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VIA ELECTRONIC FILING

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

Re: Request for Comment on Proposed Rule on Safeguarding Advisory Client Assets; Rel. No. IA-6240; File No. S7-04-23

Dear Ms. Countryman:

We appreciate this opportunity to comment on the rule recently proposed by the Securities and Exchange Commission (the "Commission") under the Investment Advisers Act of 1940, as amended (the "Advisers Act") which addresses how registered investment advisers safeguard client assets (the "Proposed Rule").[1] We write from the perspective of our clients that are large asset managers and institutional investors that transact in the derivatives and brokerage markets. Our firm represents hundreds of asset management firms that are registered with the Commission as investment advisers, including those that advise hedge, credit, private equity, and real estate funds, across a wide range of industries and asset classes, as well as institutional investors that invest in these products through separately managed accounts (and funds) managed by registered investment advisers. The comments and opinions expressed herein are not intended to represent individual clients' views, but rather Ropes & Gray's perspective complemented by the broad input from our clients.

This letter is focused on the significant impacts the Proposed Rule would have on our clients' use of derivatives and brokerage arrangements. Please also see our firm's companion letter for commentary regarding other aspects of the Proposed Rule that would impact our clients.

While we support the Commission's efforts to protect investors by safeguarding client funds and securities from the financial hardship of an investment adviser and to prevent client assets from being lost, misused, stolen, or misappropriated, the proposed changes involve a significant departure from current practices and would lead to serious repercussions for the investment advisory, custodial, and accounting industries as well as the derivatives and brokerage markets. The Proposed Rule's requirements would fundamentally disrupt a wide range of transactions in such markets and cause participants in those markets to incur significant costs. The Commission has not fulfilled its obligations under Section 202(c) of the Advisers Act because it does not

[1] *See* Proposed Rule: Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672 (Mar. 9, 2023) (the "Proposing Release"), *available at* https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf.

adequately account for such costs in its economic analysis. We have highlighted some of those impacts in this letter.

Executive Summary

- **The Commission has not adequately considered (and in a number of cases, not considered at all) the costs the Proposed Rule would have on derivatives and brokerage arrangements in its cost-benefit analysis.** With respect to many of the points we discuss below, the Commission has cited no instances of misappropriation or other activity by registered investment advisers that warrants the proposed expansion of the custody rule, nor are we aware of any such instances or activity.

- The Proposed Rule would expand significantly the scope of the current custody rule by amending the definition of "assets" to mean "funds, securities, *or other positions held in a client's account*" (proposed new language italicized). This would include an overly broad array of assets, including financial contracts held for investment purposes and collateral posted in connection with a "swap contract"[2] on behalf of the client, over which a registered investment adviser has custody. Coupled with the proposal to expand the scope of what constitutes custody, these changes would have significant impacts on our clients that use derivatives and brokerage arrangements.

- The Proposed Rule would upend current practices in derivatives and brokerage markets, which have been shaped and supported by extensive regulations adopted by the Commission, the Commodity Futures Trading Commission ("CFTC"), U.S. Prudential Regulators and other financial regulators across the globe. For example, the Proposed Rule appears to prohibit the long-standing practice of rehypothecation of client assets by broker-dealers, which is permitted under Rule 15c3-3 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and is an aspect of the brokerage markets (among many others) that is already subject to numerous requirements and limitations designed to protect customers against risk of loss.

- The Proposed Rule would require registered investment advisers to enter into contractual arrangements and obtain assurances from qualified custodians that are in many respects inconsistent with current market practice and in some cases, applicable regulations. We are concerned that custodians (and counterparties with whom they transact or hold derivatives positions, to the extent they are required to act as qualified custodians) will not be willing to agree to these requirements, which could limit the number of custodians and counterparties that are available to our clients (increasing concentration of credit risk, as well as decreasing price competition), increase costs (which costs will be borne by clients of investment advisers and passed on to investors), and potentially decrease hedging activity more generally (increasing risk in portfolios).

[2] In the Proposing Release, the Commission refers to collateral posted in connection with a "swap contract" in its non-exclusive list of the types of assets that fall within the definition of "assets" subject to the Proposed Rule. Proposing Release at 14679. "Swap contract" is not otherwise defined in the Proposed Rule or Proposing Release. This letter assumes the Commission intended a broad definition of "swap contract" (including, for example, swaps, security-based swaps, foreign exchange swaps, foreign exchange forwards, options, and other similar instruments) and did not intend to limit the definition to "swaps," as such term is defined in Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and rules adopted thereunder.

- Specifically, we respectfully request that the Commission undertake a comprehensive cost-benefit analysis that takes into account the significant impact the Proposed Rule would have on derivatives and brokerage arrangements (among other matters). If, after undertaking the cost-benefit analysis, the Commission determines that it would be appropriate to proceed with the Proposed Rule, it should:
    - Provide an exception from the Proposed Rule for collateral posted in connection with uncleared derivatives transactions, including swaps, security-based swaps, foreign exchange forwards and foreign exchange swaps[3], forwards, and options as well as securities financing transactions (including repurchase and securities lending transactions) (hereinafter collectively referred to as "derivatives transactions").
    - Provide an exception from the Proposed Rule for positions held in a client's account that are contracts in respect of uncleared derivatives transactions.
        - Alternatively, we would urge the Commission to: (1) expand the privately offered securities exception to include contracts in respect of uncleared derivatives transactions; and (2) remove the conditions that would (a) require an independent public accountant to verify transactions and (b) require the adviser to notify the independent public accountant of purchases, sales and transfers of transactions.
    - With respect to all cleared derivatives and collateral posted in connection with such derivatives:
        - Revise the definition of "qualified custodian" to enable a futures commission merchant ("FCM") to serve as a qualified custodian with respect to all types of futures contracts, cleared swap transactions and cleared security-based swap transactions and related collateral;
        - Provide an exception from paragraph (a)(1) of the Proposed Rule (*Written agreement; Reasonable assurances obtained by adviser*); and
        - Clarify that client assets held by an FCM may be pledged, re-pledged, rehypothecated, transferred, invested, or otherwise used by the FCM (including, without limitation, rehypothecation or transfer of client assets to a derivatives clearing organization), in accordance with CFTC regulations.
    - With respect to all brokerage arrangements and collateral posted in connection with such arrangements:
        - Provide an exception from paragraph (a)(1) of the Proposed Rule; and
        - Clarify that the Proposed Rule does not prohibit rehypothecation of client assets by a broker-dealer, to the extent otherwise permitted under the Commission's broker-dealer regulations.
    - Exclude from the Proposed Rule accounts over which the adviser has custody solely due to the adviser having discretionary trading authority, particularly in the context of separately managed accounts ("SMAs").

