THE ASSOCIATION OF GLOBAL CUSTODIANS

BNP Paribas
BNY Mellon
Brown Brothers Harriman
Citibank, N.A.
Deutsche Bank
HSBC Securities Services
J.P. Morgan
Northern Trust
RBC Investor Services
Skandinaviska Enskilda Banken
Standard Chartered Bank
State Street Bank and Trust Company

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February 6, 2024

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

Re: Investment Advisers Act Release No. 6240, Safeguarding Advisory Client Assets (February 15, 2023) ("Release No. 6240") - SEC Meeting of August 29, 2023: Follow-up action items for the AGC and AGC responses

File Number S7-04-23

Dear Sir/Madam:

In connection with U.S. Securities and Exchange Commission's (the "Commission") proposed Investment Advisers Act Rule 223-1, Safeguarding Advisory Client Assets (the "Proposal")[1], the Association of Global Custodians[2] is pleased to provide you with information that we hope is responsive to your requests expressed in the above-captioned meeting, during which we discussed key considerations set forth in our letter of March 8, 2023, providing comments on the Proposal. Each of such requests and our responses to the requests are set forth below.

In a follow-up call on November 9, 2023, members of the Commission's staff requested from AGC members further background in addition to the foregoing requests. We have tried to memorialize this background in the attached Annex to this letter.

SEC Request #1

(a) SEC Request

Provide information and details on the regulatory framework regarding capitalization requirements for Custody Banks.

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[1] See, the Commission's Notice of Proposed Rulemaking on Safeguarding Advisory Client Assets (File No. S7-04-23), SEC Release No. IA-6240, 88 FR 14,672 (March 9, 2023) (the "Release").
[2] The members of the Association are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.

(b) AGC Response

We understand from subsequent meetings and conversations of AGC members with the staff that the SEC has information responsive to this request. Notably, we understand that:

- The staff recognizes that capitalization requirements of regulated banks, while based generally on Basel Committee framework, are subject to variation based among other factors on the particular prudential regulator, on the size and systemic designation of the bank, on the nature of the bank's businesses and on any applicable stress testing requirements.
- The staff is aware of the recovery and resolution regimes that apply to US and other Custody Banks, which aim to limit potential insolvency risk and facilitate the transfer of client assets either to a bridge bank or alternative custody provider.
- The staff is aware of the depositor preference schemes applicable to U.S. federally and state regulated banks that afford depositors creditor positions ahead of general creditors of the bank.

We note that broker-dealer client cash rules depend upon and enjoy the benefit of the current capital framework applicable to banks. It has been our consistent position that the issue of bank capital and liquidity adequacy should be left to bank prudential regulators and that the current proposal assures definitionally that eligible banks will be subject to appropriate capital requirements and that requiring eligible U.S. banks to conform definitionally to section 202(a)(2) of the Advisers Act or to be savings associations as defined in section 3(b)(1) of the Federal Deposit Insurance Act appropriately addresses this issue. Incremental capital and liquidity requirements since the Great Financial Crisis have established a suite of prudential standards that govern a banking organization's liquidity, capital, stress testing, and resolution planning requirements. Examples include Regulation YY, long-term debt requirements, capital and liquidity requirements.

We also take guidance from prior examples where the SEC and CFTC have recognized the appropriateness and sufficiency of enhanced prudential regulation, with precedence for providing limited exception for such firms subject to the Federal Reserve Board's most stringent liquidity risk management requirements:

- CFTC's Capital Requirements of Swap Dealers (SD) and Major Swap Participants final rule recognized that: "Some covered SDs are subsidiaries of much larger parent organizations, many of which are banking entities, that are subject to sophisticated liquidity risk management policies and procedures at both the parent and subsidiary levels. Other covered SDs are not part of a large bank holding company or financial organization and have different, less sophisticated liquidity policies and procedures that are more suited to the type of swaps activities that they engage in with counterparties."
- FINRA's 2023 Concept Proposal for a Liquidity Risk Management Rule noted that:
  "Also, in light of the regulations that already apply to a member that is controlled by a bank holding company that is subject to enhanced prudential regulation (EPR) and complies with the Federal Reserve Board's most stringent liquidity risk management requirements (referred to in this Notice as an "EPR firm"), Rule 4610 includes a limited exception for such firms from the presumption of insufficient current liquidity."

