June 20, 2023

Via Electronic Submission

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

Re: File Number S7-04-23: Safeguarding Advisory Client Assets

Dear Ms. Countryman:

The Loan Syndications and Trading Association ("LSTA")[1] writes today to convey its serious concerns with the rule proposed by the U.S. Securities and Exchange Commission ("SEC" or "Commission") under the Investment Advisers Act of 1940 ("Advisers Act") regarding how investment advisers safeguard client assets ("Proposal").[2] Proposed Rule 223-1 under the Advisers Act would replace existing Rule 206(4)-2 under the Advisers Act ("Custody Rule").[3] The LSTA has significant reservations and objections to the Proposal. The Proposal would adversely impact all registered investment advisers by imposing impractical protocols and increasing costs, and the Proposal's attempt to alter standard contractual terms negotiated at arm's length between sophisticated parties is misguided and would result in a jurisdictional overreach by the Commission with respect to banking entities.[4] Accordingly, the LSTA believes that the Proposal is critically flawed and should be withdrawn.

However, in the event the Commission decides to move forward with the Proposal, we wish to comment more specifically on the Proposal's application to the custody of interests in bank loans ("Loan Interests"). The Proposal, if adopted, would impose impractical protocols and

[1] The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trade of commercial loans. The 600 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty. For more information, visit www.lsta.org.

[2] Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672 (Mar. 9, 2023) ("Proposing Release").

[3] 17 C.F.R. § 275.206(4)-2.

[4] We strongly endorse the comments on this point and others included in letters submitted in response to the Proposal by the Securities and Financial Markets Association, https://www.sec.gov/comments/s7-04-23/s70423-186100-340162.pdf; the Investment Adviser Association, https://www.sec.gov/comments/s7-04-23/s70423-189019-370362.pdf; and the Joint Letter from the American Bankers Association, ABA Securities Association, the Financial Services Forum, and the Bank Policy Institute, https://www.sec.gov/comments/s7-04-23/s70423-185019-339463.pdf.

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significant costs on advisers (which likely would be passed on to clients) by establishing an expensive, unnecessary, and largely redundant requirement that an independent public accountant verify each purchase or sale of Loan Interests in a client's account at the time it occurs. Given the extensive involvement of various third parties in the settlement process for the transfer of Loan Interests, we urge the Commission to modify the Proposal to exempt Loan Interests from the trade-by-trade accountant verification requirements entirely. Alternatively, we request that the Commission modify the Proposal to expressly permit this trade-by-trade verification to be performed by a third-party other than an independent public accountant because the verification is already functionally performed.

I. Background on the Proposal.

The Proposal would impose several requirements on advisers that have "custody" of client assets that the Commission believes would help to safeguard such assets from theft, loss, or misappropriation. The Proposal would define "custody" to include any arrangement where an adviser maintains "discretionary authority" over a client's assets (*i.e.*, "the authority to decide which assets to purchase and sell for the client").[5] Among other things, the Proposal would require that "a qualified custodian … maintain *possession or control* of [an advisory] client's assets pursuant to a written agreement between [the adviser] and the qualified custodian."[6] The Proposal would define "possession or control" as:

> [H]olding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.[7]

With respect to assets that are unable to be maintained in the possession or control of a qualified custodian, the Proposal would provide an alternative way to safeguard client assets, including by requiring that an independent public accountant "verifies any purchase, sale, or other transfer of beneficial ownership of such assets, promptly" upon receipt of notice by the adviser required within one business day after such purchase, sale, or transfer.[8] In effect, this would impose on advisers a trade-by-trade verification requirement, performed by an independent public accountant, for assets in the adviser's custody that are not subject to the possession or control of a qualified custodian as defined in the Proposal. This requirement would impose a significant

[5] *See* Proposed 17 C.F.R. § 275.223-1(d)(3)(ii), (4).

[6] Proposed 17 C.F.R. § 275.223-1(a)(1)(i) (emphasis added).

[7] Proposed 17 C.F.R. § 275.223-1(d)(8).

