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May 8, 2023

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1091

Re: Safeguarding Advisory Client Assets (File No. S7-04-23)

Dear Ms. Countryman:

Dechert LLP[1] respectfully submits this comment letter in response to the request of the Securities and Exchange Commission (Commission) for comment in connection with Investment Advisers Act Release No. 6240 (February 15, 2023), which proposes new rules and amendments to Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940 (Advisers Act) that would expand the current Custody Rule to cover a broader array of client assets and advisory activities and impose new custodial protections on client assets held under the Advisers Act (Proposed Rule).[2] We note this is a letter focused solely on the application of the proposal to the financial contracts discussed herein. We also note that the proposal raises many concerns, which other commenters have discussed and addressed, and we request that the Commission carefully consider these concerns even though we do not address them in this letter.

We appreciate the Commission's desire to enhance safeguards for client assets. However, in significantly expanding the scope of investments that the Proposed Rule would cover, the Commission's proposal fails to recognize and address the unique aspects of many types of investments. This is, perhaps, most clearly illustrated in the proposal's treatment of transactions in derivatives (e.g., futures contracts, options on futures contracts and swaps) and other similar contracts (e.g., short sales, TBAs and other forward-settling securities transactions, and repurchase agreements and reverse repurchase agreements, among others, and together with derivatives referred to herein as "financial contracts").

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[1] Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and worldwide. Our clients include, among others, a wide variety of registered and unregistered investment companies (including mutual funds, closed-end funds and business development companies), private funds, investment advisers, broker-dealers and institutional investors. An extensive part of our services for these clients involves assistance with the federal securities laws in the organization, distribution and operation of investment funds. Dechert LLP offers specialized buy-side derivative trading regulatory advice that covers the Commodity Exchange Act of 1936 (CEA), Commodity Futures Trading Commission (CFTC) regulations and the rules of self-regulatory organizations such as the National Futures Association and futures exchanges, as well as the Commission's and the Prudential Regulators' regulation of buy-side aspects of the derivatives markets. The comments herein reflect our own views and not necessarily the views of our clients.

[2] Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023) (Proposing Release).

The Commission's proposed definitions of the terms "assets" and "custody" as applied to financial contracts and proposed requirements and conditions applicable to "qualified custodians" with respect to financial contracts, including broker-dealers and futures commission merchants (FCMs) in their capacity as such, would present significant hurdles and challenges for advisers that transact in financial contracts on behalf of their clients and other market participants that would be subject to obligations directly or indirectly under the proposal.

If adopted as proposed, the Commission's proposal would result in significant uncertainties in the application of the requirements to client transactions in financial contracts and necessitate significant outlay in terms of human capital and financial expenditures to redocument client trading arrangements to comply with the proposed requirements (likely far exceeding the Commission's estimates). Further, the requirements as applicable to broker-dealers and FCMs as qualified custodians transacting with advisory clients would likely increase transaction costs that are passed along to advisory clients by such entities. Accordingly, if adopted as proposed, it appears that the proposal could effectively block many advisers from trading in cleared and over-the-counter (OTC) financial contracts for their clients. We note that the Commission has not cited any market fraud or scandal or other tangible issues that would justify such an effect, and we believe these consequences would be to the detriment of advisory clients and the financial markets as a whole.

In addition, the proposal completely fails to recognize the impact of the proposed changes on advisory client advisers' transactions in OTC swaps and other OTC financial contracts and the custody of a client's assets posted as margin thereunder.[3] As discussed herein, given the importance of these contracts, we believe that if the Commission finalizes its custody rule it must provide an explicit exception to the safeguarding requirements with respect to the OTC financial contracts themselves and the margin and collateral posted in connection with the OTC financial contracts. Without such an exception, market participants would not have been afforded the opportunity for notice and comment on how the Commission's proposal would affect OTC financial contract trading.

A. Proposed Definition of "Assets"

Proposed Rule 223-1(d)(1) would define client "assets" that would be in-scope for the requirements under the proposal as including "funds, securities or other property held in a client's account." The Proposing Release suggests that this would include "swaps,"[4] and notes that assets would include "financial contracts held for investment purposes, collateral posted in connection with a swap contract on behalf of the client, and other assets that may not be clearly funds or securities covered by the current rule."[5]

A futures contract, option contract, swap or other financial contract itself is a live, two-way bilateral contract between two parties or a set of two contracts with a clearinghouse interposed as a party to each opposing contract (long/short). A futures contract, an option on a futures contract, and a cleared swaps contract is evidenced solely in the statement delivered to the buy-side counterparty. An OTC swap transaction is evidenced by a confirmation between the two parties. Other financial contacts are similarly evidenced.

