APA. Any re-proposal of the Proposed Rule should expressly exclude any asset where the source of ownership is based in contract, including bank loans and derivatives like futures and options, and also expressly exclude any other asset that similarly precludes a qualified custodian's possession or control, such as certain foreign currency transactions.

Positions That Are Extremely Impractical to Custody. Even for those asset classes that would be newly covered by the Proposed Rule and for which a bank may be able to exercise control, the Proposed Rule fails to account for the economics of custodial services and the impact a disruption of those economics would have on investors and trading markets. Of course, the Proposed Rule does not require a bank to hold any particular asset, and a custody bank has full discretion to determine which assets it is willing to hold in custody. Banks may reject custody of assets that are too costly or complex to hold. Thus, investment advisors may have few or no options to custody a number of assets that the Proposed Rule would require to be held in custody simply because the compensation to the custodian does not justify the risk, expenses, and complications. For example, though a bank could theoretically exercise control of client real estate by taking title, it is highly unlikely to do so due to the risk profile of such an asset, such as the risk of environmental liability. Custodial services provide low profit margins even for asset classes that can easily be held at scale without significant complication or risk, such as cash and securities.

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72 It is true that a bank may enter into cleared futures or swaps, or execute contracts, as a trustee of a trust or in a similar capacity. In those cases, the bank is the customer of the FCM, or the party to the transaction, in its capacity as trustee. However, a trustee does not "custody" the contract or transaction on behalf of a third party; it *is* the party to the transaction, in its capacity as trustee.

Crypto Assets. Given recent high-profile events, such as the collapse of FTX Trading Ltd., we understand the Commission's desire to implement a floor of custodial protections for investors in crypto assets. Some, but not all, custody banks have expressed an interest in providing custody services for crypto assets. A new article of the UCC has been published by the Uniform Law Commission that would clarify the underlying commercial law governing these assets, and has been proposed for enactment in several states. Furthermore, technology tools and practices are being developed to facilitate the responsible provision of custody services for these assets. However, the regulatory expectations for custody banks to provide custody services for such assets remains unclear.[73] In any event, the application of and definitions used SAB 121 makes it impractical for custody banks to provide custodial services for significant quantities of these assets, limiting their ability to provide custodial services in accordance with the Proposed Rule. If the primary goal of the Proposed Rule is to implement a floor of custodial protections for investors in crypto assets, then the Commission should consider proposing a rule which focuses on crypto assets and not traditional custody practices.

V. Other aspects of the Proposed Rule would also negatively impact the provision of custodial services.

The Proposed Rule mandates other changes to the bank custody model that would negatively impact custody banks, trading markets, and investors.

Damaging to U.S. Investment in Non-U.S. Markets. Foreign financial institutions, which are subject to differing law and market practices, are unlikely to consent to a number of significant burdens the Proposed Rule would impose in order to serve as a qualified custodian, including consent to Commission enforcement.[74] The regulatory framework and market practices of other countries also seek to safeguard assets in custody, but may take a different approach to these issues. As such, many non-U.S. sub-custodians are unlikely to consent to Commission enforcement of U.S. standards. For instance, the standard of care in the Proposed Rule might not accord with the standard of care in a non-U.S. jurisdiction, and a U.S. custody bank is highly unlikely to indemnify an RIA at a higher standard than the standard of indemnification the bank receives from the non-U.S. sub-custodian that it relies upon to operate in the RIA's country of choice. In these circumstances, a custody bank will either significantly increase fees to offset risk or exit the custody market. In either case, the impact of the Proposed Rule will be to limit access by U.S. investors to non-U.S. markets due to a truncated and more expensive market for custody services. Additionally, beyond all the other problems discussed with respect to monitoring trades, U.S. custody banks will likely reject custody of assets that would involve monitoring a non-U.S. sub-custodian's review of trades. The operational complexity and risk would be compounded by a lack of direct control and oversight in the non-U.S. context, lead to increased trade fails, and serve as another inhibitor to non-U.S. investment. Indeed, the Proposed Rule may have gone so far as to make it difficult for U.S.-advised clients to invest outside the U.S. at all.

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73 *See, e.g.,* Federal Reserve, OCC, FDIC, Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf.

