



Federated Hermes, Inc.
1001 Liberty Avenue
Pittsburgh, PA 15222-3779

May 18, 2023

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

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV

Re: Comment Letter of Federated Hermes, Inc. on the Securities and Exchange Commission’s Request for Comment on “Safeguarding Advisory Client Assets” File No. S7-04-23

Dear Ms. Countryman

Federated Hermes, Inc. and its affiliates (“**Federated Hermes**”)¹ appreciate the opportunity to provide comments in response to the U.S. Securities and Exchange Commission’s (“**Commission**”) release and accompanying new rule proposals and amendments for safeguarding advisory client assets, which are intended to impose new requirements related to the custody of customer assets managed by registered investment advisers (“**Proposing Release**”).² The Proposing Release would revise and redesignate the Commission’s current Rule 206(4)-2 (the “**Custody Rule**”) under the Investment Advisers Act of 1940, as amended (the “**Advisers Act**”).

Federated Hermes joins with and fully endorses and supports the comments and recommendations provided by the Investment Company Institute (the “**ICI**”) dated May 8, 2023, the Securities Industry Financial Markets Association (“**SIFMA**”) dated May 8, 2023, and the Money Management Institute (“**MMI**”), dated May 8, 2023. We agree with these letters particularly in respect of the concerns that they have raised regarding the equivalence of investment discretion and custody, the imposition of contract terms, and the overall impact on the market, including the efficiency of existing custodial structures, securities and transactional instruments, and logistical problems implementing the rule changes and amendments included in the Proposing Release (e.g. obtaining indemnities from custodians).

¹ Federated Hermes, Inc. (NYSE: FHI) is a global leader in active, responsible investment management, with \$701 billion in assets under management as of March 31, 2023. We deliver investment solutions that help investors target a broad range of outcomes and provide equity, fixed-income, alternative/private markets, multi-asset and liquidity management strategies to more than 11,000 institutions and intermediaries worldwide. Our clients include corporations, government entities, insurance companies, foundations and endowments, banks and broker-dealers.

² “Safeguarding Advisory Client Assets” Release No. IA-6240; File No. S7-04-23 (Feb. 15, 2023), available at <<https://www.sec.gov/rules/proposed/2023/ia-6240.pdf>>

Ms. Vanessa Countryman
Securities and Exchange Commission
May 18, 2023
Page 2

In a significant departure from the existing regulatory regime, the Proposing Release explicitly pulls discretionary trading authority into the definition of custody.³ This is a paradigm shift, apparently influenced by the view, stated in the Proposing Release, that discretionary authority presents the types of risks that the rule is designed to address.⁴ While it is true that discretionary authority and custody each give an investment manager a certain amount of control over client assets, these concepts should not be conflated.

Fundamentally, investment discretion itself does not give a manager the power to withdraw assets from client accounts without a separate grant of legal authority (e.g. a power of attorney). Investment discretion is constrained to contractually agreed upon investment strategies, objectives and limitations. The manager's limitation to activities within the account and inability to withdraw from client accounts (without a separate grant of authority) is a fundamental and important difference between discretion and custody.

For this reason, while we understand that the custodian's participation in the transaction and the contemporaneous nature of delivery versus payment minimizes the risk that an investment adviser with investment discretion, and no other authority, could withdraw or misappropriate the assets in its client's custodial account.⁵ Before making such a significant departure from the existing regulatory regime, a detailed analysis, taking into consideration existing contractual and market controls surrounding non-DVP transactions, should be completed.

Investment discretion exposes the client to fundamentally different and substantially less risk than custody. In this regard, therefore, we disagree with the view that discretionary authority presents the similar risks to those that the rule is intended to address. We are also concerned that the proposed rule and amendments to include investment discretion in the definition of custody as set forth in the Proposing Release exceeds the Commission's rulemaking authority granted under section 223 to the Advisers Act, which is explicitly limited to the safeguarding of client assets over which advisers have custody, not discretion.⁶

³ See Proposing Release at 32. "We believe we need to provide specificity, however, regarding the arrangement category of the custody definition to state explicitly that discretionary trading authority is an arrangement that triggers the rule."

⁴ See Proposing Release at 32.

⁵ See Proposing Released at 34.

⁶ Advisers Act § 223 [15 U.S. Code § 80b-18b], "[a]n investment adviser... shall take such steps to safeguard client assets over which such adviser has custody..."

Ms. Vanessa Countryman
Securities and Exchange Commission
May 18, 2023
Page 3

The rules and amendments included in the Proposing Release also require that an adviser must maintain client assets at a qualified custodian pursuant to a written agreement with mandatory contract terms prescribing the custodian's standard of care, a new required indemnity from the custodian, prohibitions against certain limitations on liability, asset segregation requirements, prohibitions against rehypothecation, among other things.⁷ Federated Hermes believes that the Commission would exceed its authority to impose terms into private contractual arrangements, as there is no separate statutory authority granted to the Commission under the Advisers Act that provides for such authority. Federated Hermes is also concerned that investment managers have no efficacious means to implement these requirements. Custodians are not obligated to agree to such terms, and many may choose not to accept them, potentially leading to greater concentration in the market for custodial services.