[8] Proposed 17 C.F.R. § 275.223-1(b)(2)(iii). We understand that the Proposal categorizes Loan Interests as investments that are subject to this provision because, in the Commission's view, they are not within the custodian's "possession and control." *See generally* Proposing Release at 14677.

burden on investment advisers that manage Loan Interests given the size of the market and the frequency with which Loan Interests are purchased and sold on behalf of advisory clients.[9]

The Proposing Release discussion regarding the expansion of custody to include discretionary authority specifically mentions Loan Interests.[10] The discussion simply notes that "[a]n adviser's ability or authority to effect a change in beneficial ownership of a client's assets, including for purposes of trading, *could* place client assets at risk of loss that the rule is designed to address."[11] Notably, the Commission provides no evidence or even an example of Loan Interests having been misappropriated, raising a question as to why such new draconian requirements are necessary. Nonetheless, the lack of evidence is no surprise given the numerous existing safeguards regarding Loan Interests that mitigate the risk of misappropriation and should be considered to address concerns underlying the Proposal.

II. The Definition of "Possession or Control" as Applied to Loan Interests Is Unclear.

We have significant concerns regarding the definition of "possession or control," both because the definition itself is unclear, and, more troubling, because the Commission appears to believe that Loan Interests fail the test. The Commission acknowledges that "a qualified custodian's participation in a change in beneficial ownership may take different forms depending on the type of asset involved."[12] We too recognize the need for flexibility in what it means for a qualified custodian to possess or control advisory assets. However, the Commission's definition of "possession or control," while potentially broad enough to cover many assets that trade and settle in a traditional manner, is less flexible than is appropriate for assets like Loan Interests, where the settlement process is subject to a myriad of protective controls, including verification of trades by various third-party service providers.

First, we believe that the definition of "possession or control" is vague and thus does not establish a clear standard of conduct. The definition of "possession or control" is "holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership."[13] It is unclear what level of "participation" by the custodian is warranted, particularly as it relates to Loan Interests, which are traded and settled through a unique process, as described more fully below. We are also unsure precisely what form

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[9] We note that the Proposing Release grossly underestimates the cost of this requirement. The Proposing Release only acknowledges 8,000 of notices to accountants based on private equity transaction data. *See* Proposing Release at 14766. However, to the extent Loan Interests are subject to such requirement, this is potentially 1.4 *million* trades and $824.2 billion of secondary trading volume (this is the total size of the market which includes registered investment companies outside the scope of the Proposal, nevertheless indicative of the general size of the market). **The estimated cost of this verification requirement is off by orders of magnitude**.

[10] Proposing Release at 14677 (stating that "[a]n adviser with discretion may also have broad authority to direct purchases or sales of client assets that may not currently involve a qualified custodian, such as *loan participation interests*") (emphasis added).

[11] *Id* (emphasis added).

[12] Proposing Release at 14687.

[13] Proposed 17 C.F.R. § 275.223-1(d)(8).

of participation is required by the custodian to "effectuate the transaction," and how that is distinct from "participating" in the transfer, or how either role differs from a "condition precedent" to a change in ownership. Are these three different ways of saying the same thing? Or are they distinct from one another and thus additive?

However, we emphasize and request that the Commission acknowledge that there are other parties independent of the investment adviser that are involved with and actively scrutinize and participate in the trading and settlement process and the transfer of beneficial ownership of Loan Interests.[14] These entities are capable of performing, and indeed do perform, the same control functions the Commission is apparently requiring of custodians with this definition. The Commission suggests in the Proposing Release that a qualified custodian's role in connection with the transfer of Loan Interests falls outside the definition of "possession or control." Indeed, the Commission states that loan participation interests, "may not currently involve a qualified custodian."[15] This is the ostensible rationale for imposing a new accountant trade verification requirement. However, this conclusion ignores the multi-faceted and well documented settlement process where more than one third party – independent of the adviser – verifies trade information, records changes in beneficial ownership, and reconciles the receipt of interest payments and Loan Interest proceeds. These controls are more than adequate to protect clients from theft, loss, and misappropriation.

Even if the Commission does not believe the role of the custodian in the transfer of Loan Interests provides sufficient protection of client assets, the roles of other third parties in the settlement process serve the requisite control function. As explained below, the buyer/assignee (the "Assignee") will become the owner of Loan Interests as reflected in the conclusive register of lenders (the "Register") only upon the Administrative Agent's receipt of completed trade documentation (*e.g.*, an assignment and assumption agreement) which comes to the Administrative Agent directly from the settlement platform, which is a third-party entity not affiliated with the Assignee or the seller/assignor ("Assignor"), or the adviser. We believe that the Administrative Agent's role, together with the settlement platform, along with the numerous other protective controls in place in the trading and settlement process, are sufficient to address the Commission's concerns with safeguarding client assets, without the additional requirement that an independent public accountant verify each trade. More broadly, because this verification is already performed in the ordinary course, the accountant verification would impose an additional cost without providing additional benefit to investors.

