THE ASSOCIATION OF GLOBAL CUSTODIANS

BNP PARIBAS
BNY MELLON
BROWN BROTHERS HARRIMAN
CITIBANK, N.A.
DEUTSCHE BANK
HSBC SECURITIES SERVICES
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NORTHERN TRUST
RBC INVESTOR & TREASURY SERVICES
SKANDINAVISKA ENSKILDA BANKEN
STANDARD CHARTERED BANK
STATE STREET BANK AND TRUST COMPANY

COUNSEL AND SECRETARIAT TO THE ASSOCIATION:

BAKER & MCKENZIE LLP

GLOBAL
ATT: ROBIN TRUESDALE
815 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006
TEL: 202 452 7000
FAX: 202 452 7074

WWW.THEAGC.COM

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Via E-Mail to rule-comments@sec.gov

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

Re: Investment Advisers Act Release No. 6240, Safeguarding Advisory Client Assets (February 15, 2023) ("Release No. 6240")
File Number S7-04-23

Ms. Countryman:

The Association of Global Custodians ("AGC") appreciates the opportunity to comment on proposed Investment Advisers Act Rule 223-1, Safeguarding Client Assets ("Proposed Rule 223-1" or "Proposal"), which would revise, restructure, and expand the requirements governing custody of the assets of clients of investment advisers registered with the Securities and Exchange Commission ("Commission"). The AGC, established in 1996, is a group of twelve financial institutions that provide worldwide securities safekeeping services and asset-servicing functions, primarily to institutional cross-border investors.[1] In that capacity, members of the AGC act as qualified custodians for the assets of clients of registered investment advisers under current Rule 206(4)-2. Proposed Rule 223-1, if adopted, would directly affect AGC members by making significant changes in the terms and conditions under which they could provide custody services to these clients.

The Proposal, which is far-reaching and complex, would represent a fundamental shift from current market practice for traditional custody services and would severely impact the ability

[1] The members of the AGC are BNP Paribas, BNY Mellon, Brown Brothers Harriman & Co., Citibank, N.A., Deutsche Bank, HSBC Securities Services, J.P. Morgan, Northern Trust, RBC Investor & Treasury Services, Skandinaviska Enskilda Banken, Standard Chartered Bank, and State Street Bank and Trust Company. The AGC represents members' common interests on regulatory and market structure matters through comment letters, white papers and interaction with legislative and regulatory authorities and financial industry organizations. Member banks are competitors, and the AGC does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses.

of global custody banks to provide custody services at scale and at low cost to a wide range of institutional investors. The AGC supports the Commission's objective of ensuring that the assets of advisory clients are subject to appropriate custody standards. However, in formulating the Proposal, the Commission does not seem to have considered the impact on the cost and availability of traditional custody services to investors. Further, the Commission does not appear to recognize the robustness of the existing global custody bank model, under which global custody banks are subject to stringent bank regulatory prudential regulation and oversight to ensure that our activities are conducted in accord with well-established principles of safety and soundness.

Many elements of the Proposal are, in the AGC's view, seriously flawed. Most critically—

- Mandatory cash segregation would significantly increase the cost and complexity of providing custody services to institutional investors, increase operational and settlement risk, and decrease market liquidity. Removing client cash from global custody bank balance sheets would also adversely impact funding and liquidity management.

- Imposing on global custody banks liability for losses beyond their control, such as at central securities depositories, and requiring broad customer indemnification would increase custody fees and restrict the markets in which custody services are offered.

- Global custody bank monitoring of adviser compliance with authority limitations would severely reduce the speed and efficiency of transaction processing and increase counterparty and settlement risk.

If adopted, the Proposal would – to the extent it could be implemented – substantially increase the cost of providing custody services to the clients of investment advisers without any corresponding reduction in custody risk. In many global markets, major financial institutions like the members of the AGC might decline to provide custody services to advisory clients, resulting in fewer investment choices. In those markets where global custody banks continued to offer custody to advisory clients, there would be a significant reduction in services, particularly cash management and liquidity services, as well as reduced market connectivity for investors. This service reduction would have serious implications for the efficient operation of the securities markets. Further, the added costs of the Proposal would likely require global custody banks to impose substantial fee increases in order to generate sufficient revenue to remain in the custody business. Higher fees would raise investor costs without offsetting benefits.

For these reasons, the AGC urges the Commission to abandon the Proposal in its current form. At minimum, the Commission should (1) not require global custody banks to segregate client cash deposits from proprietary assets and liabilities; (2) clarify that global custody banks are not liable for entities, such as central securities depositories ("CSDs"), or events, such as sub-custodian insolvency or force majeure, that are outside their control; (3) not require that global custody banks broadly indemnify clients against loss; (4) not require global custody banks to review investment adviser settlement instructions to determine if they are within the scope of the adviser's authority; and (5) exempt from the custody requirements asset classes that are impossible or infeasible to hold in custody. The Commission should instead consider regulatory alternatives that more appropriately achieve the Commission's policy goals and target specific issues – such as crypto asset custody or lightly regulated alternative custody providers – without disrupting the functioning of traditional markets.

Before proceeding further, the Commission should also undertake a more comprehensive cost/benefit analysis than is provided in Release No. 6240, including a more complete inventory of the impacts of the rule on registered advisers, their clients, and qualified custodians. It is also essential that the Commission consult with the federal bank regulatory agencies to ensure that its proposals do not conflict with banking regulation and policy.

In this letter, the AGC describes the current global custody model, outlines policy concerns raised by the Proposal, and comments on key aspects of the Proposal that would be unworkable or disruptive to the operation of the global markets.