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[3] With respect to OTC financial contracts, this letter focuses mainly on OTC swaps and security-based swaps. However, many of the same issues arise with respect to other categories of OTC financial contracts and the comments should be read as also applicable to such types of contracts to the extent the context allows. Note that where this letter refers to "swaps" it also encompasses "security-based swap" trading unless otherwise noted because of a regulatory difference in their treatment.

[4] See Proposing Release, at footnote 14.

[5] See Proposing Release, at text acc. footnote 59.

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Instead, we believe that the concept of "assets" relating to a financial contract is more accurately represented by a receivable equal to the amount of unsettled gains on the transaction and any client assets posted as margin in connection with the transaction. These financial contracts do not have CUSIPs or certificates. As a result of the nature of these financial contracts, an FCM or other custodian may not be able to have or otherwise evidence possession or control of the financial contracts themselves. Instead, the client assets maintained in connection with such financial contracts consist of funds, securities and other assets delivered to the swap dealer, counterparty, FCM or broker-dealer as margin or collateral in connection with such financial contracts.

To require custody of the financial contracts themselves to comply with the Commission's proposal would result in advisers needing to arrange for custody of the evidence of the financial contract with a qualified custodian. We submit that such a requirement would be unworkable and therefore unduly burdensome, which we believe has been explicitly and tacitly acknowledged in the application of the Advisers Act custody framework to such financial contracts over time.[6] Further, we do not see how treating a financial contract itself as an asset would serve the "core purpose" of the custody requirements cited by the Commission – protecting client assets from "loss, misuse, theft, or misappropriation, or the insolvency or financial reverses of, the adviser."[7]

Accordingly, we propose that the Commission specifically acknowledge in any final rulemaking that the term "assets" for purposes of the custody requirements does not include the financial contracts themselves and that an adviser may focus solely on the application of the custody requirements to the margin and other client assets maintained in connection with such financial contracts.

B. Proposed Definition of "Custody"

Proposed Rule 223-1(a) would apply the substantive safeguarding requirements under the proposal only with respect to client "assets" of which an adviser has "custody." Proposed Rule 223-1(d)(3) would define the term "custody" as "holding, directly or indirectly, client assets, or having any authority to obtain possession of them" including any arrangement (including general power of attorney or discretionary trading authority) where an adviser is "authorized or permitted to withdraw or transfer beneficial ownership of client assets" under its instruction. As the Commission articulates this general principle, the definition of "custody" would apply the rule when an adviser has the ability or authority to effect a change in beneficial ownership of a client's assets citing a concern that where an adviser has this authority, such arrangement could place client assets at risk of loss. This means that an adviser with discretion to trade client assets under an arrangement in which it may instruct the custodian to dispose of client assets would have constructive custody of the client's assets. This definition of custody would apply regardless of whether

[6] See Privately Offered Securities under the Investment Advisers Act Custody Rule, Division of Investment Management Guidance Update No. 2013-04 (Aug. 2013) (2013 IM Guidance) at footnotes 2 (categorizing securities that are evidenced by an ISDA that cannot be assigned or transferred without the consent of the counterparty as privately offered securities) and 4 (articulating the exception from the custody rule requirement to maintain securities at a qualified custodian for certain privately offered securities so long as certain audit conditions are met); see also the discussion of the "authorized trading" exception herein, infra note 16. Under the proposed rule, privately offered securities must be custodied at a qualified custodian unless the adviser determines that they "cannot" be so custodied, which exposes derivatives evidenced by an ISDA (and similar financial contracts) to the same challenges discussed in the 2013 IM Guidance. We also note that the application of the Investment Company Act custody requirements by the Commission and the staff of the Commission's Division of Investment Management over time has solely focused on custody of margin in connection with such financial contracts and that such framework has functioned effectively without revealing any significant gaps in customer protection.

[7] Proposing Release, at text acc. footnote 32.

another party such as the custodian, clearinghouse or counterparty would also be required to participate in any transaction in client assets.[8]

If the Commission determines to treat financial contracts as falling within the scope of the definition of "assets," we propose that the Commission provide explicit guidance in adopting any final rule that an adviser would not "have custody" of such financial contracts where an adviser cannot effect a change in beneficial ownership of such financial contracts because the financial contracts are non-transferrable without the consent of the counterparty. This approach would recognize that transacting in these types of financial contracts for client accounts is substantively different than transactions in publicly-offered equities and bonds and other transferrable assets.