<u>SEC Request #2</u>

(a) SEC Request

Provide list of asset classes/client positions that are impossible or infeasible to hold in custody.

(b) AGC Response

There are two broad categories of assets that are capable of being held in custody:

(1) Assets such as a bearer bond, a stock certificate in the name of the borrower (together with an undated stock power in blank), or gold bullion. Custody of these assets is referred to as "on premises custody" or "direct custody"; the Custody Bank has physical custody of the asset. In each of these cases, the Custody Bank has the power to transfer title to the asset by delivery thereof – it may not have the right vis-à-vis the beneficial owner (i.e., the Custody Bank may be liable for breach of its duty to the borrower), but it does have the power.

(2) Assets that are held in an indirect holding system. This is referred to as "off premises custody" or "indirect custody." This would be one typical example of how an indirect holding system works: a clearing company (such as Depository Trust and Clearing Company) holds a master share certificate for 500 million shares of an S&P 500 publicly-traded company. The clearing company identifies on its books and records 10 million of such shares as being held for the account of the Custody Bank (in its capacity as a member of the clearing company) and, in turn, the Custody Bank identifies on its books and records 100,000 of such shares as being held for the account of the client. In this case, the Custody Bank has the power to (a) "move" some or all of those 100,000 shares on its books and records to another of its custody clients, or (b) advise the clearing company that some or all of such shares have been transferred to a third party that does not maintain an account with the Custody Bank (in which case the clearing company would revise its books and records to reflect that such shares are held by or through another member of such clearing company). In any event, generally, the Custody Bank has the power to transfer the client's interests in these shares. It is normal industry practice to only transfer the client's interest in these shares based on the receipt of specific client instruction (i.e., the Custody Bank acts as a 'directed agent' on behalf of the underlying owner of the shares).

But what about an asset such as the beneficial owner's investment in a bank loan? The bank loan may have a CUSIP number, the client may have alerted the Custody Bank that it purchased an interest therein, and the Custody Bank may have noted on its books and records that the client has an interest in the bank loan. Notwithstanding the foregoing, the Custody Bank does not have "direct custody" of any asset that is capable of being transferred by delivery. Nor does the Custody Bank have "indirect custody" of any asset that may be transferred on either its books and records or the books and records of any third party (e.g., the administrative agent for such bank loan or any clearing company). Most if not all bank loans are transferrable only upon the execution and delivery of an assignment agreement by the holder thereof, together with the consent of both the underlying "borrower" and the relevant administrative agent. In effect, then, the bank loan is not in "custody" at all: the Custody Bank has no power to transfer it, at the direction of the lender after default or otherwise. In addition, in the above example, if the lender's security interest is limited to the custody account and the assets therein, the lender would not have a security interest (not even an unperfected one) in the bank loan at all. This result is not just limited to bank loans, but to other assets as well.

Custody Banks typically consider a number of factors when determining whether an asset can be held in custody. Three key criteria are below:

1. Possession – i.e., can the Custody Bank demonstrate that it has possession of the asset (either physically or through account registration for immobilized or dematerialized securities).
2. Control – i.e., can the Custody Bank demonstrate that it has control over the asset (e.g., the Custodian's participation is required to effect any change in beneficial ownership).
3. Administration – i.e., can the Custody Bank demonstrate that it administers or services the asset (typically in the form of record keeping, asset servicing or reconciliation).