I. The Role and Responsibilities of Global Custody Banks.

Global custody banks perform a suite of essential services without which financial markets could not properly function. They do so pursuant to well-defined relationships with institutional asset owners. The Proposal would fundamentally upset this model, which has functioned well over many decades, and which underpins the ability of investors to gain low-cost access to global markets. To place these concerns in context, we briefly summarize the role and responsibilities of global custody banks below.

Global custody banks provide important services to institutional investors that contribute to market efficiency and financial stability. These institutional investors include pension funds, insurance companies, national, state, and local governments, and mutual funds, among others. Institutional investors, in turn, support the ability of their participants, representing a broad range of the public, to secure and preserve wealth and financial security. They aim to deliver financial returns for end investors, provide those investors with access to a diverse range of investable assets globally, and ensure the safety and protection of their assets. The beneficiaries of the services of global custody banks are the investing public – for example, pensioners, employees saving for retirement, people served by educational and other non-profit institutions, and retail investors – which gain access to the financial markets through the institutions that global custody banks serve.

To achieve their aims, institutional investors must operate at scale and in a cost-effective and efficient manner. However, most do not have the infrastructure, technology, or expertise to access global financial markets directly. Providing that infrastructure, technology, and expertise is the role of a global custody bank.[2] AGC members facilitate investor demand to

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[2] In 2016, The Clearing House, published a white paper entitled Custody Services of Banks (Clearing House Paper). The paper is a comprehensive discussion of the custody and related services provided by U.S.-based banking organizations that act as global custody

invest in assets in multiple markets globally by connecting institutional investors with those markets.[3] In doing so, global custody banks act as directed agents for their institutional investor clients.

The primary services global custody banks provide are safekeeping, settlement, payment and liquidity services, and asset servicing:

- Safekeeping. As reported by Global Custodian, at the end of the fourth quarter of 2022 the largest custodians collectively held nearly $250 trillion in assets under custody.[4] Securities held on behalf of clients are segregated from the bank's own assets and cannot be used to satisfy the claims of the global custody bank's creditors in the event of insolvency. Global custody banks perform daily reconciliations of these securities positions against books and records of subcustodians and CSDs when these entities are part of the custody chain and have a direct relationship with the global custody bank.

- Settlement. The largest global custody banks collectively process millions of settlements daily by providing the post-trade infrastructure that connects buyers and sellers of investment assets. Disruption of this activity would impair the efficiency and reliability of routine clearance and settlement processes.

- Payment and Liquidity Services. Global custody banks hold client cash on deposit for operational purposes in order to support client investment activity across multiple currencies. This cash is generally held in demand deposit accounts (and reflected as a liability on the global custody bank's balance sheet). These accounts permit institutional investors to face a global custody bank as their single counterparty, rather than carrying exposure to multiple foreign banks. Important payment and liquidity services include the extension of billions of intraday and overnight credit/liquidity, foreign exchange services, collateral management, securities lending, and sweep services. Without these services, institutional investors would not be able to invest efficiently and across many markets with minimal operational and credit risk.

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banks. As The Clearing House observes: "The activities of custodians help to link investors to issuers of securities and thereby facilitate the infrastructure investment and physical capital formation necessary for economic growth and the accumulation of retirement and other long-term savings. * * * [T]he services provided by custodians are critical to the functioning of the global financial system * * * ." Clearing House Paper at iii, footnote omitted.

[3] Bank custodians provide client access to components of the global financial system, such as central counterparties and central securities depositories, "without which clients could not conduct transactions across global financial markets." Clearing House Paper at iii.

[4] Global Custodian, Custodians by assets under custody and administration, Q4 2022 Rankings, available at https://www.globalcustodian.com/custodians-assets-under-custody/.

- Asset Servicing. Global custody banks provide important asset servicing functions, such as corporate action, income, and tax processing. These services ensure that cash generated by investment activity is efficiently directed to institutional clients and ultimately to end investors.

Custody banks provide these services within a framework of prudential regulation that addresses such matters as capital, liquidity, stress testing, and other financial soundness requirements; cyber security and other operational resiliency obligations; recovery and resolution planning; and anti-money laundering and financial crime compliance.[5] Global custody banks have served institutional investors for many years without major failures, and no evidence justifies the fundamental changes in their service model that the Commission has proposed.

II. The Proposal's Unintended Policy Consequences.

Apart from the AGC's concerns with specific aspects of the Proposal, we believe that the Commission's approach to custody regulation in Proposed Rule 223-1 would undermine important policy objectives and overstep the statutory boundaries between the Commission and the bank regulators.

A. The Proposal Would Significantly Impair the Efficient and Orderly Operation of the Securities Markets.

The Proposal would impair the efficient operation of the securities markets. First, the functions that global custody banks perform depend on access to liquidity and the integration of that liquidity with custody services. When a client engages in the purchase or sale of a security, a global custody bank facilitates the delivery or receipt of the security and the related cash consideration at the direction of the client. The source of the cash used to facilitate settlement is the global custody bank's deposit base. If custody client cash were segregated off-balance sheet and no longer part of the bank's deposit base, the ability to service clients and extend intraday liquidity would be seriously diminished. Depriving global custody banks of access to this liquidity source would have severe market impacts, such as a reduction in straight-through-processing (STP), impairment of the ability of global custody banks to provide intraday liquidity to facilitate settlement on a delivery-versus-payment (DVP) basis, and an increase in settlement risk.