To summarize, it is clearly unnecessary to impose an additional accountant trade verification requirement simply because an entity other than the custodian performs the control function contemplated by the Proposal. We therefore ask, if the Commission proceeds with the Proposal, that the Commission modify the rule – either through the definition of "possession and control" or otherwise to acknowledge that if a service provider independent of the adviser *other than the custodian* performs the functions that the Commission believes are necessary to prevent

[14] For purposes of this letter, we generally consider "beneficial ownership," as used in the Proposal, to be legal title.

[15] Proposing Release at 14677.

theft, loss, and misappropriation, the trade-by-trade accountant verification is unnecessary and superfluous.

III. The Trading and Settlement Process for Loan Interests Already Includes Robust Controls, including Trade Verification, That Protect Clients and Renders the Proposal's Trade-By-Trade Accountant Verification Requirement Unnecessary and Superfluous.

In our view, the protections provided by the trading and settlement process for Loan Interests renders the trade-by-trade verification by an independent public accountant unnecessary and superfluous for these investments. Trades are effectively already verified, documented, and reconciled during the normal settlement process by various third parties independent of the adviser.

In addition to the role of the Administrative Agent in recording changes in beneficial ownership, at least one other third party servicing a client's account is notified of each transaction and tracks the payment and receipt of interest and other proceeds associated with the Loan Interest. That function may be performed by a collateral administrator, in the case of a collateralized loan obligation ("CLO") or an administrator, in the case of a private fund or separate account, as designated by the client. As noted above, the settlement platform also plays a central role in facilitating transfers of Loan Interests. The role of these third parties serves the very same protective function that the Commission addresses through requiring that an independent accountant verify each trade, making such requirement redundant in respect of Loan Interests. So long as trade-by-trade verification is performed at some point in the settlement process by an independent third party, this control, coupled with the annual auditor verification required by the Proposal, is sufficient to prevent misappropriation of client assets. There is no need for an additional verification requirement by an independent public accountant on a trade-by-trade basis.

A. Trading and Settlement Process for Loan Interests.

1. Role of Various Parties in the Process.

Bank loans are originated, negotiated, and structured by arranging banks and allocated to and purchased by a syndicate of lenders consisting of CLOs, mutual funds, insurance companies, finance companies or other financial institutions and provide critical financing to U.S. companies (each a "Borrower") for a variety of business purposes. Allocations of bank loans are further sub-allocated by asset managers to individual clients, and such Loan Interests are available for sale in the secondary market. Typically, one of the syndicate banks administers the bank loan on behalf of the syndicate and is referred to as the agent bank or the Administrative Agent.[16] The Administrative Agent, among other things, maintains the Register and effectively serves as the transfer agent for the Loan Interests.

Once the allocations have been given to the syndicate of lenders, syndicated Loan Interests trade in the secondary market with loan trading desks at large banks (each, a "Bank Party"). Transfers of Loan Interests are typically structured as assignments, in which the assignee becomes

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[16] Some banks may use a non-bank affiliate to perform some or all of their administrative responsibilities as agent bank.

a lender of record. These assignments settle on a non-delivery-versus-payment basis. After the agreement setting out the terms and conditions of the loan between the borrower and the arranging banks ("Credit Agreement") has been executed, the transfer of the Loan Interests is legally effected through a formal written assignment and assumption agreement between the Assignor and the Assignee. Approximately 98% of these transfers settle through a settlement platform.

As a condition precedent to the transfer of the Loan Interests to the Assignee, the Borrower (generally if the Assignee is new to the loan and not affiliated with an existing lender of record) and the Administrative Agent must consent in writing to each assignment. Before a new lender is added to the Register, the Administrative Agent will conduct a "Know Your Customer" due diligence process to confirm the identity of the Assignee, which includes, among other things, review of Form W-9s or W-8s (as applicable), confirmation of applicable wire instructions and proof of the relationship between the investment adviser and the Assignee.