In this regard, each of a futures contract, an option on a futures contract, and a cleared swaps contract is non-transferrable under applicable clearinghouse rules and the only way for an adviser to exit the contract on behalf of a client is by entering into an offsetting transaction. OTC swaps are transferrable only with consent of the OTC swap counterparty.[9] In addition, trading OTC derivatives involves an extensive credit analysis by the dealer of its counterparty, negotiation of trading documentation, and exchange of information through protocol adherence or bilateral agreements to meet Commission, CFTC and Prudential Regulator Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) regulatory requirements. The transfer of an OTC financial contract without substantial involvement of and buy-in from the counterparty is not an inherent aspect of this type of trading and how the OTC derivatives markets operate. Other categories of financial contracts generally also are subject to similar transfer restrictions. The Commission notes in the Proposing Release that "if a stock certificate is non-transferrable (i.e., it cannot be used to effect a change in beneficial ownership of a client's investment), an adviser would not be subject to the rule as a result of holding it."[10] We believe the same principle should apply with respect to financial contracts that are non-transferrable or transferrable only with counterparty consent, and that such transfer restrictions significantly reduce any potential concern that an adviser could misappropriate or lose its client's financial contracts. Accordingly, we propose that the Commission provide explicit guidance in adopting any final rule that an adviser would not have custody of any financial contracts that are transferrable only with counterparty consent.

Similar to the above, viewing an adviser as having custody of such financial contracts, and thereby requiring compliance with the safeguarding requirements portions of the proposal with respect to the financial contracts themselves, would be unduly burdensome, and we do not see how such a requirement would serve the core purposes of the custody requirement. We believe that the proposed requirements would serve as significant impediments to investing in these instruments while providing no investor protections beyond those already afforded by the limitations on transfer and/or the complete absence of the ability to transfer a financial contract.

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[8] Proposing Release, at text acc. footnotes 35-37.

[9] The CFTC and U.S. futures exchanges have a number of rules, reporting regimes and procedures in place to identify and track the ownership and control of futures, options on futures, and cleared and uncleared swaps trades and who is doing the trading which would prevent the unilateral transfer of such a position (See e.g., CFTC Part 17 addressing FCM daily reporting of client positions to the CFTC on CFTC Form 102, CFTC Part 38 addressing designated contract market surveillance of trading, CFTC Part 18 addressing the periodic filing with the CFTC of certain trader ownership and control information for futures, options on futures and swaps trades of CFTC Form 40, CFTC Part 45 addressing swap data repository reporting which includes the legal entity identifiers (LEI) for the parties to the reported swap, CME Group Rule 576 requiring the use of individual user Tag 50 IDs when trading on a Globex terminal and ICE US Rule 4.13 requiring the use of eBadges for direct trading access).

[10] Proposing Release, at footnote 64.

C. Treatment of Margin Posted to Support OTC Financial Contracts

The Commission did not recognize the impact of the proposed changes on advisory client transactions in OTC financial contracts for their clients, and the custody of a client's assets posted as margin thereunder, which we believe must be addressed in any final rulemaking. As a result, significant gaps remain in the proposal that we respectfully request the Commission address. We request that the Commission create an exception to the custody requirements with respect to margin and collateral posted in connection with OTC financial contracts. Without such an exception, we believe that the rulemaking process that would apply the substantive conditions under the Proposed Rule to such contracts and related margin would be deficient for its lack of the required notice and comment process and cost-benefit analysis.

For OTC swaps and OTC security-based swaps traded with banks, regulatory initial margin is required to be deposited with a third-party custodian pursuant to an arrangement meeting certain specifications under the CFTC and Prudential Regulator rules, but only when financial-end user counterparties—such as client accounts and funds—meet the material swaps exposure threshold of $8 billion and thereby trigger the regulatory initial margin posting requirements for these categories of swaps.[11] Likewise, where a client transacts in a financial contract with a U.S. registered broker-dealer (e.g., TBAs and short sales), the broker-dealer maintains custody of customer securities and cash posted as margin to it subject to strict customer protection requirements under the Exchange Act. In each case, these requirements are different than the substantive requirements of the proposal even though they offer similar protections to those under the FCM customer funds rules. We believe these arrangements provide sufficient protection to client funds and assets, and therefore propose that the Commission provide guidance in connection with adopting any final rule that such custodians should be able to serve as "qualified custodians" without any additional compliance requirements (similar to our proposal described below with respect to FCMs and broker-dealers).

However, other types of margin for OTC swaps and for OTC security-based swaps traded with non-banks and subject to the Commission's security-based swap margin requirements generally are posted directly to the counterparty or broker-dealer to the financial contract. Such a counterparty (other than a broker-dealer or a bank) may not fall within the categories of "qualified custodians" set forth in the Proposed Rule. Further, even if a counterparty meets the proposed qualified custodian definition, a counterparty generally would not hold client assets posted as margin in an account meeting the substantive requirements of the proposal. Instead, for example, for swaps and security-based swaps, the counterparty would hold such client assets in its general operating account or with its own custodian in an account in its name.[12]

If the custody requirements in the proposal were applied to margin posted in connection with OTC financial contracts, an adviser trading in such contracts for a client would need its client to enter into tri-party account control agreements among the counterparty / broker-dealer, custodian and the client for the posting of margin. These arrangements are generally not used for advisory clients other than registered investment companies and clients subject to policies or other regulatory requirements requiring such arrangements. In our experience implementing the CFTC and Prudential Regulator regulatory initial margin requirements and registered investment company tri-party agreements, putting in place this additional contract creates significant burdens for the client (or its adviser) in terms of human capital and financial expenditures

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[11] See Prudential Regulator Rules §__.2 Definition of material swaps exposure, §__.3 Initial margin and §__.7 Segregation of collateral; see also CFTC Rules 23.151, 23.152 and 23. 157. Cf. Exchange Act Rule 18a-3.

