May 8, 2023

Via E-Mail to rule-comments@sec.gov
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn: Vanessa A. Countryman, Secretary

Re: FIA Comment on SEC Proposal, "Safeguarding Advisory Client Assets"; File Number S7-04-23

Dear Ms. Countryman:

The Futures Industry Association ("**FIA**")[1] welcomes the opportunity to comment on the U.S. Securities and Exchange Commission's ("**SEC**" or the "**Commission**") proposed new safeguarding rule, which would replace the custody rule, current Rule 206(4)-2 of the Investment Advisers Act of 1940 (the "**Advisers Act**"), with new Rule 223-1 of the Advisers Act (the "**Proposed Rule**").[2] Since 2003, the Commission has considered futures commission merchants ("**FCMs**") registered with the U.S. Commodity Futures Trading Commission ("**CFTC**") to be qualified custodians ("**QCs**") 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 because they provide robust, secure protections for client funds and securities. However, application of the Proposed Rule, specifically its expansion of the scope of assets covered and its imposition of new requirements on FCMs as QCs, would undermine the CFTC's customer protection regime, inhibit and possibly restrict investment advisers and their underlying customers from being able to utilize FCM services, and subject FCMs acting as QCs for the clients of investment advisers to custodial requirements that are inapposite to the core functions FCMs perform for all of their customers—as memorialized in the Commodity Exchange Act ("**CEA**"), CFTC regulations, and customer relationship documentation and disclosures. We urge the Commission to consider the severe impacts of the Proposed Rule on FCMs as QCs and other market participants in the futures industry and revise the Proposed Rule as recommended below.[3]

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[1] FIA is the leading global trade organization for the futures, options, and centrally cleared derivatives markets. FIA's mission is to support open, transparent, and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry.

[2] *See* Safeguarding Advisory Client Assets, 88 Fed. Reg. 14,672 (Mar. 9, 2023).

[3] FIA is aware of similarly situated, highly regulated market participants, such as broker-dealers and financial institutions that would be seriously impacted by the Proposed Rule, and many of our comments regarding the Proposed

I. Executive Summary

The Proposed Rule is flawed in its proposed application to FCMs as QCs and must be revised to avoid severe adverse consequences for FCMs, investment advisers and their respective customers.

In essence, the Proposed Rule would impose on FCMs as QCs, custodial requirements that are inconsistent with their core functions and operations. FCMs are not custodians in the traditional sense. Rather, FCMs serve as execution and/or clearing agents for their customers and facilitate their customers' trading and clearing activities. Although FCMs accept customer funds, they do so in a way that is limited to collecting and posting margin to support customers' trading and clearing activities, which funds are deposited directly into depository bank accounts by the FCM's customers and may be transferred to a derivatives clearing organization ("**DCO**"), or other central clearing counterparty (each such location is segregated for the benefit of the FCM's customers). The futures and cleared swaps regulatory framework is designed to support these core FCM functions with customer protection at the forefront, and on a level playing field such that no futures customer receives preferential treatment over another futures customer.

As explained immediately below, the Proposed Rule would impose conflicting, overlapping, unduly burdensome and unnecessary regulatory requirements on investment advisers and FCMs acting in their capacity as QCs, with no apparent customer asset protections.

- FCMs are already subject to a comprehensive customer protection regime under applicable law and regulation. Under the CEA and CFTC regulations, FCMs are subject to a customer protection framework that sets forth standards for how FCMs hold customer funds. FCMs must hold customer funds in a segregated account titled with an account name that clearly identifies them as futures customer funds (or cleared swaps customer collateral), and such account title must reflect that such funds are segregated as required by Sections 4d(a) and 4d(b) of the CEA and by Part 1 of the CFTC's regulations (or, with respect to cleared swaps customer collateral, Section 4d(f) of the CEA and Part 22 of the CFTC's regulations). In addition, the CFTC's regulations prescribe qualifications for depositories in which an FCM may hold customer funds, including those located outside the United States.

- Unlike the securities laws, the CEA applies directly to depositories that hold customer funds on behalf of an FCM (including DCOs, other FCMs, banks, and trust companies, among others), making it unlawful for a depository that has received customer funds to hold such funds as belonging to the FCM or any person other than the FCM's

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Rule's duplicative and unnecessary regulation apply to these other types of qualified custodians. FIA's comment letter, however, addresses the Proposed Rule's adverse impacts on FCMs.

customers.[4] Such customer fund depositories must sign and submit to the CFTC an acknowledgment letter in which they acknowledge that customer funds will be segregated and treated in accordance with the provisions of Section 4d of the CEA and CFTC regulations thereunder, among other things.[5]

- The Commission previously analyzed the CFTC's customer funds protection regime, describing the CFTC's "extensive regulations" governing the safekeeping of customer funds held by an FCM.[6] In the context of futures margin of registered investment companies held by FCMs the SEC went so far as to say that third-party custodial arrangements may be "redundant in view of the safeguards for customer assets afforded by the CEA and CFTC rules."[7]

- The Proposed Rule would require investment advisers to obtain reasonable assurances in writing from an FCM as QC. The requirement would be redundant or impracticable when applied to FCMs. For example, the Proposed Rule requires assurances that the QC will clearly identify the client's assets as such, hold them in a custodial account, and segregate them from the QC's proprietary assets and liabilities, but such segregation requirements are already addressed with respect to FCMs by the CFTC.

- The Proposed Rule does not adequately address how its application of QC requirements to FCMs overlaps and conflicts with existing CFTC regulations. A proper cost-benefit analysis would seek to identify the marginal value of the proposal in view of CFTC rules applicable to FCMs and compare that with the costs and burdens of the Proposed Rule. Here, we see no marginal value. To the contrary, the Proposed Rule would impose substantial costs on FCMs, investment advisers, and their respective customers, with no benefit to advisory clients or other market participants. The SEC failed to identify any need for FCMs acting as QCs to be subject to new requirements, nor has the Commission identified or evaluated reasonable alternatives to the proposed regulatory approach. The existing CFTC customer protection regime is a reasonable alternative to the Proposed Rule, yet the Commission gave no meaningful consideration

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[4] 7 U.S.C. § 6d(b) ("It shall be unlawful for any person, including but not limited to any clearing agency of a contract market or derivatives transaction execution facility and any depository, that has received any money, securities, or property for deposit in a separate account as provided in paragraph (2) of this section, to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant."); *see also* § 6d(f)(6) for a similar prohibition applicable to cleared swaps customer collateral.

[5] A DCO is not required to provide acknowledgment letters to FCMs if the DCO has established rules that provide for customer segregation. 17 C.F.R. § 1.20(d)(1).

[6] Custody of Investment Company Assets With Futures Commission Merchants and Commodity Clearing Organizations, 61 Fed. Reg. 66,207 (Dec. 17, 1996), https://www.govinfo.gov/content/pkg/FR-1996-12-17/pdf/96-31891.pdf.

[7] *Id.* at 66,208.

of the protections already afforded to investment advisers' clients under federal statute (*e.g.*, the CEA and the Bankruptcy Code) or federal CFTC regulations.

- The expanded scope of the rule raises other issues related to physical commodities. Access to both spot and futures markets is critical for facilitating price discovery in both markets and managing risk. Dually-registered commodity trading advisors and investment advisers participate in the commodity and energy markets through both futures contracts and the underlying spot markets, but their clients could be restricted from accessing spot markets based on the Proposed Rule's expanded scope and related requirements that mandate that an independent public accountant promptly verify "any purchase, sale or other transfer of beneficial ownership" of a spot commodity transaction. For spot markets that are actively traded, this proposed requirement would be unworkable. Even if an investment adviser could effectively comply with this proposal, the cost and the timeliness of doing so would make it untenable. FIA urges the Commission to consider the unintended consequences of expanding the scope of "client assets" and revising the Proposed Rule to mitigate against these consequences by clarifying that physical commodity assets are not included in the expanded scope.