74 Proposed 17 C.F.R. § 275.223-1(10)(iv)(A).

Impracticality of Reporting Requirements. The Proposed Rule states that a custody bank "will send account statements, at least quarterly, to the client, or its independent representative, and to [the adviser]."[75] The Commission should clarify that the Proposed Rule is consistent with the Commission's "access equals delivery" model, and current industry practice, by noting that a custody bank can fulfill this requirement by posting account statements on a secure website and providing notice to custody clients, rather than affirmatively sending account statements directly to clients, whether physically or electronically.

Additionally, the Proposed Rule states that account statements must "not identify assets for which the qualified custodian lacks possession or control, unless requested by the client and the qualified custodian clearly identifies any such assets that appear on the account statement."[76] We agree it is important to avoid customer confusion regarding assets held in custody, but, as the Proposing Release notes, accommodating reporting can help "alert a client or an auditor to the existence of an investment."[77] To provide a more complete picture of a client's investments, banks provide accommodation reporting as a service to their clients upon request. Therefore, the Proposed Rule should address any concerns about client confusion in a less burdensome manner that aligns with current industry standards, provides clients more information, and still protects against confusion. For instance, the Commission could require any assets not held in custody to be clearly identified by a caption, such as "The following positions are not held in custody and are reported based on information provided to us by third parties."

The Commission would also require that a custody bank look through a pooled investment vehicle so that it could deliver quarterly account statements to all underlying investors.[78] Custody banks do not have access to this level of information on an investment structure or the beneficial owners of that structure, so such a requirement would dramatically expand the information custody banks must maintain and update and conform to complex data privacy protections. The complexity of looking through investment vehicles, which may have multiple levels, would add significant operational costs to a custody bank's reporting procedures, in addition to the many costs discussed throughout this letter.

Application to Collective Investment Trusts. Collective investment trusts under 12 CFR 9.18(a) are exempt from various provisions of the securities laws due to the oversight bank regulators already provide. Additionally, a bank that maintains a CIT as a trustee may be a fiduciary under ERISA and so obligated to act in the best interests of the CIT's assets. As trustee, the bank determines whether it or a third party will serve as custodian and whether it, an affiliate, or a third-party RIA will be involved in managing the assets. Solely by virtue of selecting an RIA as a sub-adviser to the CIT, the bank and the CIT would become subject to the Proposed Rule. In such a case, the Proposed Rule would require an RIA to modify certain contractual terms of the custody relationship with the bank serving as trustee for the CIT. This result would create a conflict with any fiduciary obligations under ERISA, including the fiduciary obligation to retain sole decision-making authority with respect to CIT operations, and that a CIT has to be

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75 Proposed 17 C.F.R. § 275.223-1(a)(1)(i)(B).

76 *Id.*

77 Proposing Release at 14,697.

78 *Id.*

maintained by a bank qualify for Section 3(c)(3) and Section 3(c)(11) exemptions under the Investment Company Act of 1940.

Interaction with the Commission's Outsourcing Proposal. The Commission has proposed an additional rule under the Advisers Act that would prohibit RIAs from outsourcing certain services or functions without meeting certain due diligence, monitoring, recordkeeping, and disclosure requirements (the "Outsourcing Proposal").[79] Although the preamble to that proposal suggests that the services of custody banks would not be covered functions under the Outsourcing Proposal, Commissioner Mark Uyeda noted that "that exclusion might be gutted by the [Proposed Rule], which requires investment advisers to enter into direct contractual relationships with their advisory clients' custodians."[80] Commissioner Uyeda noted that certain services could "be subject to both proposed rules" and that "it would appear on the surface that little thought has be [sic] given to how one change interacts with the other."[81]