Second, imposing responsibility on global custody banks to monitor investment adviser trade settlement instructions for conformity with the adviser's authority would significantly delay transaction processing and would not be manageable. Even if information regarding the

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[5] The Clearing House points out that, although nonbanks could provide some custody services, clients generally prefer to use global custody banks because banking entities (i) can provide traditional banking services, cash deposit accounts and access to payment systems and (ii) are subject to robust prudential regulation and oversight. Clearing House Paper at iii.

investment adviser's authority were included in the agreement between the global custody bank and the adviser, the Proposal mistakenly assumes adviser's authority can be clearly specified for all types of trades. There would inevitably be ambiguity as to whether a specific instruction falls within the scope of the agreed-upon authority (e.g., trades for hedging purposes). Transaction monitoring, like cash segregation, would reduce the ability to provide STP and increase settlement risk. This would be inconsistent with the speed and automation of modern securities trading and with the Commission's objectives relating to shortening the settlement cycle to one business day after the trade date ("T+1").

B. The Proposal Impinges on Federal and State Bank Regulation.

The Proposal impinges on federal and state bank regulation. Overlapping and inconsistent regulation of global custody banks by the Commission and the bank regulators would potentially erode important aspects of bank regulation. For example –

- Maintaining the safety and soundness of the banking system is the core responsibility of the bank regulators, and bank liquidity and risk mitigation are central elements of prudential regulation. However, several aspects of the Commission's proposal would undercut safety and soundness and make the banking system more brittle. For example, segregating cash in an account that would protect it from a global custody bank's creditors in the event of insolvency or failure (i.e., requiring that cash be bankruptcy remote) could require some global custody banks to seek new sources of financing that would introduce higher capital costs and new credit risks into their capital structures. In addition, the Proposal would expose global custody banks to liabilities that are difficult to anticipate or quantify and that arise from CSD and subcustodian risks over which the bank has no control.

- Cash segregation would undermine one of the objectives of the federal deposit insurance regime by affording the claims of some stakeholders (i.e., investment adviser clients) priority over the claims of general depositors and the Federal Deposit Insurance Corporation (FDIC) as receiver.

- The Proposal would force changes in bank custody practices for all clients, not just those that are clients of registered investment advisers. However, determining the terms and conditions under which a bank can provide a traditional banking service like custody is the responsibility of the banking regulators, not the Commission.

C. The Proposal Would Increase Investor Costs and Limit Investor Choice.

The proposal would dramatically increase the cost of investing and reduce the range of available investments for the clients of investment advisers. Custody is a low margin business,[6] and new costs imposed on global custody banks, particularly as a result of the proposed cash segregation and liability provisions, would likely affect their institutional

[6] Release No. 6240 at 257.

investor clients and ultimately the underlying investment beneficiaries. Global custody banks might also limit the markets in which they offer services, particularly by avoiding those that present higher risk of loss. As a result, investors would find it far more difficult, or impossible, to access many global markets. Investing in the markets that remained available would be more expensive.[7]

Before proceeding further with this rulemaking, the Commission should undertake a comprehensive cost/benefit analysis of the impact of all aspects of the Proposal. The economic analysis in Release No. 6240 identified several areas as to which the Commission did not fully discuss or quantify likely costs. Further, in some respects, the analysis the Commission does provide is based on assumptions that differ from market practice. We urge the Commission to address these gaps and deficiencies in its analysis and reconsider the Proposal based on a full understanding of its economic effects on investors, investment advisers, global custody banks, and the securities markets overall.

III. Key Elements of the Proposal are Unworkable and Would Disrupt the Markets.

Many aspects of the proposal raise significant operational issues for global custody banks and would dramatically impact the ability of AGC members to provide current custody services to the clients of investment advisers.

Before turning to specific aspects of the Proposal, we note that the means by which the Commission seeks to impose new requirements on global custody banks are inappropriate and possibly ineffective. Proposed Rule 223-1(a)(1)(i) would require an investment adviser that has custody of client assets to enter into a written agreement containing certain prescribed terms with a qualified custodian to maintain possession or control of the client's assets. Similarly, Proposed Rule 223-1(a)(1)(ii) would require the investment adviser to obtain written reasonable assurances from the qualified custodian that its custody practices will comply with certain requirements.

Some global custody banks may be unwilling to enter into the type of contract required under the Proposal or to provide certain of the written reasonable assurances to the investment adviser, and the Commission has no power to force banks to do so. If major global custody banks conclude that the contractual terms and reasonable assurances that the Commission proposes to require are operationally or economically infeasible, advisers will be forced to place client assets in the custody of other types of institutions, possibly increasing, rather than reducing, the risks to which those assets are exposed. Those global custody banks that are willing to accept the new terms would incur significant additional costs as a result of the need

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[7] As applied to major financial institutions such as AGC members, the costs the Proposal would impose on investors would not be outweighed by any benefits. Investment adviser clients of global custody banks have not suffered custody-related asset losses under the existing rule. There is no factual record justifying the substantial increase in the cost of custody that would result from the Proposal.

to enter into contracts with clients' investment advisers (which is today uncommon) and to provide the required continuing assurances.