Ultimately, absent revisions or complete withdrawal, the Proposed Rule would undermine, and could even prevent, FCMs from continuing to provide execution and clearing services to investment advisers and their underlying customers. The cost of complying with redundant regulations, and the potential unintended consequences that we have had too little time to fully consider during the comment period, present unavoidable and uncertain legal and regulatory risks that are not outweighed by any potential benefits of FCMs engaging with the investment adviser community pursuant to the Proposed Rule's requirements.

As explained throughout this letter, the Commission does not need to apply the Proposed Rule's conditions to investment advisers that use FCMs as QCs to accomplish its policy goal of preventing potential fraud, misappropriation, or misuse of client assets.[8] FCMs are subject to statutory and regulatory obligations to safeguard customer funds, and any additional requirements are "redundant"[9] and unnecessary. If the Proposed Rule is adopted, the Commission should deem FCMs to be exempt QCs or, in the alternative, provide investment advisers an exemption from the Proposed Rule's requirements relating to written agreements, reasonable assurances, and segregation when an FCM holds their clients' assets (thereby effectively exempting FCMs from these requirements).

Therefore, FIA strongly recommends that the Commission:

[8] 88 Fed. Reg. at 14,679.

[9] 61 Fed. Reg. at 66,208. The Commission previously has not required FCMs to comply with SEC regulations that overlapped and were redundant with CFTC requirements applicable to FCMs.

1. Preserve the current robust and effective requirements applicable to investment advisers that use FCMs as QCs by exempting investment advisers from the requirements in Proposed Rule 223-1(a)(1) and (a)(3) when an FCM holds their clients' assets, effectively exempting FCMs from the redundant written agreement, reasonable assurances, and segregation requirements.[10]

2. Alternatively, rely on the existing robust CFTC customer funds protection regime applicable to FCMs and allow investment advisers to use FCMs as exempt from being QCs (similar to the way that the Commission allows investment advisers to use a transfer agent in lieu of a qualified custodian with respect to shares of a mutual fund).[11]

II. FCMs Are Already Subject to a Robust Regulatory Framework Under the CEA and CFTC Regulations Relating to the Treatment of Customer Funds, and the Commission Should Defer to the Existing Framework

The Commission should defer to the CFTC's existing statutory and regulatory customer protection framework applicable to FCMs under the CEA. Pursuant to Section 4d of the CEA, FCMs, DCOs and depositories that hold customer funds on behalf of FCMs and DCOs are subject to strict customer protection requirements overseen by the CFTC. For example, FCMs, DCOs and any such depositories must treat all money, securities, and property used to margin, guarantee, or secure the trades or contracts of a customer ("**customer funds**") "as belonging to such customer".[12] An FCM must separately account for and may not commingle customer funds with the FCM's funds. Further, an FCM may not use customer funds to margin or guarantee any trades or contracts of, nor may it use such funds as security or credit for, any person other than the customer for whom the customer funds are held. CFTC Regulations 1.20 and 22.2 (applicable to FCMs) and CFTC Regulations 1.20(g) and 22.3 (applicable to DCOs) codify the CEA's customer protections and provide further safeguards. FCMs and DCOs may only use permissible depositories that satisfy the CFTC's qualifications for depositories that hold customer funds on behalf of FCMs and DCOs.[13] In addition, CFTC Regulation 1.25 provides customers with additional protections as it limits the types of instruments in which FCMs and DCOs may invest

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[10] FIA requests the Commission to revise the definition of "qualified custodian" with respect to FCMs to align that definition with the broader scope of client assets covered by the Proposed Rule. *See* Section VII, below.

[11] Current Rule 206(4)-2(b)(1) and Proposed Rule 223-1(b)(1) allow investment advisers to use a transfer agent in lieu of a qualified custodian with respect to shares of a mutual fund. The Commission could similarly allow investment advisers to use an FCM in lieu of a qualified custodian with respect to client assets that are held incidental to transactions in commodity interests.

[12] 7 U.S.C. § 6d(a)(2), (b), (f).

[13] *See, e.g.,* 17 C.F.R. § 1.49.

customer funds, and CFTC Regulation 1.29 limits an FCM's ability to pass along to customers investment losses arising from investments in those approved instruments.[14]

A. The Highly Regulated FCM-Customer Relationship

One of the principal functions of a clearing member FCM is to clear transactions on behalf of its customers. If a party is not a clearing member of a DCO, it must become a customer of an (i) FCM that is a clearing member; or (ii) originating FCM that, in turn, clears customer trades through another FCM that is a clearing member (*i.e.*, the carrying broker). The clearing member FCM enters into an agreement with the DCO and must adhere to the rules of the DCO. The FCM and its customer, in turn, enter into a customer agreement that enables the FCM to establish accounts and clear and carry transactions on behalf of the customer. Pursuant to the terms of the customer agreement, the FCM establishes one or more accounts on its books and records in the customer's name (referred to as the customer account), and the customer authorizes the FCM to execute, carry and clear transactions for the purchase and sale of U.S. futures, foreign futures and/or cleared swaps on behalf of the customer. The effect of this authorization, and the FCM's acceptance, is to cause the FCM to become the customer's agent for these purposes.

An FCM maintains at least two relevant accounts: (1) the customer's account on the FCM's books in the name of a specific customer to which the FCM credits all transactions cleared for the customer by that FCM across all DCOs or foreign clearing organizations on which the FCM acts as a clearing member for the customer (and which may be made up of numerous accounts or sub-accounts for different purposes); and (2) an omnibus customer positions account of the FCM held at the applicable DCO, or foreign futures broker, to which the FCM's customer transactions for all its customers in the relevant account class at that DCO, or foreign futures broker, are credited. The relevant DCO also maintains omnibus accounts to hold customer funds deposited by its clearing member FCMs, subject to CFTC requirements.

When considering the QC conditions under the Proposed Rule and the broader application to FCMs, it is important to understand the nature of the customer's legal interest in the different types of assets that a customer might hold with a QC. Unlike an advisory client that holds assets pursuant to the securities laws in the client's own account (that the client itself opened), an advisory client that enters into a futures or cleared swap transaction must deposit funds (used to secure, margin, or guarantee the transaction) with an FCM, generally in an omnibus account opened by the FCM for the benefit of all of its customers. An FCM is obligated to return the value of the customer's assets to the customer, but it is not obligated to return the same exact assets deposited by the customer. This is because an FCM's customer generally has an undivided interest in the margin held in the omnibus account, not an interest in the specific assets that the customer deposited with the FCM.

[14] 17 C.F.R. § 1.25 (requiring an FCM or DCO that invests customer funds in instruments permitted under the regulation to manage such permitted investments consistent with the objectives of preserving principal and maintaining liquidity and to comply with the requirements of the regulation and related no-action relief and guidance); 17 C.F.R. § 1.29(b); *see also* CFTC No-Action Letter No. 16-68 (Aug. 8, 2016); CFTC Staff Interpretative Letter No. 16-69 (Aug. 8, 2016); CFTC No-Action Letter No. 22-21 (Dec. 23, 2022).

B. The Existing Customer Protection Regime Comprehensively Covers FCMs

The CFTC's customer protection regime requires that an FCM separately account for customer funds and hold customer funds for the benefit of customers. An FCM may not commingle customer funds with the FCM's own funds. An FCM may, however, commingle customer funds with those of other customers and may deposit its own funds in the customer segregated account (*i.e.*, the FCM's residual interest) as a buffer to maintain sufficient funds in the customer segregated account in the event of an unanticipated shortfall.[15] In addition, an FCM must hold customer funds such that they are available immediately upon demand.[16]

Nearly a decade ago, the CFTC introduced an enhanced customer protection regime, stating at the time:

> *The protection of customers—and the safeguarding of money, securities or other property deposited by customers with an FCM—is a fundamental component of the [CFTC's] disclosure and financial responsibility framework.*[17]

The CFTC amended the customer protection regulations to provide greater certainty to the industry that customer funds entrusted to FCMs would be protected and to ensure that an FCM has sufficient capital and liquidity to continue operating as an FCM.[18] In addition, the CFTC adopted a new risk management program requirement that, among other things, mandates that FCMs monitor segregation risk, including the risks posed by depositories, and conduct annual due diligence reviews of approved depositories.[19] Through the enhanced customer protection regime, the CFTC also bolstered oversight and examination programs to effectuate the statute's purposes and mitigate risks.