2. Documentation of the Process.

Documentation relating to the transfer of Loan Interests is extensive and incorporates the participation of several parties independent of the investment adviser placing the order. Each Loan Interest transaction is documented in the form of (i) a trade ticket, (ii) a trade confirmation, (iii) an assignment and assumption agreement, and (iv) a funding memorandum (collectively, the "Trade Documentation"):

First, a trade ticket is generated by an electronic settlement platform, based upon trade details submitted by the Bank Party (in its capacity as Assignee or Assignor) to the settlement platform that memorialize the Bank Party's understanding of the transaction. The trade ticket includes the identity of the Assignee, the Assignor, the Borrower, the trade date, the amount of Loan Interests being transferred, the purchase rate, and applicable fees (if any) (collectively, the "Trade Details").

Second, in the case of a trade involving a Bank Party and an adviser managing a client account, the adviser sub-allocates (*i.e.*, among multiple accounts) the Loan Interests among the actual end Assignees or Assignors on the settlement platform or submits its own version of the trade and allocations via electronic message to the settlement platform, which matches the Trade Details submitted by the Bank Party to those submitted by the adviser. In either method, the suballocation results in the documents described below being generated in the names of the Assignee and Assignor, as principals on the trade.

Third, a trade confirmation is generated by the settlement platform, memorializing the agreed upon terms of the transaction, including the Trade Details. This document lists the Assignee or Assignor as the principal but is signed by the adviser (on behalf the client) and the Bank Party.

Fourth, an assignment and assumption agreement, generated by the settlement platform (based on the form of assignment and assumption agreement that is an exhibit to the respective Credit Agreement), effects the legal transfer of the Loan Interests based on the terms referenced between the Assignee and Assignor. The adviser signs the assignment agreement on behalf of the client (the client is listed as the Assignee or Assignor), the Bank Party signs on its behalf and both

the Administrative Agent and the Borrower (generally only if the Assignee is new to the loan and not affiliated with an existing lender of record) execute the assignment agreement to evidence consent of the assignment. Upon execution of the assignment agreement by all parties thereto, the party acquiring the Loan Interest is recorded as a lender of record in the Register and the Assignee becomes a party to the Credit Agreement. So, while the adviser typically signs the assignment and assumption agreement on behalf of and in the name of its client, the adviser does not own the Loan Interest and is not a lender of record in the Register.

Finally, once the above documentation (*i.e.*, the trade ticket, the trade confirmation and the assignment and assumption agreement) is completed, a funding memorandum is generated by the settlement platform, calculating the purchase price and providing the wire instructions of the party receiving payment. This funding memorandum is reviewed and signed by the adviser on behalf of the client. Throughout the lifecycle of the trade, from the moment of suballocation of the Loan Interests by the adviser up to the completion of the trade as outlined above, the settlement platform is able to send real-time electronic messages for each suballocation to the custodian in the case of a fund or separate account, or to the trustee in the case of a CLO, including all trade details, document review or execution status, trade proceeds calculations, closing date and wire details. On or prior to the settlement date, the settlement platform, through secure electronic file delivery methods, can deliver files including the funding memorandum (which includes the Assignor's payment instructions) to the Assignor's or Assignee's custodian or trustee, as applicable. The custodian or trustee will release funds only to the account identified in the funding memorandum. Accordingly, the Commission's suggestion that the adviser can simply call the "transfer agent or administrator" and divert the loan proceeds to its own account is not realistic.[17] Wire and administrative details are verified by the adviser in a secure site maintained by the electronic settlement platform, which provides auditable records about entry and amendments of such instructions and includes them in the funding memorandum without human intervention. In the event the wire instructions are not sent via the settlement platform but rather by email or facsimile, the custodian or trustee will typically perform callback verification procedures to authenticate wire instructions. When the callback verification and other internal control and regulatory processes (*e.g.*, OFAC checks) are completed, payment is transmitted in accordance with the wire instructions. In addition to the verification processes described above, best practices include reasonability checks as agreed between the custodian or trustee and the adviser, on behalf of the client, are performed, *e.g.*, verifying routing and account numbers when large movements of funds are requested to be sent to destinations not sent to previously. Wire instructions may also be received by the custodian or trustee via SWIFT messaging, an authenticated industry standard system-to-system communication, utilizing encryption keys in a secure network. It is a standard practice to allow only authorized personnel at the adviser to be able to send the message. A list of authorized personnel must be provided to the custodian or trustee in advance.