[3] Pursuant to authority granted by the Dodd-Frank Act, the Treasury Department has exempted both foreign exchange swaps and certain foreign exchange forwards from the definition of "swap" under the Commodity Exchange Act (the "Commodity Exchange Act"). Accordingly, these transactions are exempt from most Dodd-Frank Act swap regulations. The commentary included in this letter regarding uncleared derivatives transactions applies to foreign exchange swaps and foreign exchange forwards. *See* Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012), *available at* https://www.govinfo.gov/content/pkg/FR-2012-11-20/pdf/2012-28319.pdf.

I. Custody of Collateral Posted in Connection with Uncleared Derivatives Transactions[4]

We respectfully request that the Commission consider the significant costs that the Proposed Rule would impose on registered investment advisers and their clients in respect of collateral posted in connection with uncleared derivatives transactions and provide an exception from the Proposed Rule for such collateral.

The Proposed Rule would broaden the scope of the Commission's existing custody rule in a number of ways that would have significant impacts on derivatives and secured financing markets. It would require a registered investment adviser to maintain client assets with a qualified custodian that has possession or control of the assets (including derivatives transactions and related collateral) pursuant to a written agreement between the custodian and the adviser. The adviser also would be required to obtain from the qualified custodian reasonable assurances that, among other things, the custodian will hold the client assets in a segregated custodial account, indemnify the client, and meet a specified standard of care with respect to the client's account.

Segregation of Collateral

Except where required by regulation,[5] or as sometimes negotiated by a party, current long-standing practice in the derivatives and secured financing markets is for funds and other investors to post collateral directly to a counterparty.

Contrary to that current and well-established market practice, the changes introduced in the Proposed Rule would require clients of registered investment advisers to hold all collateral posted in connection with derivatives and secured financing transactions with the client's qualified custodian.[6] As a practical matter,

[4] Issues arising in respect of custody of collateral posted in connection with cleared derivatives transactions (including futures and cleared swaps) as well as brokerage transactions are discussed in Sections III and IV, respectively.

[5] For example, registered investment companies are required to hold collateral that is pledged to a counterparty with the fund's qualified custodian under the Investment Company Act of 1940, as amended (the "Investment Company Act"), and regulations adopted thereunder. The Investment Company Act's custody provisions are distinguishable from the statutory requirements under the Advisers Act. Under the Investment Company Act, Congress specifically provided that "[e]very registered management company *shall* place and maintain its securities and similar investments in the custody of [a qualified custodian]" (emphasis added). Under the Advisers Act, Congress provided that registered investment advisers "shall take such steps to safeguard client assets over which such adviser has custody…as the Commission *may*, by rule, prescribe" (emphasis added). In the case of the Investment Company Act – which regulates products that are available to the broadest classes of investors – Congress specified that all fund assets must be held with a qualified custodian. It is telling that Congress could have, but did not, impose the same requirements on registered investment advisers.

[6] In the Proposing Release, the Commission references the Staff's previously stated position regarding collateral posted in connection with swap transactions. Proposing Release at n.59; *see also* Staff Responses to Questions About the Custody Rule, Question II.10 (May 20, 2010), *available at* https://www.sec.gov/divisions/investment/custody_faq_030510. In our experience, it is not market practice for swap collateral to be segregated with a custodian, unless otherwise required by law or where the parties to a transaction voluntarily agree to do so but only with respect to initial margin (*e.g.*, for mitigation of credit and counterparty risk). In 2019, when the Commission adopted its margin rules (which notably do not require collateral segregation in respect of security-based swaps), the Commission acknowledged that "[e]xisting market practice under the baseline is for dealers generally not to segregate initial margin related to OTC derivative transactions." Final Rule: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 Fed. Reg. 43872 at

compliance with this requirement would involve posting collateral into a segregated account with the client's qualified custodian, pledging the assets in the segregated account to the counterparty, and entering into an account control agreement among the client (and, it would appear, the adviser), the qualified custodian and the counterparty.[7]

Required segregation of margin in this manner would impose significant costs on participants in the derivatives and secured financing markets.[8] Counterparties to derivatives transactions rely on their right to rehypothecate collateral posted in connection with derivatives transactions as a source of funding, including to fund the counterparty's collateral requirements under hedge transactions. Since the collateral would have to be segregated under the Proposed Rule, the counterparty would not have the ability to use the collateral in its business, which would disrupt hedging activities and increase costs for funds and other investors to enter into derivatives transactions. These costs will be passed on to clients of registered investment advisers and borne by investors.

Indeed, these opportunity costs have been widely acknowledged by regulators across the globe when considering (in other contexts) whether to require segregation of collateral posted in connection derivatives transactions.[9] For example, in weighing the costs and benefits of individual segregation of initial margin in its SBS Margin Rules for uncleared security-based swaps, the Commission acknowledged that:

> Having unhindered access to customers' collateral represents a significant benefit to a dealer. Such collateral can be used by the dealer in its hedging and proprietary trading activities. In its absence, the dealer will bear the cost of financing the collateral to support these activities. Depending on the level of segregation required by the dealer's counterparties, the collateral required to support current levels of security-based swap activity could be significantly greater than in a regime without segregation and no restrictions on re-hypothecation. To the extent that the provisions of the final segregation rules increase demand for segregation in non-cleared security-based swap transactions, a dealer's costs of hedging these transactions may be higher than under existing market practice. Similarly, increased use of segregation for non-cleared security-based swaps would reduce dealers' ability to otherwise benefit from the use of customers' collateral. Both of these factors could potentially lead to higher apparent transaction costs in the security-based swap market…
>
> The Commission has considered the costs and benefits of requiring segregation at a third-party custodian and prohibiting re-hypothecation. Based on its judgment and prior experience, the Commission determines that the potential benefits to financial stability do not justify the potentially

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43984 (Aug. 22, 2019) (the "SBS Margin Rules"), *available at* https://www.govinfo.gov/content/pkg/FR-2019-08-22/pdf/2019-13609.pdf.