Generally, the asset in question must be able to satisfy two of the three above criteria for the Custody Bank to conclude it can be "held in custody" and, as a result, assume the obligations and liabilities that accompany the standard of care associated with "custody" (as opposed for example to a record keeping-only service). However, in certain situations, although the asset may meet two of the three criteria (e.g., cryptocurrencies), the Custody Bank may deem the associated risk of the asset too high to allow it to be held in Custody. Custody Banks generally reserve the right to accept assets into their books and care at the Custody Bank's sole discretion.

The Association of Global Custodians has prepared a non-exhaustive list of assets and the collective view as to whether they can be deemed to be held in-custody or whether alternative arrangements would be required to manage these assets on behalf of beneficial owners.

Asset Class	Nature of Asset	Assessment
Bank Loan	Bilateral Contract	Cannot be held in Custody
Commercial Paper		Held in Custody today
Commodity	Contract of ownership of physical assets	Cannot be held in Custody
Contract for Difference	Bilateral Contract	Cannot be held in Custody
Depository Receipt		Held in Custody today
Equity		Held in Custody today
Exchange Traded Fund		Held in Custody today
Fixed Income		Held in Custody today
Forward	Bilateral Contract	Cannot be held in Custody
Future	Bilateral Contract	Cannot be held in Custody
FX Forward	Bilateral Contract	Cannot be held in Custody
Guaranteed Investment Contract	Bilateral Contract	Cannot be held in Custody
Hedge Fund		Depends on structure and jurisdiction
Loan	Bilateral Contract	Cannot be held in Custody
Mineral Interest	Contract of ownership of physical assets	Cannot be held in Custody
Misc Document		Physical Safekeeping only
Mutual Fund		Held in Custody today
Option	Bilateral Contract	Cannot be held in Custody
Partnership	Bilateral Contract	Cannot be held in Custody
Private Equity		Cannot be held in Custody
Real Estate		Cannot be held in Custody
Real Estate Mortgage	Bilateral Contract	Cannot be held in Custody
Repurchase Agreement	Bilateral Contract	Cannot be held in Custody
Rights / Warrants		Held in Custody today
STIF		Held in Custody today
Swap	Bilateral Contract	Cannot be held in Custody
Unit Trust		Held in Custody today
Venture Capital Fund	Bilateral Contract	Cannot be held in Custody

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SEC Request #3

(a) SEC Request

Provide (i) information and details regarding a Custody Bank's capability to limit the types of SWIFT messages that an investment adviser can send, **and** (ii) sanitized examples of investment authority letters.

(b) AGC Response

We understand that the SEC aims at enhancing control on RIA's operational authority on investor accounts (typically represented through a POA); this is distinct from the investment authority (typically represented through an Investment Authority Letter). Custody Banks receive the POA granted by clients to advisers as part of the onboarding process, but might not have access to Investment Authority Letters.

In most cases, the POA granted by clients to advisers is generally broad in scope and does not have specific operational restrictions. This allows the adviser to maintain full authority to instruct Custody Banks to process instructions in the client account in line with their mandate and avoid the need for additional controls by the Custody Bank which would slow down processing and create operational risks. Any potential restrictions would therefore have to be instructed by the investor at the initial onboarding stage. This would require detailed analysis to ensure viability of the proposed restrictions and whether this achieves the objective. This would also lead to significantly higher custody costs. A few of these issues are listed below as an example:

(a) Scale: the large transaction volumes processed by Custody Banks do not allow for manual application of restrictions: any such restrictions would need to be automated.

(b) Automation: system-building would require time and additional operating cost, negatively impacting client investment returns.

(c) Scope: Given the large volume of transactions to be processed in a short timeframe (T+1), it is necessary to limit complexity, and avoid imposing granular and bespoke limitations.

(d) Impact: Any limitation will require processes to handle instructions which do not meet the restriction criteria, and add delays, increase cost and complexity and create potential conflicts between the registered investment adviser, Custody Bank and client.