We urge the Commission to make clear that custody and ancillary services are not "outsourced" services and therefore not within the scope of the Outsourcing Proposal. Except in very limited circumstances, Rule 206(4)-2 prohibits investment advisers from having custody of client assets and further requires a "qualified custodian," such as a bank, to maintain those client funds and securities, and the Proposed Rule would require all client assets to be held by a qualified custodian.[82] Outsourcing, although not specifically defined in the Outsourcing Proposal, typically means "a business practice in which a regulated entity uses a service provider to perform tasks, functions, processes, services or activities (collectively, 'tasks') that would, or could in principle, otherwise be undertaken by the regulated entity itself."[83] In the case of custody of client funds, a non-dually registered adviser cannot "outsource" that function to a third party, because it does not have the authority to do so itself without it being deemed "a fraudulent, deceptive, or manipulative act, practice or course of business."[84] Further, the contractual agreement for custody services is between the investor and the custody bank. Even if the RIA has a relationship with the custody bank and does perform a certain level of due diligence pursuant to its fiduciary duties, it is the investor client, not the advisor, who ultimately chooses and contracts with the custody bank. In the case of a registered investment company, the

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79 *See SEC* Release No. IA-6176, 87 FR 68816 (Nov. 16, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-6176.pdf.

80 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#_ftn18.

81 *Id.*

82 The Signatories' direct the Commission's attention to a letter submitted the American Bankers Association on the Outsourcing Proposal. *See*, American Bankers Association, Re*: Proposed Rule, Outsourcing by Investment Advisers* (Dec. 27, 2022), *available at* https://www.aba.com/-/media/documents/comment-letter/clsec20221227.pdf?rev=7e1aefc6f6bb42ef88ce6a6649f7a4ea.

83 IOSCO, Principles on Outsourcing Consultation Report (May 2020), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD654.pdf. The Basel Committee similarly defines outsourcing to mean activity that "would normally be undertaken by the regulated entity, now or in the future." Basel Committee on Banking Supervision, Outsourcing in Financial Services (February 2005), available at https://www.bis.org/publ/joint12.pdf.

84 17 C.F.R. § 275.206(4)-2(a).

fund's board of directors would exercise its own oversight of the contract for custody or ancillary services pursuant to its fiduciary duties and/or 17 C.F.R. § 270.38a-1.

Additional Issues. The Commission provided only sixty days to comment on the Proposed Rule, despite the Proposed Rule seeking to fundamentally upend the bank custody model. This compressed time frame does not allow for a sufficient exploration of all of the impacts of the Proposed Rule. We have set forth in Annex I additional potential impacts of the Proposed Rule that require consideration.

VI. The Proposed Rule exceeds the Commission's authority.

The Commission does not have the authority to issue the Proposed Rule in its current form. The Advisers Act grants the Commission authority to regulate investment advisory services across many areas, including reporting, proper treatment of confidential information, rules governing advisory contracts, the scope of lawful transactions, an RIA's custodial arrangements, and more. Yet no provision of the Advisers Act provides the Commission authority to regulate custodians for advised clients generally – much less to directly or indirectly regulate banking organizations across core banking functions, such as balance sheet structure and risk management. The Proposed Rule inserts the Commission into matters at the core of the bank regulatory system and conflicts with well-established priorities in maintaining the safety and soundness of the banking sector. The Proposed Rule is an unwarranted intrusion on matters properly left to the bank regulators.[85]

Congress has made clear the circumstances in which it will permit the Commission to govern custodial relationships. The U.S. Supreme Court has stated explicitly that it "expects Congress to speak clearly when authorizing an agency to exercise powers of vast economic and political significance."[86] Congress gave the Commission authority in Sec. 223 of the Dodd-Frank Act to prescribe rules related to examining and requesting information from a custodian holding assets for an advisory client.[87] It did not offer the Commission the authority to intrude on the jurisdiction of the federal banking regulators in order to dramatically alter the banking system, including its safety and soundness.

Courts have made clear that an agency that does not have direct authority to regulate may not do so by indirect means. Indeed, case law has expressly held against an agency shackling private contracts to indirectly regulate activity outside the authority Congress has

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85 The Proposed Rule, if finalized, would impact financial markets and the banking system to such a significant degree that it may also implicate the major questions doctrine. *See, e.g., W. Virginia v. Env't Prot. Agency,* 142 S. Ct. 2587, 2608 (2022) ("[C]ases in which the history and the breadth of the authority that the agency has asserted and the economic and political significance of that assertion[] provide a reason to hesitate before concluding that Congress meant to confer such authority.") (internal quotations omitted). Additionally, the Proposed Rule's treatment of private contracts is a substantial departure from the Commission's previous treatment or private contracts and raises questions with respect to its authority to abrogate those contracts. *See, e.g., Trustees of Dartmouth Coll. v. Woodward*, 17 U.S. 518, 518 (1819) (discussing the limits of governmental authority to impair private contracts.)