The CFTC also requires that depositories that hold customer funds satisfy certain qualifications. For example, depositories located in the US must be a bank or trust company (and may include, for a DCO that is designated as systemically important, a Federal Reserve Bank), a CFTC-registered FCM, or a DCO.[20] If a depository is located outside the US, to hold customer funds, it must be a bank or trust company that has in excess of $1 billion of regulatory capital, a

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[15] *See* 17 C.F.R. § 1.23; Section 16 of the NFA Financial Requirements.

[16] 17 C.F.R. § 1.20(h).

[17] Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68,506 (Nov. 14, 2013), https://www.govinfo.gov/content/pkg/FR-2013-11-14/pdf/2013-26665.pdf.

[18] *See, e.g.*, 17 C.F.R. § 1.17(a)(4) (requiring an FCM that is not in compliance with its regulatory capital requirements or that does not have sufficient access to liquidity to continue operating as a going concern to transfer all customer accounts and immediately cease doing business as an FCM until it is able to demonstrate compliance).

[19] 17 C.F.R. § 1.11(e)(3)(i).

[20] 17 C.F.R. § 1.49(d)(2).

CFTC-registered FCM, or a DCO.[21] The CFTC's regulations extend to FCMs that hold foreign futures or foreign options customers funds, and the regulations permit these FCMs to hold such funds with the following depositories: (1) a bank or trust company located in the US; (2) a bank or trust company located outside the US that has in excess of $1 billion of regulatory capital; (3) a CFTC-registered FCM; (4) a DCO; (5) the clearing organization of any foreign board of trade; (6) a member of any foreign board of trade; or (7) such member's or clearing organization's designated depositories.[22]

DCOs are subject to these same requirements, as well as the requirement that they employ settlement arrangements that "eliminate or strictly limit its exposure to settlement bank risks," including credit and liquidity risks.[23] Any such settlement bank must satisfy criteria that addresses the bank's capitalization, creditworthiness, access to liquidity, operational reliability, and regulation or supervision of such bank. A DCO must monitor approved settlement banks against these criteria on an ongoing basis, as well as review the "full range and concentration of its exposures to its own and its clearing members' settlement banks."[24] Part of this ongoing monitoring requires a DCO to assess its own and its clearing members' potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail.[25]

Notwithstanding the foregoing, the Proposed Rule would indirectly introduce an entirely new and unnecessary layer of regulation on FCMs when they hold investment adviser client assets as QCs. By placing these requirements directly on advisers who wish to utilize an FCM as a QC, the Commission indirectly affects the practices and agreements of QCs who are FCMs, which already are regulated by the CFTC. The Commission should not use its regulatory authority over investment advisers to indirectly impose regulations on FCMs that are already comprehensively regulated by the CFTC.

C. Specific Bankruptcy Protections for Customers in the Event of an FCM Insolvency

The regulatory framework for cleared derivatives is a comprehensive regime for protection of customer funds and extends protections in the event of clearing member default or bankruptcy that seek to prioritize customer fund return. In the event of an FCM clearing member default, the CFTC's rules applicable to futures allow a DCO to use all of the collateral in the FCM's customer account to meet a loss in that account, without regard to which customers actually supplied that collateral. While this framework potentially exposes the non-defaulting customers of the defaulting FCM clearing member to loss as a result of this "fellow customer risk," the regime seeks to minimize that outcome.

[21] 17 C.F.R. § 1.49(d)(3).

[22] 17 C.F.R. § 30.7(b).

[23] 17 C.F.R. § 39.14(c).

[24] *Id.*

[25] *Id.*

If an FCM becomes insolvent, Chapter 7 of the Bankruptcy Code and Part 190 of the CFTC's regulations mandate that customer funds held by an FCM pursuant to Section 4d of the CEA have priority over the claims of the FCM's creditors. The provisions of Part 190 of the CFTC's regulations, consistent with the CFTC's customer protection regime, require that shortfalls in customer segregated accounts be made up from the FCM's general assets. The Bankruptcy Code and the CFTC favor public customers (*i.e.*, generally any person who uses an FCM, introducing broker, commodity trading advisor, or commodity pool operator as an agent in connection with commodity interest trading, excluding an owner or holder of a proprietary account of the FCM) over non-public customers and entitle public customers to a pro rata distribution of customer property based on their respective claims.

The existing customer protection framework that the CFTC oversees is a proven, workable framework. The Commission does not need to apply the Proposed Rule to FCMs that serve as QCs. As described in more detail in Appendix A, the CFTC's customer protection regime already offers the safeguards that the Commission is seeking to establish under the Proposed Rule. FIA urges Commission staff to take notice of existing requirements applicable to FCMs. We do not see how the requirements of the Proposed Rule, as applied to FCMs as QCs, are necessary or suitable in light of the CFTC's customer protection regime. The Proposed Rule's negligence standard in the indemnification requirement might be construed to give advisory clients priority in an FCM insolvency despite the Bankruptcy Code's provisions that require pro rata distribution of customer property. In this regard, not only is the Proposed Rule antithetical to the letter and spirit of the CEA, but it also potentially contradicts the Bankruptcy Code's provisions. The Commission should not attempt to override the Bankruptcy Code's requirements, including the pro rata distribution scheme. Anything that could be viewed as altering the pro rata distribution scheme could result in lengthy litigation proceedings, potentially wasting customer assets. FIA recommends that the Commission (1) reject the Proposed Rule as it applies to FCMs as QCs or, alternatively, (2) allow FCMs to hold advisory client assets as exempt QCs (or, at a minimum, permit FCMs to serve as QCs without being subject to the Proposed Rule's written agreement, reasonable assurances (particularly indemnification and insurance), and segregation requirements).

III. History of the Custody Rule and its Purpose and Application to FCMs as QCs and Its Limited Scope of Application to FCMs

The Commission has for thirty years permitted FCMs to hold assets for registered investment companies and even more recently has permitted FCMs to hold customer futures and securities positions and related margin in portfolio margining accounts governed by the CEA and CFTC regulations.[26] The SEC also allows FCMs that are notice registered as broker-dealers to hold security futures positions and related margin in accounts that are subject to the CFTC's

[26] Rule 17f-6 allows an investment company to "place and maintain cash, securities, and similar investments with a Futures Commission Merchant in amounts necessary to effect the Fund's transactions in Exchange-Traded Futures Contracts and Commodity Options," provided that the FCM "maintain cash, securities, and similar investments with a Futures Commission Merchant in amounts necessary to effect the Fund's transactions in Exchange-Traded Futures Contracts and Commodity Options" and the CFTC's rules thereunder (including, if applicable, CFTC Regulation 30.7, which applies to foreign futures customer funds). 17 C.F.R. § 270.17f-6(a)(1).

customer protection rules. In 2003, the Commission adopted rules permitting FCMs to serve as QCs for advisory clients.[27] When the Commission amended the custody rule to encompass FCMs, it noted that the amendments included "the types of financial institutions that clients and advisers customarily turn to for custodial services," such as banks, savings associations, and registered broker-dealers.[28] The Commission also stated that it included FCMs in the expanded definition of QC "to allow advisers that also offer futures advice to comply with Commodity Futures Trading Commission rules."[29] As a result of the amendments, the updated custody rule allowed FCMs to hold an adviser's client assets in customer accounts, including funds used for a client to invest in security futures and securities that are incidental to the client's futures transactions.[30] As this background demonstrates, the Commission has explicitly recognized the adequacy of the CFTC's customer protection regime applicable to FCMs.