[7] *See* "Appointing the Counterparty as Qualified Custodian" section below regarding the impracticality (and in some cases inability) of many counterparties to act as qualified custodians that meet the requirements of the Proposed Rule.

[8] While we note it is common in the triparty repo markets (but not other repo markets) for collateral to be posted to a third party custodian bank, conforming such arrangements to other requirements under the Proposed Rule will be extremely challenging and costly, as described in Section II below.

[9] *See* SBS Margin Rules at 44027-28; *see also* Basel Committee on Banking Supervision's and Board of the International Organization of Securities Commissions' margin requirements for non-centrally cleared derivatives (April 2020) at para. 5(b) (the "BCBS/IOSCO Margin Framework"), *available at* https://www.bis.org/bcbs/publ/d499.pdf ("requiring the segregation or other protection of initial margin collateral may create material incremental liquidity demands and trading costs relative to current practices, as…firms would no longer retain the unlimited ability to use initial margin collected as a source of funding, for re-hypothecation, re-pledge or re-use, or for other discretionary purposes").

> considerable additional costs that would need to be borne by market participants under this alternative approach.[10]

In addition to costs that would be incurred by counterparties and passed along to clients, advisers and their clients would be required to put in place new documentation (*e.g.*, account control agreements) and procedures to hold collateral in the manner required by the Proposed Rule. This documentation and the related operational procedures would need to be negotiated and arranged individually with each derivatives counterparty that a client faces as well as the relevant custodian. In our experience, because these contracts involve multiple parties and tend to be lengthy and complex, they take a considerable amount of time and can be costly to negotiate. The increase in costs that advisers will incur in relation to setting up these arrangements will be passed on to clients of the registered investment adviser and borne by investors.

As a substantive matter, investment advisers also will face significant challenges in entering into contractual arrangements that meet the requirements prescribed by the Proposed Rule. As noted above, counterparties would have to agree to give up long-standing and business-critical rights to use collateral in their hedging and proprietary trading activities. The Proposed Rule would also require investment advisers to be party to an agreement with the qualified custodian and obtain certain assurances from the custodian in respect of the standard of care, implementation of appropriate measures to safeguard client assets from misappropriation or other similar types of loss and indemnification of the client by the custodian, all of which would be a stark change from current practice. It is not at all clear that counterparties or custodians will be willing to enter into the written agreements and provide the assurances required under the Proposed Rule with respect to collateral for derivatives transactions. Indeed, we expect it will be very difficult to convince counterparties and custodians to agree to such terms and, in any case, the cost of putting such agreements in place will undoubtedly increase. This will cause increased costs for clients of investment advisers (reducing returns), a reduction in the number of counterparties available to market participants (concentrating risk and inhibiting price discovery and liquidity) and likely a reduction in hedging activity by market participants more generally (increasing risk in portfolios).

These and other impacts on collateral posted in connection with uncleared derivatives transactions are not addressed in the Commission's cost-benefit analysis. Moreover, the Commission has cited no instances of misappropriation or other activity by registered investment advisers that warrants the proposed requirements in respect of collateral posted in connection with uncleared derivatives transactions, nor are we aware of any such instances or activity.

<u>Existing Regulatory Protections for Investors</u>

Following the lead of the BCBS/IOSCO Margin Framework, regulators across the globe (*e.g.*, the Commission, the CFTC, U.S. Prudential Regulators, and other foreign regulators) have adopted mandatory minimum margin requirements for uncleared swaps and security-based swaps, including requirements to segregate certain collateral posted in connection with such transactions. While the rules differ in certain ways, they all seek to balance costs and benefits of segregation, including mitigation of credit risk and the need for counterparties to use margin – especially variation margin – to finance derivatives positions.

[10] SBS Margin Rules at 44027-28.

These regulations typically require segregation of *initial* margin that is required to be posted under applicable regulation, permit parties to opt into segregation of other *initial* margin, and do not contemplate segregation of *variation* margin. For example, the Dodd-Frank Act and the Commission's SBS Margin Rules promulgated thereunder do not require individual segregation of variation margin or initial margin and, in certain circumstances, permit customers to waive segregation, so that the customer's property can be commingled with the security-based swap dealer's property.[11] This reflects the fact that variation or "mark-to-market" margin generally is intended to cover, on a daily basis, the amount that would be owed by the "out-of-the-money" party to the "in-the-money" party if all of the swap transactions between them are terminated. The in-the-money party (collateral receiver) is entitled to collect variation margin from the other party, and has contractual rights to apply that variation margin to satisfy amounts owed to it by the other party in the event that the swap transactions between them are terminated. Initial margin, on the other hand, is intended to provide an additional cushion of collateral to secure against potential future exposure in the parties' portfolio of swap transactions. Unlike variation margin, a collateral provider generally expects initial margin to be returned upon termination of the parties' swap transactions, as long as its obligations have been satisfied.

Market participants (including registered investment advisers and their clients) recently have concluded a nearly decade-long effort, at great time and expense, to put in place arrangements to comply with these regulations. If adopted as proposed, we are concerned that the Proposed Rule would override and conflict with this carefully-crafted global framework governing segregation of margin, minimize the number of counterparties that are willing to transact in derivatives with investment advisers and their clients, significantly increase costs to clients (therefore lowering returns) and make it more difficult to hedge (therefore making portfolios riskier).

Appointing the Counterparty as Qualified Custodian

As an alternative to segregation of collateral, investment advisers would need to treat each counterparty to its derivatives transactions as a custodian of the client. This would only be available for counterparties that qualify as custodians under the Proposed Rule; we expect that many counterparties with whom our clients typically transact, particularly foreign entities, would not qualify. This alternative approach also would require investment advisers to follow all of the requirements of the Proposed Rule with respect to each counterparty to its derivatives transactions, including putting in place a written agreement between the adviser and the counterparty (as a custodian of client assets) and obtaining certain assurances from the counterparty relating to its standard of care, indemnification of the client, limitations on the attachment of liens on client assets without client consent, and requirements to segregate collateral.