[12] Note this does not apply to registered investment companies which must post margin to tri-party account control agreements with their own custodians to satisfy Section 17(f) of the Investment Company Act. It also does not apply to broker-dealers as discussed below.

relating to negotiation of contracts and development of operational infrastructure. Accordingly, we believe that advisory clients that do not currently use these arrangements would need to incur significant expense to put them in place if required for compliance with any final rule.

Moreover, we understand that the staff of the Commission's Division of Trading and Markets has a longstanding view that broker-dealers are generally restricted in maintaining tri-party custody accounts for securities credited to margin accounts, unless transacting with a registered investment company or another customer that is prohibited from maintaining collateral directly with a broker-dealer. Changing the framework for margin posted in connection with financial contracts with broker-dealers would necessitate coordination with the Division of Trading and Markets to obtain guidance for broker-dealers as to how more widespread use of these arrangements would impact the broker-dealer capital charges, among other issues. Otherwise, we expect that broker-dealers would view themselves as limited in engaging in such transactions with advisory clients. Further, we do not see how such a requirement would serve the core protective purposes of the custody requirements given that broker-dealers are subject to strict customer protection requirements as noted above.

In addition, the financial impact that these aspects of the Commission's proposal would have on clients would go beyond the human capital and financial expenditures needed to negotiate agreements and establish operational infrastructure. In this regard, if margin is held in such an account, swap dealers, security-based swap dealers, broker-dealers and other counterparties to client OTC financial contracts would not be able to rehypothecate that margin. Rehypothecation is a significant economic aspect of the trade, and the inability to do so would drive up trading costs that are passed through to advisory clients. Eliminating rehypothecation also could drive counterparties out of the relevant markets and limit advisers' use of OTC financial contracts for investments and hedging for client portfolios.

Further, we believe that requiring tri-party account control agreements for client margin would not add meaningful protection from adviser misappropriation and therefore would not be well-suited to addressing the core purposes of the proposal.[13] The generally recognized risk of posting assets to a counterparty is loss of such assets upon the counterparty's insolvency – not the misappropriation of such assets by the client's adviser or the adviser's insolvency. In addition, to trade in OTC swaps and security-based swaps for a client, the client is required to be a highly sophisticated eligible contract participant and therefore is well-positioned to assess the risk of posting assets to its counterparty when engaging an adviser to trade in this type of contract on its behalf.[14] Also, as noted above, any advisory client trading with a broker-dealer would be protected by the broker-dealer customer protection requirements discussed above. Further, given that Congress gave the CFTC, Prudential Regulators and the Commission ample opportunity under the Dodd-Frank Act to limit swap and security-based swap trading directly, and these regulators only determined to put in place tri-party custody account requirements with respect to certain transaction types, it seems

[13] It is noteworthy that the Commission declined to require tri-party account arrangements for initial and variation margin posted for security-based swaps of a non-bank security-based swap dealer.

[14] CEA Section 2(e) states that only individuals or entities who are eligible contract participants (ECPs) may enter into swaps that are not executed on, or subject to the rules of, a designated contract market (DCM). Exchange Act Section 6(l) provides that only individuals or entities who are ECPs may enter into security-based swaps that are not effected on a national securities exchange. In other words, only ECPs may enter into swaps and security-based swaps unless the transactions are exchange traded.

Individuals, funds and entities can qualify as ECPs, but generally unless other conditions are met, they must have assets of at least $10,000,000 (CEA Section 1a(18); CFTC Rule 1.3 (regulatory definition of ECP)). The Exchange Act cross-references the CEA for its ECP definition (See Exchange Act Section 3(a)(65)).

inappropriate now to add similar and more broadly applicable requirements with a purpose of preventing adviser misappropriation of client assets.

Finally, requiring tri-party account control agreements for client margin was not contemplated in the Commission's cost-benefit analysis.[15] We note that in the 2003 and 2009 amendments to the Custody Rule, the Commission recognized that "authorized trading" was not within the definition of "custody."[16] In reliance on the authorized trading exception, many types of client funds and accounts have been structured in such a manner that the adviser to those accounts is not deemed to have custody of client funds or securities with respect to that account and still is able to post margin for its clients' transactions in financial contracts without the need to put in place special custody arrangements. Changing this framework with respect to OTC financial contracts without opportunity for affected parties to provide meaningful input and the required cost-benefit analysis would not be appropriate.