The Commission analyzed the CFTC's framework in its 1996 rulemaking that allowed investment companies to hold assets with FCMs.[31] In this rulemaking, the Commission modified its no-action position related to registered investment companies, unit investment trusts, and face-amount certificate companies (collectively, "**funds**") using a special account with a third party custodian to enter into commodity interest transactions, which had the effect of requiring an FCM to use its own assets to effect commodity trades for funds.[32] The Commission acknowledged that when a fund deposited initial margin with an FCM, the fund could be viewed as depositing its assets in the FCM's custody, but the FCM must clear the transaction by posting the fund's margin directly with a clearing organization or with another FCM that clears the transaction through a clearing organization.[33] The text of the SEC's rule references the CFTC's customer protection regime, allowing an FCM to hold funds' assets as long as the FCM "compl[ies] with ***the segregation requirements of section 4d(2) of the Commodity Exchange Act*** (7 U.S.C. 6d(2)) and the rules thereunder (17 CFR Chapter I) or, if applicable the secured amount requirements of rule 30.7 under the Commodity Exchange Act (17 CFR 30.7)."[34]

In evaluating the futures industry trading and clearing infrastructure and the existing customer protection framework applicable to futures customers, the Commission described the CFTC's "extensive regulations" that are designed to protect customer funds in an FCM's possession, including the CFTC's rules that govern the safekeeping of margin related to foreign

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[27] Custody of Funds or Securities of Clients by Investment Advisers, 68 Fed. Reg. 56,692 (Oct. 1, 2003), https://www.govinfo.gov/content/pkg/FR-2003-10-01/pdf/03-24813.pdf.

[28] 68 Fed. Reg. at 56,693.

[29] *Id.*

[30] *Id.* n. 21.

[31] 61 Fed. Reg. 66,207.

[32] *Id.* at 66,208.

[33] *Id.*

[34] 17 C.F.R. § 270.17f-6(a)(1) (emphasis added).

futures and foreign options transactions.[35] The Commission ultimately decided to permit FCMs to hold fund assets directly (with the exception of when a fund is affiliated with the FCM), acknowledging that commenters noted that third-party custodial arrangements "are unlikely to provide any special protection to fund assets in FCM bankruptcy proceedings."[36] The Commission went on to state that such third-party arrangements may be "***redundant in view of the safeguards for customer assets afforded by the CEA and CFTC rules***."[37]

Moreover, in its 1996 rulemaking, the Commission did not adopt its initial proposal to increase an FCM's minimum adjusted net capital requirements in connection with holding fund assets because of the CFTC's segregation and net capital requirements to which FCMs already are subject. The Commission "agree[d] that the CFTC net capital requirements are designed to safeguard fund assets in an FCM's custody."[38]

The Commission's remarks from 1996 are relevant to the Proposed Rule, but the Commission limited its discussion in the preamble of the Proposed Rule about the customer protections already afforded to FCM customers or the CEA and CFTC regulatory framework that has worked well to protect customers to a single question asking whether the CFTC's 2013 regulatory enhancements were sufficient to broaden the scope of the definition of QC related to FCMs.[39] The enhancements are sufficient and provide robust customer protections. The Proposed Rule does not provide greater or better protections to advisory clients that use FCMs, and the proposed requirements should not apply to FCMs that serve as QCs. Before adopting rules that implicate Section 4d of the CEA (a fundamental original provision in the CEA when it was adopted in 1936), the Commission should first consider whether the rules are necessary in light of that regime and how the rules could interfere with and impose unnecessary costs and burdens on the operations of the market participants and the market infrastructure (including depositories and central clearing counterparties) subject to that regime.[40] FIA encourages the Commission to perform this analysis before imposing unnecessary additional QC requirements on FCMs.

IV. The Proposed Rule Would Conflict with Core Functions Performed by FCMs

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[35] 61 Fed. Reg. 66,208.

[36] *Id.*

[37] *Id.* (emphasis added).

[38] *Id.* at 66,209.

[39] *See, e.g.*, Question 26; 88 Fed. Reg. at 14,685-86.

[40] The SEC is required to consider the efficiencies of a new rule and, as part of this analysis, it must analyze whether any existing regime provides sufficient protections. In one case involving the SEC's efficiency, competition, and capital formation analysis, the court found that "The SEC's failure to analyze the efficiency of the existing state law regime renders arbitrary and capricious the SEC's judgment that applying federal securities law would increase efficiency." The SEC's failure to analyze the efficiency of the existing CFTC and bankruptcy regimes appears to implicate its legal requirement to do so. *American Equity Investment Life Insurance Co. et al. v. SEC*, 613 F.3d 166, 176 (July 12, 2010).

The Proposed Rule's requirements for QCs are inapposite to the core functions and operations of FCMs. An FCM's primary business function is to clear as agent customer transactions in, or incidental to, transactions in commodity interests, not to serve as a custodian of client assets more generally. Accordingly, the Commission should not apply the Proposed Rule with respect to FCMs or should deem FCMs exempt QCs (or, at a minimum, the SEC should not subject FCMs to the written agreement, reasonable assurances, and segregation requirements).

A. The Proposal's Indemnification Requirement is Overly Broad and Inconsistent with Existing Industry Practices

Existing protections afforded to FCM customers under the CEA and CFTC regulations obviate the need for the Proposed Rule to apply indemnification and related insurance requirements to FCMs that act as QCs. The Commission has proposed to require that an adviser obtain written assurances from a QC that such custodian "will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the QC in the event of the QC's own negligence, recklessness, or willful misconduct." As a practical matter, it is FIA's understanding that FCMs generally do not indemnify customers for all losses. CFTC rules require FCMs to provide prominent risk of loss disclosures and prohibit FCMs from guaranteeing against certain losses.[41]

Typically, an FCM is reluctant to provide indemnification to customers because an FCM's customers receive extensive disclosures about the risk involved with trading futures and swaps, and in markets used for hedging (such as futures), one cannot discern the resulting loss of positions without evaluating the market movement in related cash market positions, and commercial realities make providing indemnification cost prohibitive. The commercial realities, such as the potential lack of such insurance in the market today, likely would make it infeasible for a QC to comply with the insurance requirement. Even if such insurance were available, it would impose a significant and prohibitive financial burden on the QCs.

FIA is concerned that the Proposal does not consider how the requirement that a QC indemnify the client against loss in the event of negligence may increase the potential for such indemnifications to be triggered and potentially reflected as a liability, which could have significant capital impacts on QCs – such as FCMs and banks – that are subject to capital or net capital requirements. Any resulting increases in capital requirements will further drive up the cost of custodial services that will be passed on to advisory clients, or, in a capital-constrained environment, potentially lead to a reduction of FCM services offered to advisory clients.

The requirement in the Proposed Rule that an FCM carry indemnification insurance introduces additional expenses and would significantly interfere with an FCM's ability to negotiate indemnification provisions with its clients. The proposed indemnification requirement does not consider extensive negotiations over indemnities related to the scope of the indemnity, degree to

[41] FCMs are required to provide customers with prescribed risk disclosures that state things like, "[t]he risk of loss in trading commodity futures contracts can be substantial[]" and "[y]ou may sustain a total loss of the funds that you deposit with your broker to establish or maintain a position in the commodity futures market, and you may incur losses beyond these amounts." *See, e.g.*, 17 C.F.R. § 1.55(b).

which one party will indemnify the other party, procedures for seeking indemnification, and any repayment of other indemnification or insurance proceeds the indemnified party has received, among other considerations. When the CFTC introduced the prohibition on FCMs from guaranteeing customers against certain losses, the CFTC noted that although it "clearly does not favor customer loss, the Commission believes that the risks of the marketplace should not be obscured to the potential detriment of customers."[42] FCMs are not allowed to indemnify customers for trading losses, but the Proposed Rule appears to suggest that they would have to start doing just that. The Proposed Rule's mandates would conflict with existing legal and regulatory requirements to which FCMs are subject and likely have the effect of increasing costs to clients and potentially causing FCMs to exit the business entirely.[43]

B. The Commission Appears to Impose Liability on QCs for Sub-Custodial Arrangements

If the Proposed Rule is adopted as proposed, an adviser would be required to obtain written assurances from a QC that "[t]he existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client." By imposing this requirement, the Commission would indirectly regulate banks, trust companies, securities depositories, and other types of custodians that are already subject to regulation by their respective primary regulators. The Commission explains that this requirement is necessary because it is concerned that QCs might try to avoid responsibility for their safeguarding obligations by outsourcing to a sub-custodian.[44] The Commission cites to papers about outsourcing certain types of back-office bank functions (such as recordkeeping) and to a discussion paper issued by the German Central Bank analyzing risks of sub-custodian chains of *German* banks.[45]

As a threshold matter, the assurance requirement should not apply to investment advisers that use FCMs as QCs because they (1) are not traditional custodians; and (2) they do not outsource any of their own obligations when they deposit customer funds with a depository. Rather, pursuant to the CEA and industry practices, FCMs deposit such funds in a customer segregated account maintained by a bank or other permissible depository in the business of providing account services. An FCM is not trying to avoid its responsibilities for any safeguarding obligations when it deposits customer funds in a customer segregated account—making a deposit of customer funds with a bank or trust company or other permissible depository is part of the FCM's safeguarding obligations. The only other choice to using a depository would be for an FCM to hold all cash and

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[42] Prohibition of Guarantees Against Loss, 46 Fed. Reg. 62,841, 62,842 (Dec. 29, 1981).