(e) Personal authority: electronic vs manual communication channels between registered investment advisers and qualified custodians require different levels of control.

We would add that:

- Existing verification processes operate through established password and authentication methods to assure that only the investment adviser authorized by the client can instruct on the investment adviser's account; and,

- The reporting provided by the qualified custodian to the client (and potentially their fund accountants) captures a record of all transactions affecting the investment adviser client assets, which is available to client and regulatory auditors, creating a definite chilling effect on potential illicit manipulation of client assets.

SEC Request #4

(a) SEC Request

Provide academic papers, regulatory sources and related information/explanation regarding the impact of an intraday failure and the related protections/controls for intraday cash.

(b) AGC Response

Please see AGC Response to SEC Request #1 above.

SEC Request #5

(a) SEC Request

Provide additional information and explanations regarding the current responsibilities and practices of Custody Banks in the selection and monitoring of sub-custodians.

(b) AGC Response

Prior to selecting a sub-custodian to hold client assets in a particular jurisdiction, a global Custody Bank generally determines whether such assets would be subject to "reasonable care, based on the standards applicable to Custody Banks in the relevant market," after considering all factors relevant to safekeeping, including the factors set forth in Rule 17f-5.[3] To assist with this determination, global Custody Banks conduct relevant due diligence with respect to such particular market and to the sub-custodian itself.

Consistent with the Custody Services Handbook issued by the Office of the Comptroller and the Currency (the "OCC Custody Handbook"),[4] factors considered by global Custody Banks when conducting market and sub-custodian due diligence include the following:

(a) Market due diligence factors:[5]

- Country risk, including the political, social, and economic environment;
- Banking and securities markets, including the regulatory environment and quality of supervision, existence of insider trading/fraud rules and bankruptcy laws, and the enforceability of laws and regulations;
- The settlement environment, including the degree of automation, the central securities depository (CSD), payment systems, and the typical settlement period;
- Restrictions on foreign investment, including registration of foreign shares, ability to repatriate capital, exit taxes, and currency controls;
- Investability of the market, including liquidity and depth;
- Availability and integrity of financial information; and
- Ability to offer custody services profitably.

(b) Sub-custodian due diligence factors:[6]

- A review of the institution's financial strength and insurance coverage;
- Position in the market and local market knowledge;
- Internal control environment, including policies and procedures, systems and controls in place to ensure accuracy of records, and the ability to keep assets safe;
- The likelihood of U.S. jurisdiction over and enforcement of judgments against a foreign sub-custodian;

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[3] Rule 17f-5(c)(1)(i)-(iv)

[4] Available at https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/custody-services/pub-ch-custody-services.pdf

[5] See OCC Custody Handbook, page 13

[6] See OCC Custody Handbook, page 14

- The degree of automation, and plans for future systems development;
- Quality and experience of personnel; and
- If assets held by the sub-custodian will include assets of a U.S. mutual fund, whether the sub-custodian meets the requirements of SEC Rule 17f.

Global Custody Banks also monitor their sub-custodians on an ongoing basis. As noted under the OCC Custody Handbook, global Custody Banks generally monitor, at a minimum, the financial condition, performance, and internal controls of their respective sub-custodians, in order to ensure that such sub-custodians continue to meet the global custodian's requirements.[7]

In addition, global Custody Banks generally obtain and may make available to their custody clients, upon request, legal opinions from reputable law firms in such particular jurisdictions. These legal opinions address several key areas under local law, including, among other matters:

- recoverability of client assets, including cash, in the event of a sub-custodian's insolvency,
- public insurance schemes, guaranty funds or similar assurances that will reimburse the global custodian (or the underlying client) for loss of assets, and
- whether there are restrictions under local law to (a) the global custodian's ability to recover lost assets or (b) the sub-custodian's ability to indemnify the global custodian for such loss.