Accordingly, for the reasons discussed above, we request that the Commission create an exception to the custody requirements with respect to margin and collateral posted in connection with OTC financial contracts.

D. Proposed Qualified Custodian Protections

1. FCMs as Qualified Custodians

Similar to current Rule 206(4)-3(d)(6)(iii), Proposed Rule 223-1(d)(10)(iii) in relevant part would define the term "qualified custodian" to mean an FCM registered with the CFTC under the CEA 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." Proposed Rule 223-1(a)(1)(i) and (ii) would impose requirements (i) necessitating that an adviser enter into a written agreement with the FCM as qualified custodian obligating the FCM to take certain actions and provide certain reports and records to the adviser, and specifying the agreed-upon level of adviser authority to effect transactions in the account, and (ii) requiring the adviser to obtain reasonable assurances from the FCM as qualified custodian that the custodian will comply with certain substantive requirements. We strongly support the designation of FCMs as qualified custodians, but we believe the Commission has overlooked a number of issues that arise under the application of the proposal's substantive requirements on advisers engaging with qualified custodians.

i. FCM Customer Funds Rules Provide Sufficient Protection

First, we believe that FCMs registered with the CFTC should be able to serve as "qualified custodians" without any additional compliance requirements. In this regard, the Commission's proposal posits that CEA

[15] Because registered funds are required to put in place tri-party collateral control agreements to post margin in connection with OTC swap and security-based swap trading, and other market participants are required to put in place similar arrangements to meet the CFTC and Prudential Regulator initial margin custody requirements, there should be ample data available in the marketplace for the Commission to review and take into account in its cost-benefit analysis and understand the cost and effect on the markets that the proposal as applied to OTC financial contracts would have.

[16] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003); Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968 (Dec. 30, 2009).

Section 4d(a)(2)[17] and the FCM customer funds rules (CFTC Rules 1.20, 1.22 and 1.25)[18] "holistically serve the same purpose" as the proposed standard of having "possession or control". We agree. Further, in response to the request for comment in the proposal, we note that we believe that the 2013 CFTC regulatory enhancements to its FCM customer fund requirements provide sufficient protections to justify the elimination of the condition in the Proposed Rule that customer assets FCMs hold be limited to an amount that is incidental to the relevant transactions. In 2013, the CFTC adopted a number of comprehensive enhancements to its FCM customer protection rules covering its customer protection regime, risk management requirements for FCMs, liquidity requirements for FCMs, the examination process of FCMs by both their self-regulatory organizations and public accountants that annually audit the FCM and provision of disclosures to customers concerning futures trading and FCMs that hold customer funds.[19] These regulatory revisions augmented the existing CFTC regulations and self-regulatory organization customer protection rules applicable to FCMs that were already fairly robust and extended beyond the FCM customer protection rules set forth in CFTC regulations 1.20, 1.22 and 1.25. In addition, we also believe that the FCM customer protection rules provide sufficient protection to render compliance with the written agreement and reasonable assurances requirements unnecessary to serve the protective purposes of the proposal.

ii. FCMs Should Be Eligible Qualified Custodians for Foreign Futures and Cleared Swaps

In addition, we propose that the Commission provide clarifying guidance in adopting any final rule that the scope of transactions for which an FCM is eligible to serve as qualified custodian as trading futures and options on futures with registered FCMs would include client transactions in foreign futures and cleared swaps. The general reference to "futures" in the text of Proposed Rule 223-1(d)(10)(iii) and the Proposing Release's reference to the FCM customer funds rules being embodied in CEA Section 4d(a)(2)[20] and CFTC Rules 1.20, 1.22 and 1.25 could suggest that an FCM may only serve as qualified custodian with respect to the futures and options on futures that fall within the scope of these rules. The CFTC FCM customer funds rules applicable to foreign futures and cleared swaps provide safeguards with respect to customer funds posted in connection with these categories of transactions that are substantially similar to the FCM customer funds rules applicable to U.S. domestic futures trading.[21] As a result, we believe that the Commission should acknowledge that FCMs holding customer margin for these other types of trading meet the definition to avoid a situation where some cleared derivatives trading becomes impermissible simply because the trader has an adviser.

2. Requirement to Have Possession and Control of Client Assets Posted

In connection with discussing the possession and control requirement, the proposal notes that "broker-dealers are required promptly to obtain and maintain in their physical possession or control all of their customers' fully paid and excess margin securities."[22] As noted above, the proposal posits that CEA Section

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[17] CEA Section 4d(a)(2).

[18] 17 CFR Rules 1.20, 1.22 and 1.25.