86 *Alabama Ass'n of Realtors v. Dep't of Health & Hum. Servs.*, 141 S. Ct. 2485, 2489 (2021) (internal citations omitted).

87 15 U.S. Code § 80b–18b.

delegated. For example, in 2018, the Fifth Circuit Court of Appeals held in the case *U.S. Chamber of Commerce v. U.S. Department of Labor* that, because "agencies are empowered only to enforce the rights Congress creates," the Department of Labor could not issue a rule requiring private contracts to include certain conduct and liability provisions that addressed activity the Department of Labor could not regulate directly. Like the Department of Labor, the Commission has sought to indirectly impose conduct and liability standards through private contracts where it cannot directly regulate, exceeding the power Congress has delegated to it.

The courts and Congress have also made explicitly clear that the Commission's authority to regulate investment activity does not extend to actions that have the effect of changing the regulatory framework governing the banking system. For example, in *American Bankers Association v. S.E.C.*,[88] the United States Court of Appeals for the District of Columbia Circuit held that a rule promulgated by the Commission that attempted to regulate banks engaged in certain securities activity was invalid as an attempt by the Commission to expand its own authority beyond the limits set by the Exchange Act. Similarly, Congress used the Financial Services Regulatory Relief Act of 2006 to mandate that the Commission engage in joint rulemaking with the Board after the Commission had attempted to unilaterally define elements of the Gramm-Leach-Bliley Act.[89]

Custody and safekeeping are among the oldest and most well-established of banking activities, and the management of a bank's balance sheet and risk is the fundamental obligation and remit of the banking regulators. The OCC notes a breadth of risks that offering custodial services create for banks, including "transaction, compliance, credit, strategic, and reputation," and the federal banking regulators already provide guidance on the "properly designed and consistently enforced system of internal controls [to] help management safeguard assets under custody, produce reliable financial reports, and comply with laws and regulations."[90] As discussed above, the proposed mechanisms to give advised clients special protections in a bank insolvency would have significant effects on both the operation of banks prior to insolvency and the treatment of their depositors in an insolvency. Furthermore, by requiring banks to accept liabilities and indemnification obligations described in the Proposed Rule, the Commission would shift significant risks to the banking system, even when those risks are inherent to the investment choices made by the end investor and its RIA and are beyond the control of the custody bank. These shifts, along with the other effects detailed above, represent a significant change that requires prior analysis and input from the banking regulators and other affected parties. Management of these kinds of risks fall under the authority of the federal banking regulators, and the Proposed Rule intrudes by creating obligations for banks that could affect the safety and soundness of the banking system.

The Proposed Release would also require a custody bank to monitor an RIA's instruction authority, even though no such monitoring is stipulated as a term by the contracts that the Proposed Rule would require between an RIA and custody bank. Therefore, without statutory

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88 *See* 804 F.2d 739 (D.C. Cir. 1986).

89 *See* Pub. L. No. 109–351 (Oct. 13, 2006).

90 *Custody Services Comptroller's Handbook*, *supra* note 15, at 2.

authority, the Commission seems to be directly mandating how a banking organization should interpret and implement its custodial responsibilities.

Additionally, the Proposed Rule appears likely to violate well-established banking law without the Commission having any clear statutory authority to do so. The privileged status the Proposed Rule would give to deposits of advisory clients, as compared to all other depositors, would be inconsistent with the priority given to all depositors and to the FDIC under the Federal Deposit Insurance Act, a statute adopted in response to the widespread bank failures of the 1980s and early 1990s and their devastating effect on depositors and the Deposit Insurance Fund.[91] It would violate the principle of ratable recovery for all depositors that underlies most bank insolvency statutes.[92] Collateralization of deposits would run afoul of *Texas & P. Ry. Co. v. Pottorff*, where the Supreme Court held, "National banks lack power to pledge their assets to secure a private deposit. The measure of their powers is the statutory grant; and powers not conferred by Congress are denied."[93] The *Pottorff* case is an exemplar of the significant history of banking law that has developed and is concerned with the appropriate treatment of deposits and the protection of depositors. The Proposed Rule attempts to displace this well-established law by intruding on the authority reserved for Congress and those agencies to which Congress has clearly its delegated authority.