As part of their ongoing diligence and monitoring efforts, global Custody Banks generally obtain updated legal opinions on an annual basis.

As it pertains to the global Custody Bank's liability for client asset losses attributable to the acts of its sub-custodian, pursuant to the terms of the custody agreement between the global Custody Bank and its underlying client:

(i) a global Custody Bank would generally assume such liability (to the same extent that the global Custody Bank would have been liable if it had performed such acts itself, subject to customary limitations of liability, including with respect to events outside the global Custody Bank's reasonable control; e.g., force majeure or country risk) when the sub-custodian is a branch or an affiliate[8] of the global Custody Bank;

(ii) with respect to third-party sub-custodians (i.e., not branches or affiliates of the global Custody Bank), a global Custody Bank would generally assume such liability, to the extent resulting directly from the global Custody Bank's breach of its reasonable standard of care in the selection, retention and monitoring of the sub-custodian; and

(iii) while global Custody Banks generally would not assume liability for acts of a third-party sub-custodian (beyond the circumstances set forth in (ii) immediately above), in general global Custody Banks would nevertheless undertake to (a) make commercially reasonable efforts to recover the damages/losses from the sub-custodian, and (b) return to the client any amounts actually recovered from the sub-custodian.

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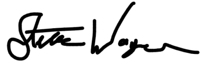
[7] See OCC Custody Handbook, page 14.

[8] An "affiliate" would generally include a separate legal entity that is controlled by the global custodian, controls the global custodian or is under common control with the global custodian.

We hope these responses are helpful to the Commission. Please do not hesitate to contact the undersigned with any further questions.

Sincerely,



The Association of Global Custodians
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ANNEX

Further background discussed in meeting of November 9, 2023

1. Background

In addition to answering the five questions set out in the letter to which this Annex is attached, the AGC provides herein additional information which reflects some of the discussion the AGC had in the meeting with the SEC Investment Management Division Staff on November 9, 2023. As discussed in that meeting, the assets serviced by a Custody Bank business consist primarily of two main asset categories: cash on deposit and securities. Custody Banks treat cash and securities differently - this is driven by both global regulations and longstanding market practice.

2. Custody Bank Treatment of Securities

For securities, there are different account structures that are utilized through the custody chain from Custody Banks to a sub-custody bank to the local central securities depository (CSD). Each account structure is designed to ensure that client positions are adequately "segregated". Segregation of arrangements made by an intermediary ("Custody Bank A") in its books and records are intended to ensure that:

1. its clients' book-entry securities will not be treated as the property of Custody Bank A and will not be used to meet the claims of creditors of Custody Bank A. This is generally achieved by keeping records to identify book-entry securities as belonging to each of Custody Bank A's clients;
2. if Custody Bank A's clients are other custody banks (e.g., "Custody Bank B"), the book-entry securities of Custody Bank B's clients will not be treated as property of Custody Bank B (nor are they the property of Custody Bank A) and are protected from the creditors of both Custody Bank B and Custody Bank A; and
3. each client's book-entry securities will not be treated as the property of any other client and are protected from the creditors of those other clients (however, "clients" are only the direct clients of each Custody Bank: e.g. in point 2, a client of Custody Bank B is not considered a "client" of Custody Bank A).

In the example of Custody Bank A and B above, Custody Bank A would maintain a segregated account, titled in the name of each of its clients. Custody Bank A would not typically know the identity of Custody Bank B's underlying customer (a "beneficial owner") at the end of the chain, but instead would maintain accounts in the name of their own proximate client, Custody Bank B on behalf of underlying clients. Book-entry securities – as intangible assets the ownership of which is evidenced on the books of Custody Banks and CSDs – thus would be expected to be ring-fenced through the chain on this basis so that they would not made available to creditors of any intermediaries in the event of their insolvency.