[19] Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68505 (Nov. 14, 2013).

[20] CEA Section 4d(a)(2).

[21] The CFTC rules applicable to foreign futures trading are located in CFTC Rule 30.7. The CFTC rules applicable to cleared swaps trading are set forth in CFTC Rules 22.2, 22.4 and 22.6.

[22] Proposing Release, text acc. footnote 119.

4d(a)(2) and the FCM customer funds rules (CFTC Rules 1.20, 1.22 and 1.25) "holistically serve the same purpose" as the proposed standard of having "possession or control." However, the Commission proposal also states that the "functional regulators have not defined possession or control in the custody context in a manner identical to our proposed rule,"[23] which suggests that the current broker-dealer and FCM customer protection regimes may not sufficiently address the Commission's proposed possession or control requirement.

We believe that these existing requirements afford ample protection to advisory clients' margin. Accordingly, we recommend that the Commission clarify that these requirements are sufficient and that no further action is necessary to evidence compliance with the definition of "possession and control." Similar to the above comments, we also recommend that the Commission clarify that FCM customer fund rules relating to foreign futures and cleared swaps also serve the same purpose as an FCM having possession and control.

Alternatively, we recommend that the Commission adopt a standard similar to that in Rule 17f-6 under the Investment Company Act of 1940, which would simply require the broker-dealer or FCM to provide contractual acknowledgement of and to agree to comply with the applicable customer protection rules in the agreement with the client.[24]

3. FCM Minimum Custodial Protections – Requirement for a Written Agreement with the Adviser

Under Proposed Rule 223-1(a)(1)(i), the Commission would require a written agreement between the adviser and the FCM or other qualified custodian that must provide specific provisions in order for a client to trade financial contracts through such FCM or other qualified custodian. Current market practice is for contractual privity under a FCM account agreement (applicable to futures, options on futures and cleared swaps) or other agreement to be solely between the FCM or other qualified custodian and the client. An adviser generally would only sign such an agreement as agent of the client and would not be a party to the agreement.

Compliance with the Commission's proposed written agreement requirement would require the redocumentation of agreements or putting in place adviser side letters. We are concerned that this redocumentation could not be achieved through an industry-wide protocol process given that these agreements tend to be highly tailored and vary significantly across different entities that act as broker-dealers and FCMs.[25] Implementing this requirement for every advisory client would entail burdensome use of human capital resources and expenditures, especially for smaller advisers with fewer internal human capital resources. In addition, we expect that broker-dealers and FCMs would pass the costs of an industry-wide redocumentation effort along to their clients through less favorable fees and spreads on their trades. We believe that the written agreement would only add incremental additional protection of client assets from adviser misappropriation given the protections afforded under the relevant customer protection rules, and do not believe that any such benefit would outweigh these costs. Accordingly, we believe it is necessary

[23] Proposing Release, text acc. footnote 121.

[24] To be clear, we are not suggesting that the Commission make applicable to all client funds and accounts all the conditions of Rule 17f-6.

[25] For example, even the annexes to FCM account agreements addressing the terms required under Rule 17f-6 under the Investment Company Act for registered investment companies tend to be significantly different in form and presentation and require careful review to confirm they adequately address the regulatory requirements.

and appropriate for the Commission to provide an exception to the specific adviser written agreement requirement with respect to broker-dealers and FCMs as qualified custodians.

If the Commission does require a written agreement between the adviser and the broker-dealer or FCM, we believe that if the adviser confirms that the agreement between the client and the broker-dealer or FCM addresses the applicable requirements, there would be no policy goal served by requiring that the adviser also enter into a separate agreement covering the same substance. Accordingly, we recommend that the Commission provide an exception to allow that an agreement between the client and the broker-dealer or FCM would be sufficient to address the written agreement requirement so long as the agreement provides for the required provisions.[26]

4. Minimum Custodial Protections – Reasonable Assurances Requirement

i. Indemnification

Proposed Rule 223-1(a)(1)(ii)(B) would require that the adviser obtain from the qualified custodian reasonable assurances that it will indemnify the client (and have insurance arrangements in place that will adequately protect the client against risk of loss) in the event of the qualified custodian's own negligence, recklessness or willful misconduct. The Proposing Release states that the goal of this proposal is "for the client to be compensated in the event of a loss for which the qualified custodian is responsible."[27]

Broker-dealer and FCM indemnification is not a current market practice. We expect that this proposed requirement will increase the costs of transacting with broker-dealers and FCMs as such parties will look to enter into insurance arrangements to address the requirement and pass the cost of obtaining such insurance along to the applicable clients through increased fees or less favorable spreads on transactions. We are not aware that a market for such insurance exists or would exist and are concerned that this may be an uninsurable risk.