Further, while proposed Rule 223-1(a)(1) is phrased as a requirement with which investment advisers must comply, to the extent it would apply to banks, it is in effect an attempt to regulate their custody practices. This backdoor approach is incompatible with federal and state bank regulation. Nothing in the federal securities laws suggests that Congress intended to empower the Commission to regulate the activities of global custody banks. If banks are to be required to implement the contractual terms and reasonable assurance provisions in Rule 223-1(a)(1) as part of their custody services, that mandate should be promulgated by their functional regulators, not by the Commission.[8]

A. Cash Segregation.

The Proposal would require that an investment adviser obtain reasonable assurance in writing from the client's qualified custodian that the qualified custodian "will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities."[9] Further, a bank could only serve as a qualified custodian if it "holds 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."[10] The release makes clear that the intent of these provisions is to require that cash held for an investment adviser's custody client must be segregated in a bankruptcy remote manner from customer deposits.[11]

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[8] Release No. 6240 (at 406-407) cites three authority sources for proposed Rule 223-1: Investment Advisers Act Sections 206(4), 211(a) and 223. None of these confers any authority over banks. Section 223, the provision on which the Commission chiefly relies, only affords the Commission authority over advisers: "An investment adviser registered under this title shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe." (emphasis added).

[9] Proposed Rule 223-1(a)(1)(ii)(D).

[10] Proposed Rule 223-1(d)(10)(i).

[11] See Release No. 6240 at 44-45 ("account terms should identify clearly that the account is distinguishable from a general deposit account and clarify the nature of the relationship between the account holder and the qualified custodian as a relationship account that protects the client assets from creditors of the bank . . . in the event of the insolvency"). The release refers to use of a special deposit account as a vehicle for cash segregation. Release No. 6240 at note 93. The concept of a "special deposit account" is not well-defined and is not consistent across the laws of the various states. The use of special deposit accounts is likely to result in more, not less, uncertainty and lack of uniformity in the treatment of cash deposits.

Impact of Cash Segregation.

Bankruptcy remote cash segregation would be a radical departure from current banking practice and would undermine the ability of global custody banks to provide core financial services.[12] Global custody banks today do not segregate custody client cash or establish "special accounts" to hold cash.[13] Custody client cash is a deposit liability and, like any customer cash deposit, becomes the property of the bank and can be used as part of the bank's regulated activities. This is the essence of banking – the receipt of deposits that become bank liabilities and the use of those deposits to extend loans that then constitute bank assets, or for other purposes, subject to prudential regulation.

In the case of global custody banks, like the members of the AGC, the primary use of depositor cash is operational -- to finance custody client transaction settlement and other client services. Loss of this liquidity source would slow settlement processing[14] and significantly disrupt the efficient operation of securities markets that are increasingly operating at accelerated speed. This would be counter to the objective of the Commission's recently adopted rule accelerating the settlement cycle to T+1.[15] In addition, by removing cash from the balance sheet, segregation would preclude global custody banks from providing intraday liquidity to facilitate STP and settlement on a DVP basis to clients. As a result, the settlement

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[12] Release No. 6240 (at 93) states: "We do not intend the segregation requirement to preclude traditional operational practices in which client assets are held in omnibus accounts or otherwise commingled with assets of other clients because we recognize that custodians regularly maintain assets in a manner that allows such assets to be identified as held for a particular client, distinct from assets of other clients, and not subject to increased risk of loss arising from a custodian's insolvency." It is difficult to reconcile this statement with proposed Rule 223-1, which would appear to prevent the "traditional practices" which the Commission asserts that it does not wish to preclude.

[13] Release No. 6240 seems to assume that national banks that act as qualified custodians are fiduciaries and already segregate cash. See Release No. 6240 at note 170. On the contrary, global custody banks are not fiduciaries and, as explained in this letter, do not segregate custody client cash.

[14] Capital market investors do not tend to prefund their trades and, if a global custody bank's access to depositor cash is curtailed, capital markets financing activities would be impacted. This would include short-term credit financing to cover temporary client shortfalls for settlement and intraday liquidity to bridge cash flow timing differences. These activities are important to the smooth operations of securities settlement.

[15] "Promoting the timely, orderly, and efficient settlement of securities transactions has been a longstanding Commission objective." Shortening the Securities Transaction Settlement Cycle, Securities Exchange Act Release No. 96930 at 7 (February 15, 2023).

process would become more costly, complex, and risky for both clients and their counterparties.

Cash segregation, and the corollary removal of client cash from the balance sheet, would also materially change the economics of the custody business by limiting the ability for global custody banks to earn net interest income ("NII") on investor deposits and to act as a cash banker for its clients. NII supports a large part of a global custody bank's infrastructure costs and allows global custody banks to offer their services at competitive rates. NII would be materially impaired as a result of the proposed bankruptcy remote cash segregation requirement. The loss of NII would require an offsetting increase in custody fees, which would come at the expense of return on investments for investment adviser clients. Reduced NII could also impact the ability of global custody banks to invest in modern technologies to safeguard client assets, facilitate smooth T+1 settlement, improve client services, and support capital market innovation.

Cash Segregation Conflicts with Banking Regulation.

The segregation of cash deposits of investment adviser clients would also be contrary to the depositor preference system in the Federal Deposit Insurance Act. (FDI Act).[16] The FDI Act affords all depositors priority over other bank creditors; in contrast, proposed Rule 223-1 appears to prioritize deposits held for clients of investment advisers over deposits of other customers and over the claims of the FDIC as receiver.[17] Giving the deposits of clients of investment advisers special status would be contrary to the intent of the FDI Act and the public policy it embodies.

Absence of Cash Segregation Benefits.

In the case of large global custody banks, like the members of the AGC, the costs of cash segregation would not have offsetting benefits for investors. For these large institutions, which are subject to stringent prudential regulatory capital and liquidity requirements, the risk that depositors will incur losses as a result of insolvency is very limited. The reduction in

[16] 12 U.S.C. 1811 et seq.