In addition to the comments raised by the ICI, SIFMA and the MMI, Federated Hermes is concerned about the potential impact on U.S. registered investment advisers who manage Undertakings for Collective Investment in Transferable Securities (“UCITS”) funds and collective investment trusts (“CITs”). We agree with the Commission's Staff's decision to maintain the existing exception for mutual funds; however, there is no exception for registered investment advisers who manage UCITS and CITs with discretionary authority.

Under the Custody Rule, there may be existing instances where a U.S. registered investment adviser is considered to have custody of a UCITS fund because a related person of the adviser acts in a capacity that is equates to the supervised legal ownership prong of the custody definition. In these instances, the adviser is required to incur unnecessary additional expense to satisfy the conditions associated with the Custody Rule for a product that is highly regulated in another jurisdiction and not distributed to U.S. individuals. The rules and amendments in the Proposing Release would subject additional UCITS funds to the requirements and require that the adviser incur additional unnecessary expense.

In addition, these products would be subject to new contract requirements as well as the new requirements applicable to foreign financial institutions (“FFIs”) under the Proposing Release. The new requirements for an FFI to be a qualified custodian, as set forth in the Proposing Release, include a requirement that the adviser and the Commission can enforce judgments against the FFI and the entity must be subject to prudential regulation in its jurisdiction.⁸ Our expectation is that few FFIs will agree to these requirements, thus potentially restricting the

⁷ See Proposing Release at 23.

⁸ See Proposing Release at 47-48.

Ms. Vanessa Countryman
Securities and Exchange Commission
May 18, 2023
Page 4

market for custodians that qualify as FFIs as well as the market for U.S. managers in Europe. As with CITs, we believe that the Proposing Release does not improve upon the native regulatory structure, which already successfully manages the risks that stand at the heart of Section 223 of the Advisers Act.

Finally, Federated Hermes urges the Commission to not change the obligation of investment advisers with respect to the maintenance of client account statements as proposed. Under the current rule, advisers must also have a reasonable belief, after due inquiry, that the qualified custodian sends an account statement, at least quarterly, to each of the investment adviser's applicable clients.⁹ One way to satisfy this requirement is to maintain physical copies of quarterly account statements; however, the Commission's Staff has resisted prescribing a single method for performing "due inquiry" and forming a "reasonable belief".¹⁰

The current approach gives advisers the ability to implement a verification process that takes into consideration how their clients access and receive account information. In certain instances, this may result in utilizing a less expensive means of satisfying the requirement, saving costs for the client. The rules and amendments included in the Proposing Release require custodians to deliver to the adviser, and the adviser to maintain, all account statements. By prescribing statement delivery and retention as the exclusive means to comply with the obligation, Federated Hermes is concerned that the Proposing Release will unnecessarily impose a new cost on client accounts and fails to take into consideration the utilization of online access for account access and statement delivery and utilization of automated technology for reconciliation between the adviser and custodian.

The significant market disruption created by the rules and amendments set forth in the Proposing Release outweigh any improvement on the overall protection of investor assets. Nor is Federated Hermes aware of any significant deficiencies in the existing custody framework that warrant

⁹ 17 C.F.R. § 275.206(4)-2(a)(3)

¹⁰ See "Custody of Funds or Securities of Clients by Investment Advisers", Release No. IA-2968 December 30, 2009), available at <<https://www.sec.gov/rules/final/2009/ia-2968.pdf>>, "We are not prescribing a single method for forming this belief, as was suggested by one commenter . . .". See also, e.g. Custody Rule FAQ, Question IV.1 (March 5, 2010.) available at <https://www.sec.gov/divisions/investment/custody_faq_030510>, "The adviser may satisfy this requirement by, for example, being copied on the email notifications of account statement postings sent to clients in addition to having access to client statements on the custodian's website, although this is not the exclusive means of forming that reasonable belief . . .".

Ms. Vanessa Countryman
Securities and Exchange Commission
May 18, 2023
Page 5

such intervention.¹¹ Accordingly, because the Commission failed to provide any reasonable justification as to why the Proposing Release is required, and for all reasons stated in this letter and in the comment letters submitted by the ICI, SIFMA and the MMI, Federated Hermes opposes the Proposing Release.

Federated Hermes appreciates the opportunity to comment on the Proposing Release. Please let us know if you have any questions or comments on this submission.

Sincerely,



David R. McCandless
Corporate Counsel

cc: The Honorable Gary Gensler
The Honorable Hester M. Peirce
The Honorable Caroline A. Crenshaw
The Honorable Mark T. Uyeda
The Honorable Jaime Lizárraga

Division of Investment Management
William Birdthistle, Director
Sarah ten Siethoff, Associate Director

¹¹ For example, in reviewing publicly available enforcement data Federated Hermes cannot find statistically significant data to support that investment advisers habitually use their discretionary authority over a client's assets to instruct an issuer's transfer agent or administrator to sell its client's interest and to direct the cash proceeds of the sale to an account that the adviser owns and controls, as suggested in page 33 of the Proposing Release.