We have several concerns with this approach, in addition to those already noted above. First, derivatives counterparties enter into transactions with funds and other investors on an arm's-length basis. The Proposed Rule would fundamentally change that relationship, subjecting the counterparty to a higher standard of care and prohibiting the counterparty from rehypothecating collateral, among other things. As noted above, derivatives counterparties rely on collateral to fund their business and hedge transactions. If they are prohibited from using collateral in this manner, the increased funding and other costs will be passed on to clients of

[11] 15 U.S.C. § 78c–5(f). The Commission also notes in the adopting release for the SBS Margin Rules that, with respect to initial margin, "when segregation is waived, the private costs associated with the requirement to collect initial margin can be significantly reduced as the [security-based swap dealer] collecting said initial margin would obtain the benefit of using the collected collateral in its operations." SBS Margin Rules at 44018.

investment advisers and borne by investors. Additionally, we anticipate that many counterparties will be unwilling to agree to the contractual terms and undertakings they would be required to provide, which (coupled with the possibility that some current counterparties would not qualify as a custodian under the Proposed Rule) will reduce the number of counterparties with whom our clients will be able to transact. This will reduce liquidity, inhibit price discovery, concentrate risk among counterparties who are willing and able to continue to transact with investors, and negatively impact the derivatives and secured financing markets.

To avoid significant market disruptions and costs, we respectfully request that the Commission provide an exception from the Proposed Rule for collateral posted in connection with uncleared derivatives transactions. There is already an extensive regulatory regime in place adopted by various regulators (including the Commission) based on judgments about when required segregation of such collateral is appropriate and when the costs are too great. At the very least, if the Commission proceeds with the Proposed Rule in its current form, it should provide an exception for <u>variation margin</u> posted in connection with uncleared derivatives transactions.

II. <u>Custody of Contracts in Respect of Uncleared Derivatives Transactions</u>[12]

We respectfully request that the Commission consider the significant costs of subjecting contracts in respect of uncleared derivatives transactions to the Proposed Rule and provide an exception from the Proposed Rule for such contracts.

The Proposed Rule would require registered investment advisers to maintain financial contracts, including contracts governing derivatives transactions, with a qualified custodian. The qualified custodian would need to maintain possession or control over the contracts, which the Commission stated in the Proposing Release means the custodian must participate in any change in beneficial ownership of the assets, the custodian's participation would effectuate the transaction involved in the change of beneficial ownership, and the custodian's involvement is a condition precedent to the change in beneficial ownership.

It is not clear as a practical matter how this could work in practice for uncleared derivatives transactions, where the client's asset is a contractual right and not a traditional asset such as funds or a security. Typically, documentation in respect of derivatives transactions consists of some form of master agreement (*e.g.*, the ISDA Master Agreement or Master Repurchase Agreement), which provides a framework for the overall trading relationship between two parties and not the specific terms of particular transactions. Transaction-specific terms are then evidenced by a confirmation (which in some cases is in an electronic format (*e.g.*, through electronic trading platforms which are commonly used by derivatives market participants))[13]. One reading of the requirement is that such documentation (and perhaps other trading documentation such as transfers/novations) must be signed by the client's qualified custodian, in order to ensure that beneficial

[12] Issues arising in respect of custody of rights under contracts in respect of cleared derivatives transactions (including futures and cleared swaps) as well as brokerage transactions are discussed in Sections III and IV below.

[13] As a technical matter, we note that under New York law (which typically is the governing law in U.S. derivatives documentation), certain agreements are required to be in writing. An exception to that requirement of a writing is made for qualified financial contracts for which there is sufficient evidence to indicate that a contract has been made or where the parties have agreed to be bound with respect to such qualified financial contract from the time agreement is reached (*e.g.*, by telephone). While swap dealers now are required under timely confirmation regulations to provide written transaction confirmations to their counterparties soon after execution, a contract is formed at the time the parties agree to the transaction, and it would appear to be impossible for a custodian to hold custody of such a contract. N.Y. Gen. Obl. Law § 5-701 (*Agreements Required to be in Writing*).

ownership of the documentation cannot be transferred without the custodian's consent. The Proposing Release further notes that the Proposed Rule would require the custodian to "participate in a way that it is willing to attest to the transaction on an account statement and for which it customarily takes custodial liability."[14] This would be a significant departure from current market practice and it is unclear what problem would be addressed by imposing these requirements on market participants. Unlike fungible assets such as funds and securities, we are not aware of any problems with or related to (and the Commission cites no instances of) contracts in respect of derivatives transactions being subject to theft or misappropriation by investment advisers.

We are also concerned that requiring custodians to become involved in the documentation of uncleared derivatives transactions is likely to cause significant delays in the processing, settlement, and reporting of such transactions, including doing so in compliance with other regulatory requirements of the Commission, the CFTC and other global regulators. For example, under current Commission and CFTC timely confirmation regulations, swap dealers are required to provide trade confirmations to counterparties within a short period of time (generally within one business day following execution) and to have policies and procedures to verify transactions and/or execute the confirmation within a specified time frame. As the Commission noted in the adopting release for its timely confirmation rule, these rules are intended to "promote the efficient operation of the SBS market…to help avoid a recurrence of documentation backlogs that had persisted in the industry prior to the adoption of the Dodd-Frank Act."[15] We are concerned that requiring custodians to participate in this process will cause significant delays in the processing and settlement of such transactions, impeding compliance and undermining more broadly the accepted market-wide benefits achieved when transactions are processed and settled efficiently, even where the timing for processing and settlement are not specifically required by regulation. Custodians do not participate in parties' decisions to enter into swap transactions or the negotiation of their terms. Clients may enter into dozens, hundreds or more derivatives transactions per day. It is unclear to us whether custodians will be willing to review and sign on to such transactions, particularly where the custodian would have to be satisfied that it has met the standards of the Proposed Rule, and in any event, we doubt this could be accomplished within timeframes required by the timely confirmation rules.