[17] In 1993, Congress amended the FDI Act to establish a system of depositor preference in failed-bank resolutions. In general, ''depositor preference'' refers to a resolution distribution regime in which the claims of depositors have priority over (that is, are satisfied before) the claims of general unsecured creditors. Under this regime, set forth in section 11(d)(11) of the FDI Act, 12 U.S.C. 1821(d)(11), the receiver of a failed bank distributes amounts realized from its liquidation to pay claims based on a prescribed order of priority: Administrative expenses of the receiver are reimbursed first; any "deposit liability" is reimbursed next; these claims are followed in order by general or senior liabilities, subordinated liabilities, and obligations to shareholders.

services and added costs that custody clients would experience as a result of the Proposal far outweigh that risk.[18]

Rather than increasing the safety of advisory client cash, segregation, as applied to AGC member banks, could actually have the opposite effect. The inability of global custody banks to use client cash to provide liquidity to facilitate settlement would force clients to prefund their trades, which would increase their deposit risk and costs. Moreover, the most direct way of segregating custody client cash and insulating it from the risk of the global custody bank's insolvency would be to deposit such cash at another bank. However, if segregation were accomplished by depositing advisory client cash in an account at another bank, the cash would become subject to the insolvency risks of that bank, which might be smaller and less well-capitalized or liquid than the global custody bank the investor chose for custodial services. In this form, cash segregation would not reduce risk, it would merely shift it to another banking institution.[19]

Recommendation.

For these reasons, the AGC strongly recommends that the proposed bankruptcy remote segregation requirement not apply to cash deposits of investment adviser clients at global custody banks, the deposit-taking activities of which are regulated by the relevant banking authorities. If the Commission believes that there are other types of entities that provide custody services to investment adviser clients that pose a demonstrable risk to the safety of cash, rather than disrupting the global custody bank industry, it should focus any cash segregation requirement on those entities. The AGC membership is composed of both federally regulated and state regulated banks as well as foreign financial institutions (FFIs), and the existing definition of qualified custodian in Rule 206(4)-2(d)(6) encompasses the members of the AGC as either banks or FFIs. The AGC sees no reason to narrow these definitions.[20] Narrowing the definition of qualified custodian would lead to further concentration in the industry.

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[18] These limitations on services and added costs would also affect subcustodians holding assets in overseas markets.

[19] In addition, cash segregation could increase operational risk and complexity for investors by requiring them to set up and manage separate cash accounts at multiple banks in multiple currencies. Multiple accounts would also create significant processing inefficiencies and contribute to a heightened risk of settlement failures.

[20] The AGC has serious concerns with the FFI definition in Proposed Rule 223-1. Our views are set forth in the joint comment letter on Proposed Rule 223-1 submitted by the AGC's European Focus Committee, the Association of Financial Markets in Europe, and the European Banking Federation.

B. Liability for Losses Arising at Depositories and Subcustodians.

The Proposal would require a custody client's investment adviser to obtain reasonable assurance in writing from the qualified custodian that "the existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client."[21] Release No. 6240 states that requiring custodians to assume liability for subcustodians and securities depositories "would help reduce the ability of a qualified custodian to avoid responsibility for the other important safeguarding obligations it has to the advisory client by delegating custodial responsibility to a sub-custodian, securities depository, or other similar arrangements."[22]

Unclear Purpose and Scope.

The intended scope and impact of this reasonable assurance is unclear. The assurance could be read to suggest that the Commission intends to impose strict liability on global custody banks for losses caused by subcustodians, CSDs, and other third parties. Alternatively, the intent could be to extend the due care standard for custodians in proposed Rule 223-1 to subcustodian conduct, such that the custodian would be liable for losses resulting from subcustodian and depository negligence. Finally, the intent could be to impose liability on custodians only if the custodian's use of the subcustodian or depository that caused a loss was a (i) discretionary decision of the custodian and (ii) a breach of the global custody bank's duty of due care.[23]

Central Securities Depositories and Market Infrastructure Risk.

If it is read broadly, as the Commission's comments in the release seem to imply, this aspect of the proposal is based on a misunderstanding of how global securities markets operate and of the role of global custody banks. By lumping together all "sub-custodian, securities depository, [and] other similar arrangements," it would impose liability on global custody banks for losses arising from the use of custody facilities that they do not select and over which they have no control. In particular, the use of CSDs is not optional and is certainly not motivated by a global custody bank's desire to "avoid responsibility," as Release No. 6240 suggests.

To invest in markets outside their home country, investors must have access to the financial system infrastructure of other jurisdictions, including CSDs, which are highly regulated market utilities. Providing that access is one of the core custody services of global custody

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[21] Proposed Rule 223-1(a)(1)(ii)(C).

[22] Release No. 6240 at 91.

[23] The latter is the only workable reading of the provision. The other interpretations would go far beyond the level of protection to which a client would be entitled if it directly hired a custodian in the local market.

banks. In virtually all markets, securities are immobilized in a CSD. Therefore, the investor's decision to purchase securities in a market is unavoidably also a decision to utilize the market's CSD. The global custody bank does not "select" the CSD or have any control over its operations or risk profile. Exposure to those risks is a consequence of the custody client's (or its adviser's) decision to invest in the market in which the CSD operates.[24]

The use of a CSD is an aspect of the "country risk" of an investment – the set of risks that stem from the decision to invest in a country's securities markets. Imposing liability on global custody banks for losses arising at a CSD would shift part of the country risk of the investment from the investor to the custodian. There is no logical basis to do so.

Subcustodians.