VII. The Commission's economic analysis is incomplete and inadequate, failing to account for numerous significant costs to custody banks and their customers.

The Proposing Release cites Section 202(c) of the Advisers Act, which requires the Commission to issue rules only after analyzing a number of factors, including whether the rule would serve the public interest, protect investors, and promote efficiency, competition, and capital formation.[94] The Commission's Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel issued guidance stating that "high-quality economic analysis is an essential part of SEC rulemaking" and that "[t]he Commission has long recognized that a rule's potential benefits and costs should be considered when making a reasoned determination

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91 *See* 12 U.S.C. 1821(d)(11). *See also* H.R. Rep. No 103-213 at 436–37 ("Because the FDIC is subrogated to the claims of insured depositors, it will increase its recovery and therefore realize a savings under a depositor preference scheme.") David J. Ratway, *National Depositor Preference: In an Attempt to Raise Revenue, Congress Completely Ignores A Potential Disaster*, 19 Nova L. Rev. 1121, 1129–34 (1995) ("From 1986 through 1993, the FDIC, through the deposit insurance fund, paid out approximately $31.93 billion for the resolution of failed banks. It appears that during this same period, if depositor preference had been in effect, the deposit insurance fund would have actually grown because the assets of the failed banks, in most instances, would have been adequate to cover the deposit liabilities of the failed banks.").

92 *See, e.g.,* 12 U.S.C. § 91.

93 291 U.S. 245, 253 (1934).

94 15 U.S.C.A. § 80b-2(c). The United States Court of Appeals for the District of Columbia Circuit has held that the Commission cannot object to challenges based on its analysis of efficiency, competition, and capital formation in a release adopting a rule by later arguing that it was not required to have included such analysis in the first instance. *See American Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010) ("The grounds upon which an administrative order must be judged are those upon which the record discloses that its action was based. The SEC conducted a § 2(b) analysis when it issued the rule with no assertion that it was not required to do so. Therefore, the SEC must defend its analysis before the court upon the basis it employed in adopting that analysis.") (internal citation omitted).

that adopting the rule is in the public interest."[95] That guidance also recognizes that the U.S. Court of Appeals for the District of Columbia Circuit has held that numerous statutes governing the Commission, along with the Administrative Procedure Act, together require that the Commission fulfill its "statutory obligation to determine as best it can the economic implications of a rule" and has found rules to be arbitrary and capricious when the Commission has failed to adequately evaluate their economic impact.[96]

In this case, the Proposed Rule fails to articulate a complete economic analysis. The Commission has not conducted a complete or accurate evaluation of the economic consequences of the Proposed Rule. The economic analysis omits any discussion of the operational, systemic, and financial effects of the Proposed Rule discussed above, and the impact of those factors on costs and competition in the custodial services market and for investors. The economic analysis is lacking with respect to custody banks and therefore we recommend that the Commission re-propose the Proposed Rule with a new preliminary economic analysis to provide the industry with a meaningful opportunity and sufficient time to comment. A fulsome economic analysis of the costs of the Proposed Rule would have to analyze, at a minimum, the following six factors:

1) *The impact of the Proposed Rule on the net interest income of custody banks and the knock on effect for custody fees charged to custody bank clients*. Net interest income generated from operational deposits held at custody banks is a key source of revenue that enables custody banks to provide services to investors at scale and low cost. If custody banks can no longer generate net interest income due to the cash segregation requirements of the Proposed Rule, then custody banks will need to significantly increase custody fees so that they can continue to offer custody services at scale. The Commission has not addressed this substantial impact in the Proposed Rule. Furthermore, the effects of the Proposed Rule would eliminate the use of cash by banks to extend credit into the economy and generate earnings, and these impacts also would need to be quantified at the level of the banking sector and the overall economy.