In addition, there are extensive requirements and tight time frames for reporting swap and security-based swap transactions under the Commission's (and other regulators') reporting regulations.[16] If a qualified custodian is required to play a role in documenting such transactions and any related transfers/novations, it could become prohibitively difficult to timely report such transactions in accordance with applicable regulations, inhibiting achievement of the policy goals of those regulations. For example, one reading of the Proposed Rule would require derivatives contracts to be held, like securities, by the custodian in "street name" on behalf of the client. Under the swap data reporting rules, would derivatives transactions then have to be reported in the name of the client's qualified custodian (on behalf of the client) because the position is held in "street name" by the qualified custodian? Unlike book-entry securities, derivatives historically have not been held in this manner.

[14] Proposing Release at 14687.

[15] Final Rule: Trade Acknowledgment and Verification of Security-Based Swap Transactions, 81 Fed. Reg. 39807 (June 17, 2016), *available at* https://www.govinfo.gov/content/pkg/FR-2016-06-17/pdf/2016-13915.pdf.

[16] 17 C.F.R.§ 43.3 and § 242.901. *See also* Final Rule: Real-Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 at 1232-4 (Jan. 9, 2012), *available at* https://www.govinfo.gov/content/pkg/FR-2012-01-09/pdf/2011-33173.pdf; Final Rule: Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 80 Fed. Reg. 14564 at 14700-14705 (Mar. 19, 2015), *available at* https://www.govinfo.gov/content/pkg/FR-2015-03-19/pdf/2015-03124.pdf (discussing the importance of timely reporting and public dissemination of swaps and security-based swaps transactions to reduce risk, increase transparency, and promote market integrity in the derivatives markets as well as the broader financial system).

This would be an absurd result and would completely undercut the policies behind the implementation of the reporting rules. As a practical matter, market participants would also have to consider whether a transaction should and/or could be reported as a valid transaction unless and until the qualified custodian had approved such transaction. This would undoubtedly make it difficult for reporting parties to comply with the already tight timing requirements under transaction reporting rules.

More generally, involving custodians in the documentation of contracts in respect of derivatives transactions will increase the costs associated with such transactions as new operational processes and contractual arrangements would need to be put in place. It is also not clear whether traditional custodians would be willing to agree to provide such services. This will potentially lead to fewer counterparties being available to investment advisers and their clients for derivatives transactions, resulting in more concentrated risk in the marketplace.

The Commission cites no examples of theft, loss or misappropriation of contracts in respect of uncleared derivatives transactions and does not consider the costs of subjecting them to these requirements in its cost-benefit analysis. We urge the Commission to exempt contracts in respect of uncleared derivatives transactions from the Proposed Rule.

Privately Offered Securities

Under the Proposed Rule, "privately offered securities" that meet certain conditions are not required to be maintained with a qualified custodian.

The privately offered securities exception, however, will not be available for most contracts in respect of uncleared derivatives transactions. Such contracts (other than security-based swap contracts) are not "securities" and, while they would typically satisfy the other parts of the definition, they therefore do not fall within the definition of privately offered securities.

Even if such contracts constituted securities and would be eligible for the exception, the proposed conditions would be unduly burdensome and impractical when applied to uncleared derivatives transactions. Advisers would be required to report to an auditor any "purchase, sale, or other transfer of beneficial ownership of [a derivative contract] within one business day" and the auditor would be required to verify such transaction upon receiving such notice. Contracts in respect of derivatives transactions are privately negotiated agreements entered into by sophisticated investors, and custodians and auditors historically have not been involved with such documentation or transfers of such contracts. It is also worth noting that contracts in respect of uncleared derivatives transactions typically cannot be assigned without the consent of the parties. As such, there is already less risk of improper transfers and introducing an additional service provider into the transfer process would thus unnecessarily complicate and slow down the process.

As noted and requested herein, we believe the Commission should exempt contracts in respect of derivatives transactions from the Proposed Rule. As an alternative, if the Commission determines that it is appropriate to proceed after considering the costs and benefits, we would urge the Commission to: (1) expand the privately offered securities exception to include contracts in respect of uncleared derivatives transactions; and (2) remove the conditions that would (a) require an independent public accountant to verify transactions and (b) require the adviser to notify the independent public accountant of purchases, sales and transfers of transactions.

As noted above, these requirements are impractical and would be unduly burdensome if applied to derivatives transactions. Like privately offered securities, derivative contracts are uncertificated, are not publicly offered, and are transferable only with the consent of the parties. The Commission has acknowledged the challenges of holding custody of such securities as well as the protections against theft, loss, and misappropriation that are inherent in these types of instruments. We believe that derivatives transactions are similar to privately offered securities and can see no practical justification for subjecting derivatives to more burdensome custody requirements.[17]

III. Futures and Cleared Swaps

We respectfully request that the Commission revise the definition of "qualified custodian" to enable an FCM to serve as a qualified custodian with respect to all types of futures contracts, cleared derivative transactions and related collateral. The Commission should also exempt positions held in a client's account that are cleared derivatives and collateral posted in connection therewith from paragraph (a)(1) of the Proposed Rule. The Commission should clarify that client assets held by an FCM may be rehypothecated or transferred by the FCM to a third party, such as a derivatives clearing organization, and pledged, re-pledged, invested, or otherwise used by the FCM as permitted under CFTC regulations.

The Proposed Rule creates significant issues for registered investment advisers who enter into cleared swaps or futures transactions on behalf of their clients. Such positions generally must be held through an FCM.[18] Futures and cleared derivatives transactions typically are governed by a bilateral agreement between the client and an FCM, and individual futures contracts and cleared swaps are then held through the FCM at exchanges and clearing houses (as applicable). Consistent with the existing custody rule, the Proposed Rule would permit an FCM to be a qualified custodian, but only with respect to "clients' funds" and "security futures," as well as other securities "incidental to" transactions in commodity futures. For the reasons described below, we believe the Proposed Rule, as currently drafted, would disrupt well-established practices within the cleared derivatives markets and make it impossible for registered investment advisers to trade futures (other than security futures) or cleared swaps on behalf of their clients. As discussed below, it is also worth noting, as the Commission has in the Proposing Release, that existing CFTC regulations provide significant protections to customer assets held by FCMs that are consistent with the Commission's policy goals.[19]

Under the current custody rule, which applies only to funds and securities, the only assets typically held by an FCM that are subject to the rule are funds, security futures (since they are securities), and securities posted as

[17] In addition to the points noted herein regarding derivatives, we have significant concerns regarding the Commission's proposed changes to the privately offered securities exception in the context of other types of securities. Please see our firm's companion letter for additional discussion on this topic.