As discussed above, the broker-dealer and FCM customer protection rules provide for robust protection of client assets. We submit that the functional regulators have addressed the concern of loss of client assets as a result of actions by the broker-dealer or FCM, and adding an additional cost that would be applied to advisers and their clients is not necessary to address the Commission's stated goal of this proposal. Accordingly, we request that the Commission provide an exemption from Proposed Rule 223-1(a)(1)(ii)(B) for broker-dealers and FCMs that serve as qualified custodian to advisory clients.

ii. FCM Deposit of Margin with a Derivatives Clearing Organizations

Proposed Rule 223-1(a)(1)(ii)(C) would require that the adviser obtain reasonable assurances from an FCM that the use of a sub-custodial, securities depository or similar arrangement will not excuse the qualified custodian's obligations to the client. In a transaction in futures or cleared swaps, an FCM serves as the clearing broker for its customers and clears the customers' transactions through a derivatives clearing organization (DCO). The CEA and CFTC regulations require that customers of an FCM post initial margin to the FCM to secure the customers' payment obligations under their futures contracts or other transactions. The FCM is in turn required to post to the DCO all or part of the margin it receives from its customers. The CEA and CFTC regulations impose customer fund requirements on DCOs that mirror the FCM customer

[26] We note that we also have concerns regarding the substance of the required provisions of the agreement. In this regard, we encourage the Commission to carefully consider concerns raised by other commenters on the substance of the required agreement.

[27] Proposing Release, at text acc. footnote 160.

funds rules.[28] It appears that Proposed Rule 223-1(a)(1)(ii)(C) would include in its scope the FCM's deposit of client assets with a DCO.

The Proposing Release highlights a concern that use of sub-custodians or other entities can create opaque structures and can increase the risk to client assets because clients and advisers are not in direct contractual privity with the sub-custodian or other entities. We are concerned that FCMs would not be in a position to guarantee the DCO. We submit that the CFTC has addressed the concern of loss of client assets as a result of actions by the FCM and DCO under its customer funds requirements, and that FCMs are required to use DCOs for clearing of their customers' transactions and therefore that these arrangements do not pose the concerns cited by the Commission with respect to sub-custodians. Accordingly, we request that the Commission provide an exemption from Proposed Rule 223-1(a)(1)(ii)(C) for FCMs that serve as qualified custodian to advisory clients.

iii. Segregation of Client Assets

Proposed Rules 223-1(a)(1)(ii)(D) would require that the qualified custodian will clearly identify the client's assets as such and segregate all client assets from the qualified custodian's proprietary assets and liabilities. This raises a number of potential issues for broker-dealer and FCM operations and potential conflicts with applicable regulations governing broker-dealer and FCM operations.

The proposal states that the segregation requirements "are drawn from Rule 15c3-3 of the Exchange Act, which requires broker-dealers to safeguard their customer assets and keep customer assets separate from the firm's assets." We are concerned that, although the proposal is drawn from the safeguards proscribed under Rule 15c3-3, there may still be inconsistencies between any final rule and the current requirements for broker-dealers. Further, the proposal elsewhere acknowledges the FCM residual interest requirements, which require that each FCM deposit and maintain certain FCM proprietary assets in the FCM customer funds account creating a buffer to ensure compliance with segregation requirements. This acknowledgement suggests that the Commission would view the residual interest requirements as consistent with the segregation requirement, but it is not clear. In light of these concerns, we urge the Commission to ensure that any final rule stemming from this proposal will not require broker-dealers and FCMs to have to change their practices with respect to carrying customer assets in order for an investment adviser to custody customer assets with a broker-dealer or FCM in compliance with the final rule. We request that the Commission provide an exemption for broker-dealers and FCMs that serve as qualified custodian to advisory clients in light of the application of Rule 15c3-3 and the FCM customer funds rules, or to affirmatively state as much in adopting any final rule.

The proposal also raises concerns regarding the movement of margin from an FCM to the DCO to facilitate trading. The Proposing Release states that the segregation requirement is designed to help ensure that "client assets are at all times readily identifiable as customer property and remain available to the client even if the qualified custodian becomes financially insolvent." With respect to futures trading, there is "fellow customer risk" in the event of a FCM insolvency because FCMs hold futures customer funds in omnibus accounts at DCOs. By contrast, there is legal segregation for cleared swaps customer funds. We request that the Commission provide guidance that these arrangements are consistent with the proposal's segregation requirements. Absent an exemption for FCMs, rule changes applicable to the entire U.S. futures trading markets—not just advisory clients—would be necessary to add "operational segregation" and "legal segregation" at the DCO for futures and options on futures trading. We believe that applying the segregation concept in this manner would represent an inappropriate method of regulating well-established markets,

[28] CEA Section 4d(a)(2), (b); CFTC Rules 1.20(a), (e) and (g) and 1.25.

and would indirectly necessitate the revising of regulatory issues that have been already extensively debated and settled.