The relationship between a subcustodian and a global custody bank differs from the relationship with a CSD. In many markets, the investor's global custody bank does not have the ability to participate directly in the CSD; participation is limited to local institutions that meet certain requirements. Therefore, the only way an investment adviser's client can invest in a market is for its global custody bank to establish a subcustody relationship with an institution that is a member of the market's CSD. Global custody banks select their subcustodians, although in some markets the choices may be limited. However, unless the subcustodian is an affiliate of the global custody bank, the global custody bank does not control the business decisions of the subcustodian, and all subcustodians are of course subject to the regulatory regime and market risks of the jurisdiction in which they operate. Therefore, even in the case of subcustodians selected by the global custody bank, losses may occur, such as from insolvency, force majeure, or some other external cause, which are beyond the control of the global custody bank and not the result of its failure to exercise due care.

Impact of Custody Chain Liability.

The Proposal seems to ignore the distinctions summarized above between CSDs and subcustodians and could be construed to impose liability on global custody banks for losses that occur anywhere in the custody chain and for any reason. Requiring global custody banks to accept this broad liability would shift significant investment risks from investors and investment advisers to banks, thereby injecting additional geopolitical risk into the banking system as a whole, with potential systemic risk implications.[25] Moreover, in the face of such

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[24] Recognition that the use of a CSD is not discretionary underpins Investment Company Act Rule 17f-7. See Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 24424, (April. 27, 2000).

[25] With regard to securities depositories, imposing liability on global custody banks for losses arising from securities depositories would also conflict with Office of the Comptroller of the Currency safety and soundness standards and principles limiting the risks that a bank can assume as a participant in a CSD.

broad liability, global custody banks may refuse to custody investment adviser client assets in many jurisdictions. This refusal could extend, not just to emerging/frontier markets, but could result in only the most developed jurisdictions being available to advisory clients. This would deprive these clients of the opportunity to invest in many markets, notwithstanding their understanding of, and willingness to accept, the risks of the market.[26]

Any global custody bank that was willing to accept full liability for subcustodians and CSDs in particular markets would require compensation for assuming this new risk. This would substantially increase the cost of providing custody services in those markets, and those costs would ultimately impact adviser clients.

Recommendation.

The AGC recommends that any revisions to the custody requirements make clear that a global custody bank has no liability for CSD losses, since they do not select CSDs, cannot oversee or control the operations of CSDs, and cannot elect to withdraw customer assets from a CSD. Similarly, subcustodian losses that result from causes beyond the global custody bank's control should not be the responsibility of the global custody bank.

C. Indemnification.

The Proposal would require that a custody client's investment adviser obtain reasonable assurance in writing from the qualified custodian that the qualified custodian "will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct"[27] The objective of this provision is to "create a minimum floor of custodial protection for investors – including those investors that have little or no power to negotiate for those protections – in the event of custodial misconduct."[28]

Unclear Purpose and Scope.

[26] Alternatively, clients (and their advisers) might attempt to interact directly with the market infrastructure to settle a trade or hold a position in markets where global custody banks refuse to provide access. However, this would be costly, and investors are seldom equipped to become direct market participants in multiple markets. Those few clients that could interact directly with subcustodians, clearance and settlement facilities, and CSDs would face the same, if not greater, risks as would arise from accessing markets through a global custody bank. It is difficult to see why global custody banks should be liable for risks that, without their participation, the client would simply face directly.

[27] Proposed Rule 223-1(a)(1)(ii)(B).

[28] Release No. 6240 at 88.

In our view, the indemnification reasonable assurance is unnecessary and injects confusion and cost into custody relationships. The Proposal seems to confuse the concepts of liability and indemnity. A separate provision of the proposal would require the custodian to provide reasonable assurance to the adviser that the custodian "will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss."[29] Presumably, any loss arising from a breach of this standard of care (which, we believe, would encompass negligence, recklessness, or willful misconduct) would result in custodian liability to the custody client. The release does not explain whether liability under the indemnification provision is intended to be broader than under the standard of care provision and, if so, in what way. If the Commission intends the indemnification provision to modify the standard of care, it should explain its objective and allow an opportunity for public comment.[30]

Insurance Requirement.

The AGC also disagrees with the aspect of the proposed indemnification that would require its members to carry insurance for the benefit of clients. The notion that banks should carry commercial insurance to cover potential losses from the performance of a core banking function like custody is at odds with the nature and purpose of bank regulation. Banks manage their risk exposures, not through insurance, but rather through the holding of capital, including operational risk capital, in accordance with requirements set by their regulators. Capital requirements are a basic element of the prudential regulatory framework to which global custody banks, like the members of the AGC, are subject. The purpose of regulatory capital is to ensure that banks have ample resources to cover potential losses arising from their businesses. For the Commission to layer an insurance requirement on top of the regulatory capital requirements is unnecessary and inconsistent with the rationale for those requirements.

The record of global custody bank liabilities to clients does not provide evidence that the major financial institutions that act as global custody banks have been, or are likely to be, unable to satisfy claims arising from their custody businesses without insurance. For AGC members, imposing this cost would not afford clients additional protection. Moreover, there is no market today for full insurance of custody assets and it is at best unclear whether insurers would be willing to create such a market.

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[29] Proposed Rule 223-1(a)(1)(ii)(A).

[30] The proposed indemnification requirement attempts to cover a complex and nuanced topic in a very brief statement. Indemnification clauses typically address third-party claims against the indemnified party and often include such matters as scope, limits, obligation to defend, limitations, and ability of either party to settle with the third party. It is unclear whether the Proposal seeks to address third party claims or what the source of such claims would be and whether it is intended to preclude the kinds of terms and limitations usually found in indemnification clauses.