[18] Section 6(a) of the CEA generally requires all futures contracts to be traded on or subject to the rules of an exchange. Section 2(h) of the CEA similarly requires certain swaps to be cleared at a registered derivatives clearing organization. In practice, members of exchanges and registered derivatives clearing organizations are almost exclusively FCMs. Although it is theoretically possible for a non-FCM to become a member of a futures exchange or derivatives clearing organization, we assume that the Commission does not intend to require advisers and their clients to incur the expense and operational burden of arranging for qualified custodians that are not FCMs (*e.g.*, banks) to do so. Moreover, CFTC Regulation 1.3 defines "futures commission merchant" to include an entity that solicits or accepts orders for futures contracts or swaps and accepts collateral in connection therewith. Engaging non-FCM qualified custodians to maintain custody of advisory clients' futures contracts and related collateral in accordance with the Proposed Rule would appear to bring the custodian within the definition of FCM, thereby requiring the custodian to register with the CFTC as an FCM pursuant to Section 6d(a) of the CEA.

[19] *See* Proposing Release at 14688.

margin. However, under the Proposed Rule, other assets that would need to held by an FCM, such as futures that are not security futures (for example, interest rate futures, currency futures and commodity futures), as well as cleared swaps (for example, interest rate swaps and cleared default index swaps – many of which are required to be cleared under Section 2(h) of the CEA) would also be required to be held by a qualified custodian. The Proposed Rule does not, however, allow an FCM to serve as a qualified custodian for those assets. Holding such assets with another qualified custodian is not workable as a practical matter and would significantly disrupt the futures and cleared swaps markets.

We respectfully request that the Commission revise the definition of qualified custodian in §275.223-1(d)(10)(iii) as follows:

> A futures commission merchant registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts~~, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon~~

This definition, as revised, would be consistent with the broker-dealer prong of the definition of qualified custodian.[20] Like registered broker-dealers, FCMs are subject to extensive regulation with respect to treatment of customer assets. As the Commission notes in the Proposing Release, these regulations "address, among other things, segregation of customer funds, limitations on institutions in which the FCM may deposit customer funds, limitations on holding customer funds outside of the United States, limitations on the use of customer funds, and recordkeeping requirements relating to customer funds."[21] Given the comprehensive nature of the regulatory regime governing FCMs and their holding and investment of customer assets, including as described in the Proposing Release, we believe there are sufficient grounds to similarly eliminate the conditions and limitations applicable to an FCM's ability to serve as a qualified custodian, as suggested in the changes above.

Even with the changes suggested above to the definition of "qualified custodian", we are concerned that compliance with the expanded scope of requirements applicable to arrangements with qualified custodians for all cleared derivatives would be extremely challenging and in some cases impossible. More specifically, the requirements for a minimum standard of care, indemnification of the client, and segregation of collateral are unduly burdensome and impractical as applied to any FCM arrangement. For all the reasons cited above in Sections I and II, these standards would be a stark departure from current market practice and, assuming it is even possible for advisers to get FCMs to agree to such terms and standards, would be very time-consuming and costly to implement. As noted in Sections I and II above, applying these requirements to futures and cleared swap arrangements will increase costs, concentrate risk (in an already concentrated industry), and reduce hedging activities more generally.

These and other impacts are not adequately addressed in the Commission's cost-benefit analysis.

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[20] "A broker-dealer registered under section 15(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(1)), holding the client assets in customer accounts…".

[21] *See* Final Rule: Enhancing Protections Afforded Customers and Customer Funds Held by Future Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68506 (Nov. 14, 2013) *available at* https://www.govinfo.gov/content/pkg/FR-2013-11-14/pdf/2013-26665.pdf; *see also* Proposing Release at n.112, 121.

Furthermore, we note that, even with the revisions noted above, Proposed Rule §275.223-1(a) appears to prohibit registered investment advisers from entering into any cleared derivatives arrangements where the FCM pledges customer collateral to an exchange or central clearing house as is required under CFTC rules.[22] Specifically, the Proposed Rule would require an FCM to maintain possession or control of the client's assets and to provide reasonable assurances to the registered investment adviser that the client's assets will be held in a "custodial account." CFTC regulations, however, generally prohibit FCMs from accepting collateral posted to segregated accounts at third party custodians.[23] CFTC regulations also permit FCMs to invest and commingle customer collateral (subject to various customer protections). Although the Commission notes its proposals are intended to be consistent with existing regulatory frameworks,[24] we urge the Commission to further clarify this in the rule.

Accordingly, we respectfully request that the Commission clarify that client assets held by an FCM may be rehypothecated or transferred by the FCM to a third party, such as a derivatives clearing organization, and pledged, re-pledged, invested, or otherwise used by the FCM as permitted under CFTC regulations. This could be accomplished by adding the following provision in the Proposed Rule:

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[22] *See* CFTC Regulation 39.13 and n.19, *supra*, noting that futures contracts must be traded on exchanges. Members of futures exchanges are subject to the rules of such exchanges which require the collection of margin.