If the Commission does not provide an exemption from these requirements for arrangements with broker-dealers and FCMs, we request that the Commission provide guidance that an agreement with a broker-dealer or FCM would satisfy this requirement if the FCM agrees to comply with applicable segregation requirements under Rule 15c3-3 or the CFTC FCM customer funds requirements, as applicable, mirroring the framework in Rule 17f-6(a)(1).

iv. Liens on Client Margin

Proposed Rules 223-1(a)(1)(ii)(E) and (c)(3) raise further concerns regarding the liens that are involved when an entity—whether FCM or other qualified custodian—is holding margin and/or trading contracts. The proposal would require that the adviser obtain reasonable assurances from a qualified custodian that it will not subject the client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client. The Proposing Release notes that the requirement would help ensure that client assets are protected and free of claims by the qualified custodian, including in cases of the qualified custodian's insolvency or bankruptcy. The Proposing Release acknowledges that margin accounts can be beneficial and also provides guidance that this would not prohibit the use of margin accounts, but rather that it would require the adviser to obtain reasonable assurances from the qualified custodian that the client has authorized the lien.

We strongly support the inclusion of the carve-out for client written consent. In transactions where a broker-dealer or an FCM is a qualified custodian, all the contracts and margin that the broker-dealer or FCM holds are subject to a general lien and a continuing, perfected first priority security interest for the benefit of the broker-dealer or FCM, and usually for the benefit of its affiliates, to secure any and all of the customer's indebtedness or other obligations and/or liabilities owed to the broker-dealer or FCM. The types of financial contracts that broker-dealers and FCMs intermediate for clients—whether those clients are advised or not—can have the potential for unlimited client losses. The broker-dealer or FCM needs this lien as protection in the event that the client's losses mount, and the client defaults. Without the carve-out for client written consent, the proposal's prohibition on custodial liens would most certainly prompt broker-dealer or FCMs to need to find other ways to protect themselves, resulting in higher trading costs for client funds and accounts.

However, we also submit that this type of custodial relationship is different from others because the client and the broker-dealer or FCM are engaged in a transaction rather than the qualified custodian solely providing custodial services. In a sense, the custody relationship is tangential to the trading relationship. The Commission's rule should reflect this. For OTC financial contracts wherein the parties must post margin to a tri-party collateral control account, the custodian contractually retains a first priority security interest in the collateral for fees related to the custodian providing securities intermediary services. We note that this practice is not prohibited under the functional regulator rules where initial margin is required to be posted to such an account. Where a qualified custodian and the client are engaged in a transaction, the Commission should go further to state that the prohibition on liens should not apply at all, and certainly should not involve any additional steps for the qualified custodian and adviser to take beyond the client entering into the trading agreement. For margin accounts, it is difficult to fathom how the broker-dealer or FCM would give the adviser reasonable assurances that the client has consented unless the trading

agreement itself is the evidence of such consent.[29] Accordingly, we recommend that the Commission provide an exception for margin posted in connection with cleared and OTC financial contracts.

Absent these requested changes, it is vitally important that the Commission maintains the carve-out in the proposal for liens authorized by the client. If not, the Commission should provide clear guidance that the grant and authorization of such security interests in a written agreement with the broker-dealer or FCM or in the account control agreement for OTC financial contracts is sufficient evidence of client consent. This should apply even if the adviser signs the applicable agreement as agent of the client. We submit that, given long-standing market practice and the recognition of such liens in the Uniform Commercial Code, the execution of the applicable agreement by the client—even if the adviser signs as agent—is adequate to meet the requirement that the client consent to the lien in writing. Without the lien, broker-dealers, FCMs and other qualified custodians may no longer be willing to provide their services to client accounts and funds.

As noted above, current market practice is for contractual privity to be between the broker-dealer or FCM and the client, and the adviser is only a party to the futures trading agreement, if at all, as agent of the client. Accordingly, if the Commission determines to apply the reasonable assurances requirement to arrangements with broker-dealers and FCMs, we recommend that the Commission provide an exception to allow that a writing between the client and the broker-dealer or FCM would be sufficient to address the reasonable assurances requirement so long as the agreement provides for the required client consent.

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We thank the Commission for the opportunity to comment on the Proposed Rule. Please contact Philip Hinkle (Philip.hinkle@dechert.com; 202-261-3460) or Audrey Wagner (Audrey.wagner@dechert.com; 202-261-3365) if we can provide any assistance to you in the further evaluation of these important issues and our comments.

Sincerely,

/s/_Philip T. Hinkle_

cc: Robert Rhatigan, Dechert LLP

[29] If a client could continue to trade OTC swaps without a tri-party collateral control account, the entity holding the margin would not be a qualified custodian, and this requirement could not apply.