2) *The impact of the proposal on bank funding*. Custody banks generate a significant share of their overall funding from custody activities, the impact on bank funding and its broader impact on financial markets and financial stability would need to be sufficiently analyzed.

3) *The impact of the Proposed Rule's mandate that custody banks assume liability for the actions of with sub-custodians and CSDs*. The Proposed Rule's new liability regime would likely result in custody banks no longer providing investors access to certain markets, an impact that the Commission's economic analysis does not consider. Additionally, without generating significant benefits, the Proposed Rule would likely lead to a significant increase in the costs of custody

95 *Current Guidance on Economic Analysis in SEC Rulemakings*, SEC (Mar. 6, 2012), p.1, *available at* https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

96 *Id.* (citing *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005); *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011)).

services in those markets where custody banks continue to facilitate investor access. The Commission's economic analysis fails to explore these costs, as well.

4) *The impact of requirements to monitor advisors' compliance with investment management agreements*. These requirements would impose new, granular, and highly prescriptive requirements that would increase costs for custody banks, RIAS, and investors, increase counterparty settlement risk, and dramatically reduce settlement efficiency. The Proposed Rule fails to explore these costs.

5) *The substantial costs associated with building new management and information systems to track and adhere to a raft of new requirements*. The Proposed Rule would require an array of new monitoring and oversight functions that would need to be managed and governed through the establishment of highly complex governance and information systems that would be expensive to establish and maintain over time due to the complexity and granularity of the Proposed Rule's requirements.

6) *The substantial costs associated with re-negotiating and redrafting a large volume of contracts with custody clients*. The Proposed Rule's new requirements would require a large volume of service contracts to be revised to comply with the new requirements. The process of revising and re-negotiating these contracts is time-consuming and costly. The Commission's economic analysis does not sufficiently assess the high cost or the extent to which client contracts and sub-custodian contracts would need to be re-negotiated.

For the reasons discussed above, the Proposed Rule would have a very detrimental effect on efficiency, capital formation, and competition because it would impose enormous costs on custody banks, RIAs, and investors without a corresponding and offsetting benefit in risk reduction. The economic analysis provided by the Commission fails to account for such costs and thereby fails to employ the well-reasoned decision-making required by the APA.

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The Signatories appreciate the opportunity to provide these comments and would welcome the opportunity to discuss them further with you. If you have any questions, please contact the undersigned at atouhey@aba.com, scampbell@fsforum.com, or tabitha.edgens@bpi.com.

Respectfully submitted,

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The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark Uyeda, Commissioner
The Honorable Jaime Lizárraga, Commissioner

ANNEX I

Numerous other impacts of the Proposed Rule require consideration that the Commission has not provided sufficient time to evaluate, including:

- The systemic effects of the Proposed Rule on other major market participants, such as FCMs;
- The costs and complexities of revising all current custody contracts that do not conform to the Proposed Rule;
- The extent of the indemnity provisions in the Proposed Rule to parties beyond the client;
- The effects of the Proposed Rule on compliance with Regulation R;
- The interaction of the Proposed Rule with Rule 15c3-3;
- The interaction of the reporting requirements in the Proposed Rule with the current provision of SOC reports to clients;[97]
- The impact of the Proposed Rule on the visitorial powers for national banks; and
- The effects of the Proposed Rule's asset segregation requirements on pooled and omnibus accounts.[98]

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97 The Proposed Rule would require that a qualified custodian annually obtain and provide to the RIA a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services. Questions 97 and 98 ask if the Commission should impose additional requirements with respect to internal control reports, such as requiring reporting of discrepancies to the Commission or to clients, or prescribing how investment advisers should evaluate control reports. Currently, clients generally require custody banks to furnish a SOC report. The Signatories have not had sufficient time to evaluate whether being required to furnish an internal controls report, as proposed in the Proposed Rule, instead of, or in addition to, a SOC report, and to furnish it to RIAs as well as clients, would result in increased costs or other burdens, or whether such a requirement would provide any appreciable benefit to clients or RIAs.

98 We are still seeking to understand how a custody bank could provide custody of such assets in practice, but note that these assets are already subject to extensive customer-protection regimes.