[23] *See* Section 4d of the CEA; CFTC Regulation 1.20; Amendment of Interpretation, 70 Fed. Reg. 24768 (May 11, 2005), *available at* https://www.federalregister.gov/documents/2005/05/11/05-9386/amendment-of-interpretation. Although the CFTC technically permits the use of third-party custodians for cleared swaps and cleared swaps collateral, such arrangements must meet certain conditions that are inconsistent with the Proposed Rule's requirements for qualified custodian arrangements. *See* Final Rule: Protection of Cleared Swaps Customer Contracts and Collateral, Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336 at 6343 (Feb. 7, 2012), *available at* https://www.govinfo.gov/content/pkg/FR-2012-02-07/pdf/2012-1033.pdf. Moreover, if an FCM accepted collateral that is held in a segregated account at a third-party custodian, the FCM would have to use its own funds to meet exchange and clearing house margin requirements in respect of its customers' positions. The FCM would pass these funding costs on to customers. In practice, we have not seen any third-party custody arrangements utilized for futures, cleared swaps or cleared swaps collateral, due to such regulatory restrictions and costs. Even registered investment companies are granted an exemption from custody requirements in respect of futures and cleared swaps transactions. *See* Investment Company Act Rule 17f-6; Letter to the Chicago Mercantile Exchange from the Office of Chief Counsel, Division of Investment Management File No. 132-3 (Dec. 19, 2017), *available at* https://www.sec.gov/divisions/investment/noaction/2017/chicago-mercantile-exchange-121917.htm.

[24] Proposing Release at 14687-14688. In 2013, the CFTC enhanced requirements applicable to FCMs related to the holding and investment of customer funds, including the ability of FCMs to withdraw funds from futures customer segregated accounts. Under the enhanced protections, FCMs are required to deposit proprietary funds (*i.e.* residual interest) into futures, cleared swap, and foreign futures customer accounts for purposes of creating a buffer to ensure compliance with segregation requirements. In addition, FCMs are required to file electronically their segregation calculations with the CFTC and their self-regulatory organization each business day. FCMs also are required to establish risk management programs designed to monitor and manage risks associated with customer funds. As the Commission acknowledged in the Proposing Release, "…the protections under section 4d(a)(2) of the Commodity Exchange Act and regulations promulgated thereunder, including, among others, CFTC regulation 1.20 (Futures customer funds to be segregated and separately accounted for), CFTC regulation 1.22 (Use of futures customer funds restricted), and CFTC regulation 1.25 (Investment of customer funds), are predicated on the acceptance of, and receipt by, a futures commission merchant of futures customers money, securities, or property. It is our understanding that together, these, and other regulations applicable to FCMs, holistically serve the same purpose. In each of the foregoing cases, the respective custodian is required by its functional regulator to possess or control customer assets. While functional regulators have not defined possession or control in the custody context in a manner identical to our proposed rule (*i.e.*, holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets), we view the proposed definition to be crucial to safeguarding client assets and reflective of the fundamental underlying principle of the custody industry—a custodian holds client assets for safekeeping until directed by the client or the client's duly authorized agent to enter into a transaction with a counterparty resulting in a change of the client's beneficial ownership." Proposing Release at 14688.

> Nothing in this section shall be construed to prohibit a futures commission merchant from pledging, re-pledging, re-hypothecating, investing, or otherwise transferring client assets when permitted under the Commodity Exchange Act and any rules and regulations adopted thereunder.

We also urge the Commission to consider the cross-border aspects of the Proposed Rule as it relates to futures contracts. For example, even if the Commission makes the revisions noted above, a registered investment adviser would be prohibited under the Proposed Rule from trading futures contracts outside of the United States (even on behalf of non-U.S. clients) if the adviser is not able to hold custody of the futures contracts and related collateral with an entity that is a qualified custodian (*e.g.*, an entity that qualifies as a futures commission merchant or a foreign financial institution as defined in the Proposed Rule). At a minimum, the Commission should consider the impacts of this action in its cost-benefit analysis.

IV. <u>Prime Brokerage Arrangements</u>

The Commission should clarify that the Proposed Rule does not prohibit rehypothecation of client assets by a broker-dealer, to the extent otherwise permitted under the Commission's broker-dealer regulations. The Commission also should exempt positions held in a client's account that are brokerage arrangements and collateral posted in connection with such positions from paragraph (a)(1) of the Proposed Rule.

Many hedge funds and other investors enter into prime brokerage arrangements with registered broker-dealers. For many hedge funds, a prime broker serves as the fund's primary custodian, in addition to providing financing and other services. Many hedge funds use a prime broker as the primary custodian because, unlike a typical bank custody arrangement, the prime broker facilitates the hedge fund's ability to short securities by lending securities to the fund. Prime brokers also extend financing to their clients, enabling them to pursue investment strategies that involve leverage.[25]

Under Exchange Act Rule 15c3-3, brokers are required to maintain possession or control of all client securities that are "fully paid securities" or "excess margin securities" and are not permitted to rehypothecate such securities. If a client borrows from the broker and incurs a debit balance, in general, the broker is permitted to rehypothecate securities with a value up to 140% of the client's debit balance. The broker also is required to make weekly deposits in a special reserve account at a bank for the exclusive benefit of customers. This is generally intended to ensure that sufficient assets are available to cover the free cash balances of the broker's customers and the amount of margin securities that have been rehypothecated by the broker.

This regulatory regime has been in place since 1972 and was adopted, in relevant part, "[t]o insure that customers' funds held by a broker-dealer (both free credit balances and deposits which may be restricted as to withdrawal) and the cash which is realized through the lending, hypothecation and other permissible uses of customers' securities are deployed in safe areas of the broker-dealer's business related to servicing his customers, or to the extent that the funds are not deployed in these limited areas, that they be deposited in a

[25] *See, e.g.,* Proposed Rule: Short Position and Short Activity Reporting by Institutional Investment Managers, 87 Fed. Reg. 14950 (Mar. 16, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-03-16/pdf/2022-04670.pdf ("Short selling has long been used in financial markets as a means to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or a related security. Short selling has also been shown to improve pricing efficiency by providing information to the market" (citations omitted)).

reserve bank account."[26] We believe that the Proposed Rule is inconsistent with other Commission rules, including the customer protection regime for broker-dealers that has been in place for more than fifty years and that, thus far, has protected customers in the event of the broker-dealer's insolvency. For example, when the Lehman Brothers Inc. liquidation proceeding under the Securities Investor Protection Act – the largest securities brokerage liquidation in U.S. history – was closed in September 2022, the Securities Investor Protection Corporation announced that all customer claims were satisfied in full.[27]

With these well-tested protections already in place, it is not clear to us why the Commission would upend that regulatory regime in connection with a rule that is designed to protect customers from their investment advisers. Broker-dealers rehypothecate client assets in order to finance margin extended to clients and to facilitate short selling, and prohibiting rehypothecation seems likely either to (a) significantly increase the fees and rates charged by broker-dealers to clients (negatively impacting returns) or (b) make margin financing unavailable to some clients. We expect that some broker-dealers would exit this business, providing fewer options for customers and severely impairing the ability of our clients to manage credit and counterparty risk and likely increasing the cost of obtaining prime brokerage services.