[43] Only approximately one-third of the number of FCMs that existed twenty years ago remain today, and even fewer of these FCMs are clearing members that clear trades for others. As of February 28, 2023, 62 FCMs were registered with the CFTC, in contrast to 174 registered FCMs that existed as of March 31, 2002. *See* Financial Data for FCMs, https://www.cftc.gov/MarketReports/financialfcmdata/index.htm.

[44] Proposed Rule at 14,695.

[45] *Id.* at 14,698, n.166.

securities in a safe in its office. For obvious reasons, that is not a desirable or practical alternative. Thus, the proposed assurance requirement for investment advisers' QCs and related sub-custodial arrangements should not apply to investment advisers that use FCMs as QCs because it does not make sense as applied to FCMs as QCs because the CFTC's customer protection framework applicable to an FCM's deposit of customer assets with depositories makes this assurance unnecessary and redundant.

Under the CEA and CFTC customer protection regime, an FCM may deposit customer funds only with permitted depositories (as discussed in Section II.B), including other FCMs (typically in the case of correspondent broker relationships), so long as these depositories provide a written acknowledgment letter in the form set out in Appendix A to Part 1 of the CFTC's regulations or, with respect to DCOs, have adopted rules that provide for segregation in accordance with the CEA and CFTC regulations and orders. The written acknowledgment letter incorporates the CFTC's customer protection regulatory requirements, such as the requirement that an FCM only use a depository that agrees to provide specified CFTC staff with direct, read-only electronic access to transaction and account balance information of customer accounts, among other requirements. Thus, a depository is on notice of its obligations that arise under specific language in the CEA, helping safeguard customer funds, even when they are held by non-U.S. custodians. For example, when an FCM holds foreign futures and foreign options customer funds with a depository, the CFTC has explained that only the initial depository is subject to the acknowledgment requirements, not any subsequent depository.[46] Customers receive a measure of protection in the event that an FCM or foreign broker becomes insolvent if the initial depository has the ability to identify customer funds.[47] The Commission should defer to the CFTC's analysis of safeguards available to FCMs and their customers, including advisory clients.

Moreover, FCMs do not select the exchange and clearinghouse for a customer's futures trading activities. The customer determines what products it wants to trade and the availability of exchanges that offer these products. In some cases, exposure to certain instruments is only available on certain exchanges, including certain non-U.S. markets. Depending on the circumstances, FCMs typically have no choice in the location where they must deposit customer funds to margin futures or cleared swaps trades because they must deposit customer funds with the depository that the relevant DCO has selected. Customers make the decision to trade these instruments and are aware of the risks of trading (in part because the CFTC requires FCMs to provide these types of risk disclosures).[48]

The CFTC also requires FCMs to have a risk management program that monitors for segregation risk, among other risks. FCMs must perform initial and annual due diligence on its

[46] Interpretative Statement With Respect to the Secured Amount Requirement Set Forth in § 30.7, Appendix B to Part 30 of the CFTC's Regulations.

[47] *Id.*

[48] 17 C.F.R. §§ 1.55(b); 30.6.

depositories to assess whether they are qualified to hold customer funds; address each depository's "capitalization, creditworthiness, operational reliability, and access to liquidity"; and consider the concentration of customer funds in any depository or group of depositories, the availability of deposit insurance, and the regulation and supervision of depositories.[49] The CFTC's requirement that an FCM have a documented process in place against objective criteria not only safeguards customer funds, but also enables regulators and auditors (including the CFTC and designated self-regulatory organizations like the CME and National Futures Association) to review the FCM's due diligence process. DCOs are subject to different regulations designed to assess the risk of settlement banks, increasing the protections available to customers. In the event a DCO needs to eliminate or limit exposure to a settlement bank, the CFTC requires the DCO to have settlement accounts at additional settlement banks, approve additional settlement banks for clearing members to use, impose concentration limits with respect to settlement banks, or take other appropriate actions.[50]

If the Commission has concerns about depositories' ability to safeguard customer funds, the Commission should provide data supporting these concerns and discuss its concerns with and defer to the governmental authorities that are charged with *directly* regulating custodians instead of attempting to regulate them itself. The Commission should not try to impose liability on a QC for each and every act that may occur within the infrastructure that supports securities and commodity interest trading activities. Custodians that currently serve as QCs may not be inclined or able to do so if they incur the liability of every other depository or clearing house involved in a customer's trading activities. The Commission's assurance for sub-custodial arrangements is not necessary for FCMs that serve as QCs to advisory clients, and FIA encourages the Commission to eliminate this requirement in any final rule.

C. Internal Control Reports are Redundant with, and Provide Less Protections than, Existing CFTC Requirements

Proposed Rule 223-1(a)(1)(i)(C) would mandate that advisers have a written agreement with a QC requiring the QC to provide a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that QC during the year).

Under the CFTC's regulations, FCMs already submit to the CFTC, designated self-regulatory organizations, and customers periodic reporting, most of which is subject to regulatory review and oversight. For example, FCMs provide monthly account statements to each customer and prepare and retain "point balance" statements (*i.e.*, statements reflecting the accrual or

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[49] 17 C.F.R. § 1.11(e)(3)(i).

[50] 17 C.F.R. § 39.14(c).

bringing to the official closing price or settlement price fixed by the clearing organization all open contracts of customers as of the last business day of each month or such other monthly date).[51]

FCMs also provide daily, monthly, and annual reports to the CFTC and their designated self-regulatory organizations. By noon the following business day, an FCM must submit to the CFTC and the FCM's designated self-regulatory organization a daily Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Commodity Exchanges reflecting the computation as of the close of each business day of (1) the total amount of futures customer funds on deposit in segregated accounts on behalf of futures customers; (2) the amount of such futures customer funds required by the CEA and CFTC regulations to be on deposit in segregated accounts on behalf of such futures customers; and (3) the amount of the FCM's residual interest in such futures customer funds.[52] It is our understanding that an FCM's designated self-regulatory organization conducts an independent review of these reports against data provided by depositories to validate the data and to identify any discrepancies with the data. An FCM must submit to the CFTC and its designated self-regulatory organization monthly financial statements on Form 1-FR-FCM (or a FOCUS Report if the FCM is registered with the Commission as a securities broker or dealer) within 17 business days after the date for which the report is made and annual audited financial statements, certified by an independent public accountant, within 60 days of the close of the FCM's fiscal year.[53] The CFTC also requires an FCM to ensure that the scope of the independent public accountant's audit and review of the FCM's accounting system, internal controls, and procedures for safeguarding customer and firm assets is sufficient to discover any material inadequacy that exists at the date of the examination in various systems and controls, including the FCM's procedures for safeguarding and segregating customer funds and procedures related to daily segregation computations.[54]

Based on the extensive reporting FCMs provide customers, the CFTC, and designated self-regulatory organizations, and based on the existing oversight the CFTC and self-regulatory organizations exert over FCMs, it is unclear what value the Commission's proposed requirement that FCMs issue internal control reports to advisers each year would add to the existing regulatory framework applicable to FCMs. In light of this existing framework, FIA requests that FCMs not be subject to the Commission's proposed internal control report requirement.