3. Custody Bank Treatment of Cash

Like any cash deposit with a banking institution, the cash "held on deposit" at a Custody Bank is on the balance sheet as a liability to the depositor; and this cash is used in the bank's own business on the asset side. The depositing client has a contractual claim to the return of the cash, making it a creditor. The claim may be made either on demand or, in the case of time deposits, on expiration of a contractual term to the deposit. On the asset side, the bank may invest the cash, including at

another bank in a correspondent banking account, where the former bank is the depositor (creditor) and the latter bank is the bank of deposit (debtor): the latter may include a central bank, such as the Federal Reserve.

Client deposits fall into two main categories: operational deposits and other deposits. Operational deposits generally constitute deposits that support Custody Bank operational activities and result from day-to-day transactional activities, such as client securities sales, dividends and interest payments paid to clients, corporate action events, client redemptions from private funds and other investment vehicles and asset-related fees received from third parties for the benefit of clients. In addition, Custody Banks hold cash deposit balances maintained by clients to address anticipated and unanticipated funding needs stemming from various operational considerations, such as pending or failed securities transactions, the non-receipt of proceeds of sales and other payments and timing differences in movements of cash (e.g., different settlement dates).

Since operational deposits are necessary for clients to obtain Custody Bank services, they are less likely to be withdrawn, as the lack of sufficient funds in a client's cash account could limit the ability of the custody bank to provide the required level of service or effect transactions on the client's behalf. As such, deposits resulting from the provision of Custody Bank services represent a relatively stable source of funding. This is recognized in the Basel III liquidity standards, where operational deposits are assigned a lower run-off factor due to the need for clients to place "deposits with a bank in order to facilitate their access to and ability to use payment and settlement systems and otherwise make payments." The stability of these deposits is also attributed to the general stability of the custody relationship between Custody Banks and their clients. Contracts governing Custody Bank relationships typically have termination provisions requiring significant advance notice periods, making it unlikely that clients would withdraw these operational deposits in a short period of time, much less without any warning.

In addition to operational deposits, clients often place additional amounts, sometimes referred to as "excess deposits," with Custody Banks, especially in times of financial market stress. This trend is evidenced by the fact that clients tend to view Custody Banks as "safe havens" in times of severe market stress.

Furthermore, various solutions exist for clients to manage their cash held at a Custody Bank and their deposit risk. For example, (i) Custody Banks typically provide clients with cash projection reports which enable clients to make decisions on whether to hold cash funds with a Custody Bank or place into other vehicles,(ii) intraday reports on cash balances, (iii) the ability to wire out cash to other banks intraday and end of day, (iv) automated sweeps where client cash can be moved into off-balance sheet and highly liquid investment such as a repurchase agreement (repos), or money market funds.

4. Custody Bank Credit Risk & Set-Off

A Custody Bank is exposed to credit risk, which is the risk that an agent or other counterparty will not be able to pay its obligations on time and in full. Custody Banks extend intraday and overnight credit to their clients to facilitate the settlement of securities transactions and short-term credit (overdraft) facilities to clients. In addition, Custody Banks take on counterparty credit risk by indemnifying their custody clients that lend securities in securities lending programs through Custody Banks against certain losses. Finally, Custody Banks take on a degree of counterparty credit risk when — in order to facilitate client investments in foreign (including emerging market) securities — they engage in FX transactions that are not settled through the CLS payment system.

These various risks typically are mitigated by the practice of clients posting collateral (e.g., securities and cash maintained by the Custody Bank). Despite this, currency market volatility and other factors could result in residual unsecured credit exposure, although custody banks try to ward against this result.

Custody Bank clients therefore face a risk of loss of cash or securities if the Custody Bank enforces its security interest by exercising its rights (often including right of set-off) against the client's cash, or foreclosing on and liquidating securities collateral. However, importantly this risk only materializes if a client fails to repay the extensions of credit made by the Custody Bank. In other words, the client itself can mitigate this risk by ensuring that it meets and performs its obligations to the Custody Bank.