Additionally, rehypothecation of client assets is critical to broker-dealers' ability to facilitate short selling activities by hedge funds and other market participants, which activities have been shown to contribute to price efficiency, market liquidity, and detection of fraud.[28] Prohibiting prime brokers from rehypothecating customers' margin securities would significantly cut back on the inventory of securities that are available to short sellers to borrow, which could lead to more short squeezes and overall inefficiency in markets.

The Commission's customer protection rule for broker-dealers (Exchange Act Rule 15c3-3) already requires registered broker-dealers to safeguard their customer assets and keep customer assets separate from the broker-dealer's own assets, and to obtain and maintain the physical possession or control of all fully-paid securities and excess margin securities carried for the account of customers. Broker-dealers are not permitted to lend or rehypothecate such securities and must hold them directly or at a satisfactory control location. Furthermore, broker-dealers are only permitted to rehypothecate securities pledged as collateral that are not fully-paid securities or excess margin securities, subject to limitations and a requirement to obtain client consent.

By requiring an investment adviser to enter into a written agreement with the qualified custodian that requires the custodian to "maintain possession or control" of client assets and obtain reasonable assurances in writing from the custodian that the custodian will, among other things, segregate client assets from the custodian's own assets and liabilities and hold them in a custodial account, the Proposed Rule will effectively prohibit any broker-dealer acting as a qualified custodian from exercising its rights to rehypothecate client assets.

We urge the Commission to clarify that the Proposed Rule does not prohibit rehypothecation of client assets by a broker-dealer, to the extent otherwise permitted under the Commission's broker-dealer regulations.

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[26] Final Rule: Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. 25224 (Nov. 10, 1972) *available at* https://archives.federalregister.gov/issue_slice/1972/11/29/25222-25229.pdf#page=3.
[27] Securities Investor Protection Corporation Press Release, Lehman Brothers Inc.'s 14-Year Liquidation Successfully Concludes (Sept. 28, 2022), available at https://www.sipc.org/news-and-media/news-releases/20220928.
[28] *See, e.g.*, Managed Funds Association, An Introduction to Short Selling, *available at* https://www.managedfunds.org/wp-content/uploads/2022/04/Short-Selling-White-Paper.pdf.

This could be accomplished by adding the following provision in the Proposed Rule:

> Nothing in this section shall be construed to prohibit a broker-dealer from pledging, re-pledging, re-hypothecating, investing or otherwise transferring client assets to the extent permitted under the Securities Exchange Act of 1934, as amended, and any rules and regulations adopted thereunder.

Finally, for the reasons noted in our discussion above with respect to derivatives transactions, we urge the Commission to exempt positions held in a client's account that are brokerage arrangements and collateral posted in connection with such positions from paragraph (a)(1) of the Proposed Rule.

V. Separately Managed Accounts

Because investment advisers are commonly engaged to provide derivative trading services to SMAs as well as the clients to whom those services are provided (such as endowments and other institutional investors), we also wanted to call attention to the significant impact the Proposed Rule would have on such arrangements. The Proposed Rule includes discretionary authority to trade client assets (*i.e.*, authorization or permission to instruct a client's custodian to purchase and sell assets for the client) as an arrangement that constitutes "custody" and thereby triggers the Proposed Rule. This is a significant departure from the current custody rule. If adopted as proposed, registered investment advisers that have discretionary trading authority (which is common for SMA arrangements, particularly in respect of implementing derivatives strategies) would be required to, among other things, enter into a written agreement with, and obtain reasonable assurances from, the client's custodian that meets the requirements of the Proposed Rule, including obtaining an indemnification of the client by the custodian as well as the custodian's agreement to assume liability for subcustodians. As noted above, such terms are not commonly agreed to by custodians in custodial agreements. Moreover, SMA advisers would be required to supervise the client's custodian in a manner consistent with the Proposed Rule including confirming that the custodian has implemented appropriate measures to safeguard client assets, that the custodian has custody of any trading agreements that the adviser enters into on behalf of the SMA and collateral posted in connection therewith, and, potentially may need to engage an independent public accountant to conduct an annual surprise examination. It is not clear how compliance with the Proposed Rule's requirements is feasible for SMA arrangements. Notably, institutional clients (including endowments and other institutional investors) commonly set up and engage multiple SMA advisers for separate accounts. As such, the client itself typically, and almost necessarily as a practical matter, is responsible for entering into and managing its custodial relationships. It is also not clear that custodians will be willing to enter into agreements with SMA advisers that meet the Proposed Rule's standards. These requirements would impose significant new operational and compliance burdens on investment advisers with respect to their SMA clients that will result in significant costs for SMA advisers and their clients. Such burdens and costs will lead to a reduction in returns, concentration of risk in fewer custodians, and potentially less engagement of SMA advisers by institutional clients to manage risk in their portfolios more generally. In exchange for these costs, we fail to see the added benefit to SMA clients. As noted above, such institutional investors are far better situated to be responsible for choosing, engaging, and overseeing their custodial relationships directly. We are also not aware of any problems with or related to derivative contracts being subject to theft or misappropriation by SMA advisers.

Accordingly, we respectfully request that the Commission return to its prior position under the current custody rule that excludes discretionary trading authority from the definition of "custody." At the very least, we urge the Commission to fulfill its obligations under Section 202(c) of the Advisers Act to consider the costs that will be imposed on SMA arrangements as part of its cost-benefit analysis.

Again, we thank you for the opportunity to provide these comments.

Very truly yours,

Leigh R. Fraser

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