D. The Proposed Rule Does Not Affect Foreign Futures Customer Funds Held Pursuant to CFTC Regulation 30.7

Proposed Rule 223-1(d)(10)(iv) includes new standards for foreign financial institutions. As discussed throughout this comment letter, the CFTC allows FCMs to hold customer funds with

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[51] 17 C.F.R. §§ 1.33, 1.34.

[52] 17 C.F.R. § 1.32(a), (c); *see also* CME Rule 971.B.

[53] 17 C.F.R. § 1.10(b); *see also* Section 16(e) of the NFA Financial Requirements.

[54] 17 C.F.R. § 1.16(d)(1).

non-US depositories and has a framework in place for doing so.[55] Because the Proposed Rule applies directly to investment advisers, FIA does not interpret the proposed new criteria related to foreign financial institutions to apply to FCMs that hold customer assets related to foreign futures with offshore depositories pursuant to CFTC Regulation 30.7.

V. The Commission's Cost-Benefit Analysis is Flawed

The Commission's cost-benefit analysis begins with "broad economic considerations" that paint with broad brushstrokes that Commission regulation is necessary, not over investment advisers alone, but over the entire market infrastructure holding client assets. The Commission takes the position that, while advisers have "private reputational incentives to maintain some level of oversight and internal controls," the adviser-client relationship presents certain conflicts that may be exacerbated by the introduction of custodians into the relationship, but "targeted regulatory requirements can help increase the level of investor protection."[56] FCMs also are required and incentivized to maintain oversight over customer funds such that further targeted regulatory requirements are redundant and unnecessary.

The Commission states that the Proposed Rule would "promote efficiency, competition, and capital formation." However, the Commission did not perform a robust analysis of the proposed requirements as they apply to FCMs against these benchmarks. For example, when the Commission analyzed "efficiency", it noted that the Proposed Rule could have the effect of driving some advisers out of the business because of the large costs associated with compliance with any new requirements, which could cause clients to "experience a decrease in the quality of advisers' services."[57] The Commission did not consider the reduced efficiencies outcome that the Proposed Rule likely would have on investment advisers and FCMs acting as QCs, whose handling and use of customer funds are subject to a separate federal regulatory regime administered by the CFTC. Any such analysis must determine whether sufficient investor protections are available under the existing regime and the efficiency of the existing regime.[58] The Commission has recognized and expressed confidence in the CFTC's customer protection regime in the past but failed to describe the regime's efficiencies in the proposing release's cost-benefit analysis. As FIA has described herein, the Proposed Rule does not provide any efficiencies for investment advisers that use FCMs as QCs or FCMs because FCMs are already subject to regulatory oversight when handling customer funds, providing protection to investment advisers' clients. If investment advisers that use FCMs as QCs are subject to the Proposed Rule, there is concern that competition amongst

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[55] *See, e.g.*, 17 C.F.R. § 30.7.

[56] Proposed Rule at 14,734.

[57] *Id.* at 14,757.

[58] Section 202(c) of the Investment Advisers Act of 1940 provides: "Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. 80b-2(c); *see also, e.g., American Equity Investment Life Insurance Co. et al. v. SEC*, 613 F.3d 166, 176 (July 12, 2010).

FCMs would suffer if the cost of providing FCM services to advisory clients becomes too expensive.

In addition, FIA and its members are not aware of any issue with an investment adviser relating to client assets custodied at an FCM specific to the investment adviser context that would necessitate an entirely new regulatory framework on entities already subject to their primary regulatory authority's requirements. Not only will FCMs that serve as QCs experience significant compliance costs, but they would also need to renegotiate each customer agreement for advisory clients and obtain insurance. Moreover, investment advisers who would need to monitor FCMs as QCs for compliance and comply with the Proposed Rule will experience new costs where none existed before. All of these costs have the potential to result in increased costs to advisers' clients and the loss of their FCMs who choose to stop doing business for advisory clients, meaning that advisory clients may lose access to security futures or other asset classes.

Thus, investment advisers will be at a disadvantage with respect to other asset managers that advise clients as to futures and swaps and are not registered as investment advisers. There will be an uneven playing field between investment advisers, on the one hand, and CFTC-registered commodity trading advisors that are not dually registered as investment advisers, on the other hand. The Bankruptcy Code and the CFTC's framework have been intentionally designed to avoid some futures customers receiving preferential treatment over other futures customers, but the Proposed Rule would require FCMs to put advisory clients ahead of all other clients pursuant to the onerous written agreement and assurances requirements. The outcome significantly undermines the CFTC's and the bankruptcy regime's fundamental policy of treating customers fairly, contrary to long-standing laws and regulations. An FCM may have no choice but to decide whether to comply with its primary regulatory regime or the SEC's custody rule and decide not to provide services to advisory clients to avoid noncompliance. Any purported benefits associated with the Proposed Rule as they pertain to investment advisers that use FCMs as QCs and other QCs do not outweigh the costs investment advisers, FCMs as QCs, and their respective customers will incur. As applied to FCMs as QCs, the Proposed Rule is redundant, and there are no apparent benefits. The Commission's cost-benefit analysis does not address these costs and policy concerns, and FIA encourages the Commission to perform a more thoughtful analysis of the costs associated with imposing the Proposed Rule's redundant requirements on FCMs.

VI. The Commission Should Remove FCMs from the Scope of the Proposed Rule or, Alternatively, Deem FCMs to be Exempt QCs or Exempt FCMs from the New Requirements of the Proposed Rule

The Commission asks in Question 26 of the Proposed Rule whether the rule should continue to include FCMs as QCs as proposed.[59] FIA believes that the Commission should remove

[59] Question 26 reads: "Should the rule continue to include FCMs as qualified custodians, as proposed? Should we remove the condition in the current rule that prohibits maintaining client securities with an FCM unless the securities are ''incidental'' to client futures transactions? In 2013, the CFTC enhanced protections afforded to customers and customer assets held by FCMs including protections covering, among other things, risk management, recordkeeping

the Proposed Rule's changes with respect to assets held by investment advisers and their customers with FCMs by exempting investment advisers from the requirements in Proposed Rule 223-1(a)(1) and (a)(3) when an FCM holds their clients' assets, effectively exempting FCMs from the redundant written agreement, reasonable assurances, and segregation requirements and, instead, preserve the current robust regime. Alternatively, the Commission could deem FCMs to be exempt QCs[60] in reliance on the comprehensive and effective CFTC customer funds protection regime applicable to FCMs.

FCMs should be permitted to hold advisory client assets in connection with commodity interest trading as QCs that are subject to the customer protection regime under the CEA and CFTC's regulations, rather than the Proposed Rule's requirements, many of which are redundant and unnecessary in light of the regulatory requirements already applicable to FCMs. As explained in more detail in Section II and Appendix A, FCMs are subject to robust oversight and safeguarding requirements when they hold customer funds. Imposing further requirements on FCMs is not necessary and, instead of adding any value to customers, may have the perverse effect of causing FCMs to exit the business for the reasons described herein.

Support for FIA's request is contained in the Proposed Rule itself. The Commission contemplates exceptions from certain requirements of the Proposed Rule. For example, the Commission provides an exception from the annual audit requirement for the account of a pooled investment vehicle if it undergoes a financial statement audit at least annually and upon liquidation. The Commission has not provided any explanation as to why the application of the Proposed Rule to investment advisers utilizing FCMs would provide new or additional customer protections to the extensive regulatory regime applicable to FCMs already in place and, therefore, it is appropriate to allow advisers to use FCMs for commodity interests that are incidental to securities under the CFTC's existing framework rather than pursuant to the Proposed Rule. The Commission should carefully review Appendix A, which demonstrates that none of the Proposed Rule's requirements are necessary or appropriate as they relate to FCMs.