Impact of Indemnification.

A one-size-fits all indemnification requirement could, as the Commission recognizes, trigger a substantial increase in potential global custody bank liability and therefore a substantial increase in the cost of providing custody services to investment adviser clients. Mandatory insurance coverage would also add a new cost. Global custody banks may be unwilling to assume those costs or willing to assume them only as to certain clients or markets; clients of custodians that agree to indemnification will also feel the impact of these higher costs.

Recommendation.

The AGC recommends that the Commission delete the indemnification reasonable assurance from the Proposal. The exact terms of liability for losses resulting directly from acts of the custodian should be left to negotiation between the global custody bank and its institutional investor client. The AGC recognizes that global custody banks may have liability for client losses that are directly attributable to the global custody bank's failure to exercise due care in accordance with reasonable commercial standards. An indemnification provision is unnecessary to enforce that liability and creates uncertainty as to whether it creates a broader scope of liability than would result from the standard of care in the Proposal.

D. Oversight of Adviser's Authority.

The Proposal would require that the investment adviser's written agreement with the qualified custodian specify the investment adviser's "agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations."[31] The Commission's objective in proposing this requirement is to address situations in which the standardized terms of the custodian's agreement with the custody client confer broader authority on the adviser than is provided in the advisory contract between the adviser and the client. The release states that custodians are reluctant to customize the level of investment adviser authority because doing so would increase "their need to monitor customer accounts, and to accept liability, for unauthorized transactions by an adviser and its personnel."[32] The Proposal would apparently force global custody banks to accept this monitoring responsibility and the attendant liability exposure.

Impact of Monitoring Adviser Authority.

Ensuring that instructions received from advisers conform to their authority is outside the role of a global custody bank, would be operationally impractical, and could create a moral hazard. Global custody banks do not exercise discretion as to client trading or asset transfers, do not analyse the underlying authority for instructions, and do not monitor the relationship

[31] Proposed Rule 223-1(a)(1)(i)(D).

[32] Release No. 6240 at 106.

between asset owners and their advisers. Global custody banks are directed agents that act on instruction to provide access to market infrastructure. Performing a compliance function for investment advisers would be inconsistent with that role.

Account monitoring would also be inconsistent with the highly automated operations of modern markets.[33] As the release recognizes, banks provide custody services under standardized contracts. It would be impossible to process large volumes of transactions if, in each case, it were necessary to refer to the underlying custody contract to determine whether the instruction from the adviser on which the transaction was based conformed to any unique limitations to which the adviser was subject with respect to the particular client involved.

At minimum, global custody bank authority monitoring would adversely affect the speed and efficiency of transaction processing. It is highly doubtful that the review process could be fully automated, and manual intervention would frequently be necessary. Since the scope of the authority of the adviser would vary from client to client, it would be necessary to examine each instruction, verify who initiated it,[34] and compare the instruction to the terms of the underlying agreement. Even if automation were possible, banks would be required to develop and deploy new technology and screening tools that do not exist today in the context of custody services. In any event, the delays inherent in monitoring compliance with any limitations on the scope of the adviser's authority on a trade-by-trade basis would preclude STP, increase settlement risk, and fundamentally conflict with the "timely, orderly, and efficient settlement of securities transactions" the Commission envisioned when it mandated T+1 settlement.[35]

The costs of providing this new service to investment adviser clients would be substantial,[36] and the operational impact would adversely affect investors.[37] The monitoring requirement

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[33] For this reason, it is misleading to characterize global custody banks as "gatekeepers." Release No. 6240 at 14, 41, and 334. The responsibilities of global custody banks do not involve oversight of investors or their advisers or veto power over their actions.

[34] Release No. 6240 (at page 106) notes explicitly that misuse of legitimate authority by "a rogue advisory employee" is one of the risks the Proposal seeks to transfer to custodians.

[35] Securities Exchange Act Release No. 96930, note 15 above at 7.

[36] For example, as noted above, requiring global custody banks to police transactions for compliance with limitations on the investment adviser's authority would be akin to imposing the duties of a fiduciary/trustee on the banks. The fees of banks acting in such a capacity are significantly greater (about one hundred basis points) than those charged for traditional custody services (which tend to be in the range of 8-12 basis points).

[37] Global custody banks might limit their willingness to enter into custody agreements with all but the largest, most well-known advisers, as to which the risk of exposure to liability for unauthorized instructions was the lowest. In addition, global custody banks

would lead to substantial delays in the processing of millions of transactions which global custody banks process on a daily basis, and create settlement and market risks, which have not been quantified. Moreover, as the Commission recognizes in Release No. 6240, specifying the investment adviser's authority and its limitations in the newly-required custodian/adviser agreements would become a source of global custody bank liability. Any monitoring error that permitted a transaction to proceed that was inconsistent with the adviser's authority and that proved to be unprofitable could result in a claim against the global custody bank. In light of the numerous instructions received daily from investment advisers, occasional errors are inevitable, and the cost of the resulting liabilities would have to be built into custody fees.

Recommendation.

For these reasons, the AGC recommends that the Commission remove the proposed requirement that the investment adviser's agreement with the qualified custodian specify the adviser's level of authority to effect transactions in the custodial account. The Commission should clarify that global custody banks are not responsible for monitoring whether instructions received from investment advisers are within the scope of the adviser's authority.