VII. The Proposed Rule, as Drafted, Appears to Improperly Limit the Types of Client Assets FCMs May Hold as QCs

The Proposed Rule contains a critical definitional issue that must be resolved if FCMs ultimately are covered by any final rule. The current rule only applies to client securities and cash. Under the current rule, FCMs are defined as qualified custodians only with respect to securities *to the extent the securities are "incidental" to a futures transaction*, *i.e.*, when client

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and disclosure, and the treatment of customer-segregated funds secured in foreign futures and options accounts. Are the 2013 CFTC regulatory enhancements sufficient grounds to eliminate that condition of the current rule?" Proposed Rule at 14,685-86 (footnote omitted).

[60] Current Rule 206(4)-2(b)(1) and Proposed Rule 223-1(b)(1) allow investment advisers to use a transfer agent in lieu of a qualified custodian with respect to shares of a mutual fund. The Commission could similarly allow investment advisers to use an FCM in lieu of a qualified custodian with respect to client assets that are held incidental to transactions in commodity interests.

securities or cash are posted as collateral for a futures transaction (or when client securities or cash are deposited for a security futures transaction). Otherwise, FCMs currently are ***not*** QCs for any other purpose. The Proposed Rule broadens the rule's scope to cover assets, defined as funds, securities, *or other positions held in the client's account*, which we interpret to encompass customer futures and swaps positions, positions held pursuant to portfolio margining arrangements, physical commodities, and intangible commodities, such as renewable energy certificates and other environmental commodities. Yet, the Commission did not modify the scope of an FCM's role as a QC to account for the expanded scope of client assets covered under the Proposed Rule.

If the Proposed Rule would cover all types of client assets, including futures, swaps, physical commodities, and intangible commodities held in a customer account, but the definition of QC with respect to FCMs is not expanded in a similar manner, then it appears that FCMs would not be qualified custodians for the very assets for which advisers use FCMs, that is, to transact futures and swaps on behalf of customers. To the extent that the Commission moves forward with a final rule, FIA urges the Commission to revise the qualified custodian definition with respect to FCMs as indicated in underlined and strikethrough font:

> 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~~ to the extent such client assets are being held incidental to transactions in (i) contracts for the purchase or sale of a commodity for future delivery and options thereon; (ii) deliveries of commodities or securities in connection with a contract for the purchase or sale of a commodity for future delivery; (iii) security futures contracts; (iv) cleared swaps; or (v) other commodity interests as such term is defined in CFTC Regulation 1.3.

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FIA supports effective client asset protections. The CFTC's regime adequately covers FCMs holding client assets. The Commission should not impose on FCMs acting as QCs conflicting, overlapping, unduly costly, and unnecessary requirements. FIA believes that investment advisers must be able to continue to utilize FCMs with respect to transactions on behalf of their clients in commodity futures and options on futures, deliveries of commodities or securities related to such contracts, security futures, cleared swaps and other commodity interests. The Commission should either: (1) continue to include FCMs as QCs under the current framework applicable to FCMs as QCs by exempting investment advisers from the requirements in Proposed Rule 223-1(a)(1) and (a)(3) when an FCM holds their clients' assets, effectively exempting FCMs from the redundant written agreement, reasonable assurances, and segregation requirements; or (2) rely on the existing robust CFTC customer funds protection regime applicable to FCMs and allow investment advisers to use FCMs as exempt from being QCs.

FIA appreciates the opportunity to provide comments to the Commission on the Proposed Rule. If you have any questions about FIA's comments, please do not hesitate to contact me at [redacted] or [redacted].

Respectfully submitted,

Allison Lurton
General Counsel and Chief Legal Officer

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester Peirce, SEC Commissioner
The Hon. Caroline Crenshaw, SEC Commissioner
The Hon. Mark Uyeda, SEC Commissioner
The Hon. Jaime Lizarraga, SEC Commissioner
Mr. William Birdthistle, Director, Division of Investment Management

APPENDIX A
EXISTING CFTC REGULATIONS DEMONSTRATE THAT THE SEC'S PROPOSED REQUIREMENTS SHOULD NOT APPLY TO FCMS

No.	SEC Proposed Requirement	Existing CFTC Requirement
1	*Proposed Rule 223-1(a)(1)(i).* Written agreement between FCM and the adviser that must include the following provisions, which the adviser must reasonably believe have been implemented.	An FCM and its customer enter into a written agreement governing the principal-agent relationship between the parties. When an FCM deposits such customer's funds with a depository, the FCM must comply with various regulatory requirements. For example, CFTC Regulation 1.20(d)(1) requires the FCM to "obtain a written acknowledgment from each bank, trust company, derivatives clearing organization, or futures commission merchant prior to or contemporaneously with the opening of an account by the futures commission merchant with such depositories; provided, however, that a written acknowledgment need not be obtained from a derivatives clearing organization that has adopted and submitted to the Commission rules that provide for the segregation of futures customer funds in accordance with all relevant provisions of the Act and the rules in this chapter, and orders promulgated thereunder". The written acknowledgment must be in the form set forth in Appendix A to Part 1 of the CFTC's regulations. CFTC Regulation 1.20(d)(2). Based on this transparency, an adviser may reasonably believe that an FCM and its depositories are appropriately safeguarding customer funds. The SEC's proposed requirement is not necessary.
2	*Proposed Rule 223-1(a)(1)(i)(A).* The qualified custodian will promptly, upon request, provide records relating to your clients' assets held in the account at the qualified custodian to the Commission or to an independent public accountant engaged for purposes of complying with paragraph (a)(4) [independent verification by an independent public accountant], (b)(1) [exception for mutual fund shares], or (b)(4) [exception from annual audit requirement for the account of a pooled investment vehicle if it undergoes a financial statement audit at least annually and upon liquidation] of this section.	An FCM may only deposit futures customer funds with a depository that agrees to provide the director of the Market Participants Division (MPD) or such director's designees, with direct, read-only electronic access to transaction and account balance information for futures customer accounts pursuant to CFTC Regulation 1.20(d)(3)(ii). The written acknowledgment must contain the FCM's authorization to the depository to provide such access to the director of MPD or its designees, without further notice to or consent from the FCM. In addition, to be an acceptable depository to hold CFTC regulated customer funds the FCM must instruct each depository to report balances held at the depository to the NFA (*see* NFA Financial Requirements Section 4(b)(c)(d)) and CME (*see* CME Rule 971.C). All FCMs must submit a daily segregated, secured 30.7 and Cleared Swap Customer account statement, as applicable, through electronic transmissions by 12:00 noon on the following business day. *See* CFTC Regulation 1.32; NFA Financial Requirements Section 16(e)(iii) and CME Rule 971.B. Reported depository balances are compared against applicable segregation statements by the CME or NFA to

No.	SEC Proposed Requirement	Existing CFTC Requirement
		identify any material differences in asset balances reported by the FCM versus those reported by of the depositories. FCMs already provide frequent statements to customers and are subject to robust regulatory oversight that could include disciplinary action in the event of noncompliance. The SEC's proposed requirement is not necessary.
3	*Proposed Rule 223-1(a)(1)(i)(B).* The qualified custodian will send account statements, at least quarterly, to the client, or its independent representative, and to you, identifying the amount of each client asset in the account at the end of the period and setting forth all transactions in the account during that period, including investment advisory fees. Such account statements shall not identify assets for which the qualified custodian lacks possession or control, unless requested by the client and the qualified custodian clearly identifies any such assets that appear on the account statement.	FCMs already provide account statements to customers under CFTC regulations. Unlike the securities practice whereby advisory clients open accounts with custodians, futures and cleared swaps customers may not open their own accounts. Rather, they must deposit margin collateral with an FCM, which, in turn, opens an account with a depository to hold such funds subject to the CEA and CFTC regulations. An FCM must send account statements on a more frequent basis – monthly – to each customer and investment adviser. For the FCM the customer is defined as the legal entity whose margin collateral is at risk. In addition, an FCM must provide customers with written confirmation of each commodity interest or commodity option transaction (including foreign futures or foreign options transactions under Part 30) no later than the next business day after any such transaction was executed. *See* CFTC Regulation 1.33. The SEC's proposed requirement is not necessary.
4	*Proposed Rule 223-1(a)(1)(i)(C).* At least annually, the qualified custodian will obtain, and provide to you a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year), and *(1)* If you are the qualified custodian, or if the qualified custodian is a related person, the independent public accountant that prepares the internal control report must verify that client assets are reconciled to a custodian other than you or your related person and be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules.	The written internal control report is redundant with several CFTC regulations. FCMs provide daily, monthly, and annual reports to the CFTC and their designated self-regulatory organizations. By noon the following business day, an FCM must submit to the CFTC and its designated self-regulatory organization a daily Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Commodity Exchanges reflecting the computation as of the close of each business day (on a currency-by-currency basis) of (1) the total amount of futures customer funds on deposit in segregated accounts on behalf of futures customers; (2) the amount of such futures customer funds required by the CEA and CFTC regulations to be on deposit in segregated accounts on behalf of such futures customers; and (3) the amount of the FCM's residual interest in such futures customer funds. It is our understanding that the CFTC conducts an independent review of these reports against its own data to identify any discrepancies. An FCM must submit to the CFTC and its designated self-regulatory organization monthly financial statements on Form 1-FR-FCM (or a FOCUS Report if the FCM is registered with the SEC as a securities broker or dealer) within 17 business days after the date for which the report is made and annual audited financial

No.	SEC Proposed Requirement	Existing CFTC Requirement
		statements, certified by an independent public accountant, within 60 days of the close of the FCM's fiscal year. CFTC Regulation 1.16 requires that the independent audit referenced in CFTC Regulation 1.10 be conducted in accordance with generally accepted auditing standards and include a review and appropriate tests of the accounting system, the internal accounting control, and the procedures for safeguarding customer and firm assets in accordance with the provisions of the CEA and the regulations thereunder. Accordingly, the SEC should not require FCMs to provide internal control reports to advisers.
5	*Proposed Rule 223-1(a)(1)(i)(D).* Specifies your [the adviser's] agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations, and permits you [the adviser] and the client to reduce that authority.	An FCM's authority is generally that of a power of attorney and may not be reduced. The SEC's proposed level-of-authority requirement is inconsistent with industry practices applicable to FCMs. For example, the CME requires trading authority that rises to the level of power of attorney over the account. To the extent that CME serves as an FCM's designated self-regulatory organization, the FCM will not be able to modify this standard to any lesser standard. Thus, the SEC's proposed requirement is not necessary.
6	*Proposed Rule 223-1(a)(1)(ii)(A). Reasonable assurances obtained by adviser.* You must obtain reasonable assurances in writing from the qualified custodian (or, if you are also the qualified custodian, the written agreement required by paragraph (a)(1)(i) of this section must provide) that the custodian will comply with the following requirements, and you must maintain an ongoing reasonable belief that the custodian is complying with these requirements: (A) The qualified custodian will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss.	An FCM is subject to statutory and regulatory duties to safeguard customer assets. In addition, an FCM must have a Risk Management Program that addresses segregation risk and that includes a program to evaluate depositories of customer segregated funds and ongoing diligence of such depositories. CFTC Regulation 1.11(e)(3)(i).[61] CFTC Regulation 1.55(o)(1) requires an FCM to make its daily computation of segregation requirements and funds publicly available on its website to evidence the FCM's adherence to its segregation obligations. To the extent that an FCM does not comply with its statutory and regulatory duties, the CFTC may take enforcement action against the FCM. The risk of an enforcement action and the financial and reputational damage that could result from an

[61] An FCM's Risk Management Program must include "[a] process for the evaluation of depositories of segregated funds, including, at a minimum, documented criteria that any depository that will hold segregated funds, including an entity affiliated with the [FCM], must meet, including criteria addressing the depository's capitalization, creditworthiness, operational reliability, and access to liquidity. The criteria should further consider the extent to which segregated funds are concentrated with any depository or group of depositories. The criteria also should include the availability of deposit insurance and the extent of the regulation and supervision of the depository." In addition, an FCM must have "[a] program to monitor an approved depository on an ongoing basis to assess its continued satisfaction of the [FCM]'s established criteria, including a thorough due diligence review of each depository at least annually." 17 C.F.R. § 1.11(e)(3)(i)(A)-(B).

No.	SEC Proposed Requirement	Existing CFTC Requirement
		enforcement action is a stronger deterrent than the Proposed Rule's written agreement requirement.
7	*Proposed Rule 223-1(a)(1)(ii)(B).* The qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the qualified custodian in the event of the qualified custodian's own negligence, recklessness, or willful misconduct.	The SEC's indemnification requirement is inconsistent with industry practices. Whether a party indemnifies another party is a commercial matter between contracting parties. In addition, the CFTC prohibits an FCM from making any representation that it will, with regard to any commodity interest in any account that the FCM carries for or on behalf of any person, guarantee the person against loss, limit the person's loss, or not call or attempt to collect margin as established by the rules of the applicable board of trade.[62] When the CFTC adopted this prohibition, it stated that "the risks of the marketplace should not be obscured to the potential detriment of customers". [63] The SEC should consider these factors in any final rule and not apply the indemnification and insurance requirements to FCMs.
8	*Proposed Rule 223-1(a)(1)(ii)(C).* The existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client.	As noted above in Item 6, an FCM must evaluate depositories that hold customer funds and perform ongoing diligence on such depositories. In regard to the CFTC's position on an FCM holding customer funds under CFTC Regulation 30.7, only the initial depository is subject to the acknowledgment requirements imposed on FCMs, and "not to the manner in which any subsequent depository holds or subsequently transmits those funds." Appendix B to Part 30 of the CFTC's Regulations (stating, in relevant part, "The Commission notes that the initial depository's ability to identify customer funds affords foreign futures and foreign options customers a measure of protection in the event that the intermediating FMC or foreign firm becomes insolvent."). The CFTC's guidance on existing industry practices should be sufficient for FCMs to continue depositing customer funds with depositories that may use sub-custodians without incurring liability for the acts of depositories or sub-custodians.
9	*Proposed Rule 223-1(a)(1)(ii)(D).* The qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities.	FCMs already title customer accounts appropriately and segregate customer funds. CFTC Regulation 1.20(a) requires an FCM to "deposit futures customer funds under an account name that clearly identifies them as futures customer funds and shows that such funds are segregated as required by sections 4d(a) and 4d(b) of the Act and by this part." As such, the Proposed Rule is not necessary.

[62] 17 C.F.R. § 1.56(b).

[63] Prohibition of Guarantees Against Loss, 46 Fed. Reg. 62,841 (Dec. 29, 1981).

No.	SEC Proposed Requirement	Existing CFTC Requirement
10	*Proposed Rule 223-1(a)(1)(ii)(E).* The qualified custodian will not subject 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.	FCMs and depositories holding customer funds already are subject to restrictions on the use of customer funds. When an FCM opens an account with a depository, the depository must agree to the terms in the CFTC-prescribed acknowledgment letter, which provides in relevant part: "You [i.e., the depository] further acknowledge and agree that the Funds in the Account(s) shall not be subject to any right of offset or lien for or on account of any indebtedness, obligations or liabilities we [i.e., the FCM] may now or in the future have owing to you. This prohibition does not affect your [i.e., the depository's] right to recover funds advanced in the form of cash transfers, lines of credit, repurchase agreements or other similar liquidity arrangements you [i.e., the depository] make in lieu of liquidating non-cash assets held in the Account(s) or in lieu of converting cash held in the Account(s) to cash in a different currency." Thus, the Proposed Rule is not necessary.
11	*Proposed Rule 223-1(a)(3). Segregation of client assets.* The client's assets must: (i) Be titled or registered in the client's name or otherwise held for the benefit of that client; (ii) Not be commingled with your assets or your related persons' assets; and (iii) Not be subject to any right, charge, security interest, lien, or claim of any kind in favor of you, your related persons, or your creditors, except to the extent agreed to or authorized in writing by the client.	Section 4d of the Commodity Exchange Act requires an FCM to segregate customer funds from the FCM's own funds and any other person's funds (although an FCM may commingle customer funds held in an omnibus account). *See also* CFTC Regulations 1.20; 22.2(a), (b)(1); and 22.3(a), (b)(1). The SEC's proposed segregation requirement is not necessary.