E. Assets Over Which Custodians Could not Take Possession or Control.

The Proposal expands the scope of customer property that is subject to the custody rule in ways that are impractical. Current Rule 206(4)-2 requires, with some exceptions, that an investment adviser that has custody of client "funds or securities" maintain such funds and securities with a qualified custodian. Proposed Rule 223-1 extends the safeguarding requirements to all client assets. "Assets" are defined as to mean "funds, securities, or other positions held in the client's account."[38] In addition, under the Proposal the qualified custodian must maintain "possession or control" of client assets. Possession or control is defined to mean holding assets such that "the qualified custodian 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."[39]

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would likely require investment advisers to agree to indemnify the bank for any losses the global custody bank incurred as a result of unauthorized instructions issued by the adviser's employees. Since the value of such an indemnity would depend on the creditworthiness of the adviser, global custody banks might decline to deal with smaller, less well-capitalized advisers.

[38] Proposed Rule 223-1(d)(1).

[39] Proposed Rule 223-1(d)(8).

Despite the Commission's intent, global custody banks are likely to conclude that it is not possible to take possession or control of some types of positions held in a client's account. Custodians cannot, of course, be forced to accept custody over assets with respect to which they cannot, in their judgment, obtain possession or exercise control. Notwithstanding the Commission's rules, global custody banks have the inherent right to determine the assets for which they offer custody services. As a result, the Proposal would likely leave advisers with no available qualified custodians for some important asset classes.

With respect to over-the-counter derivatives, bank loans, foreign exchange transactions, and other assets that are bilateral contractual obligations, the Proposal is not feasible. The principals to an OTC derivative or foreign exchange contract are not likely to permit the custodian to become a party to their contract, and global custody banks are not likely to agree to become such parties. Where the client so requests, global custody banks could report OTC derivatives and other bilateral contract asset positions on an accommodation basis.[40] However, expecting global custody banks to take custody of such assets by becoming a party to the contract is not realistic.

With respect to crypto assets, the AGC agrees with the Commission's desire to implement minimum custodial standards where existing rules are insufficient. However, the Commission should do so without disrupting the existing legal framework. The Uniform Commercial Code already addresses the application of the concept of "control" to crypto and other digital assets.[41] Any attempt by the Commission to bring these assets into the custody framework should proceed from the concepts already embedded in the Code. In addition, a workable approach to crypto asset custody should consider the impact of Staff Accounting Bulletin 121 on the willingness of global custody banks to provide custody for these assets.[42]

IV. The Proposed Implementation Period is Unrealistically Short.

For the reasons discussed in this letter, the AGC believes that significant portions of the proposal are critically flawed and urges the Commission not to adopt the proposal in its current form. While we are confident that the Commission will carefully consider our concerns and those of other commenters before acting, the AGC would also emphasize that, even if the Proposal were amended to address the key concerns discussed above, the proposed one-year implementation period for registered advisers with more than $1 billion of

[40] See Proposed Rule 223-1(a)(1)(i)(B). Account statements could include assets for which the qualified custodian lacks possession or control, provided (i) the client requests that such assets be reported, and (ii) the assets are clearly identified on the account statement.

[41] See UCC Article 12, Controllable Electronic Records. Under the UCC, "control" is a central feature of defining rights and entitlements. See Official Comment 1 to Section 8-016.

[42] Staff Accounting Bulletin 121 requires a global custody bank holding crypto currency on behalf of a client to recognize both an asset and a liability on the bank's balance sheet.

regulatory assets under management and the eighteen-month implementation period for smaller advisers are unrealistic in light of the extensive changes in custody practice that would be necessary to implement the proposal.[43]

The Proposal would require an unprecedented restructuring of custody and safeguarding practice with respect to investment adviser clients. This would entail a significant expenditure of time and resources by global custody banks. Banks would have to reconsider their business models, funding sources, scope of services offered, and the overseas markets where subcustodians provide custody services. Significant operational and contractual changes would be necessary. Further, global custody banks would need to engage in considerable discussion with their functional regulators. Indeed, the banking regulators might find it necessary to develop and promulgate new guidance in response to changes in custody practice. The Proposal also raises interpretive issues which the Commission would have to resolve before the new rule could take effect.

The Commission should also recognize that, if proposed Rule 223-1 is adopted, global custody banks would likely need to restructure their practices for clients not within the scope of the rule. It would not be practical to simultaneously operate two different custody models, one for the clients of investment advisers and one for other types of custody clients. Therefore, adoption of the Proposal, or any variation with similar characteristics, is likely to require restructuring of the services global custody banks provide to all their clients. For these reasons, we believe that a one-year implementation period for large advisers and an 18-month period for smaller advisers would be insufficient.

[43] For similar reasons, we believe that the 60-day comment period the Commission has allowed on the Proposal is inadequate. The Commission should afford commenters an additional opportunity to analyse the Proposal, seek to understand its consequences, to consult with their functional regulators, and to provide the Commission with additional views. This letter focuses on the AGC's key concerns and is not an exhaustive list of all issues the Proposal raises.

V. Conclusion.

We appreciate the opportunity to comment on Proposed Rule 223-1. Because of the significant impact that the Proposal would have on the members of the AGC, we would welcome the opportunity to discuss these matters with the Commission and its staff. If you have any comments or questions, please contact Steven Wager, Head of Global Markets Management, BNY Mellon, at Steven.Wager@bnymellon.com.

Sincerely,

The Association of Global Custodians
By: Steven Wager
Chair, Americas Focus Committee
(212) 815-8029
Steven.Wager@bnymellon.com

CC: Gary Gensler, Chair
Hester M. Peirce, Commissioner
Caroline A. Crenshaw, Commissioner
Mark T. Uyeda, Commissioner
Jamie Lizárraga, Commissioner

William A. Birdthistle, Director, Division of Investment Management