3. Controls that Prevent Loss and Misappropriation.

As noted above, any transfer of beneficial ownership will result in the Administrative Agent recording such transfer in the Register. On or prior to the date on which the Administrative Agent records the transfer in the Register, in the vast majority of trades an electronic settlement platform provides secure transmission of the Trade Documentation, including the effective funding

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[17] *See* Proposing Release at 14680.

memorandum which has been assented to by the adviser on behalf of the client, to the custodian. Therefore, several third parties, including trustees, custodians and collateral and fund administrators have access to information regarding the par amount of the transfer, sale price, fees, accrued interest, payment instructions, and other relevant terms in respect of the transaction. Custodians and trustees, working with collateral and fund administrators, play an important role in preventing theft, loss, or misappropriation of Loan Interests.

The custodian or trustee will not authorize the release of client funds for the transfer of the Loan Interest unless it receives an effective funding memorandum in good order, and thereby confirms that funds should be sent per the settlement instructions set forth therein. The Assignee will in fact become the owner of the Loan Interests as reflected in the Register.

The controls incorporated in every step of the process are clearly effective in preventing misappropriation by the adviser prior to settlement. However, there are also controls in place that would serve to identify any misappropriation shortly after settlement. Once the transaction settles, the collateral/fund administrator is subject to an obligation to match payables and receivables against transactions in the client's account to ensure that the client receives all payments to which it is entitled, including the proceeds from the sale. Therefore, when the Assignor enters into a transaction to sell a Loan Interest, the applicable administrator monitors for receipt of either the purchase price of the Loan Interest or, in the alternative, continued receipt of interest payments. If neither is received, it would soon become apparent that there was an error and the collateral or fund administrator would contact the Administrative Agent for the transaction to make a follow-up inquiry and, if necessary, seek to unwind the sale. Likewise, the collateral/ fund administrator would become aware of an issue if, upon transferring beneficial ownership of Loan Interests, the Assignee did not subsequently receive interest payments. The Administrative Agent customarily sends notifications to the collateral/fund administrator in connection with future interest and principal payments. If expected payments are not made by the Administrative Agent to Assignee's account, the reconciliation process will identify discrepancies and either the adviser or the administrator will contact the Administrative Agent to follow up, inquire where the payment is, and further research any issues. Thus, any attempt to misappropriate client funds would be identified shortly after settlement – another deterrent to misconduct.

B. The Proposal's Trade-By-Trade Accountant Verification Requirement Is Unnecessary and Superfluous.

Furthermore, we do not believe that an accountant trade verification process would add any protection regarding the transfer of Loan Interests. The accountant verification would not add investor protection to the robust role of the settlement platform and the process in maintaining the Register, which are subject to their own controls. As you can see, the Administrative Agent, the settlement platform, and the collateral/fund administrator each plays a significant role in ensuring integrity and accuracy in the settlement process, and in fact collectively perform the same trade verification function contemplated by the Proposal. The electronic settlement platform captures and stores transaction records and provides them, as well as the underlying documents, to custodians and trustees, serving as another control against theft, loss, or misappropriation. The transaction process for Loan Interests already incorporates robust independent checks and controls against accidental and deliberate misdirection of client assets. The accountant verification would

be a duplicative function that is already performed by these collateral/fund administrators and the settlement platform; the duplicative function also would be impractical and expensive under the proposed timeframe.

Moreover, as explained above, the settlement process for the transfer of Loan Interests includes extensive documentation and the involvement of several outside parties, all of which serve to place checks on the adviser's activities and mitigate the risk of an adviser's misappropriation (as well as inadvertent errors that could harm clients). Trading and settlement instructions are sent directly to the Administrative Agent and collateral/fund administrators by an electronic settlement platform. Additional verifications can be made upon request if collateral and/or fund administrators find discrepancies. The requirement that an independent public accountant perform an additional real time verification (in addition to the annual verification that is also required) is redundant, impractical, and would impose an undue burden upon all transaction parties for little to no benefit (and at a cost to clients), subverting a process that already includes robust controls. In this respect, Loan Interests are clearly distinguishable from crypto assets and other types of assets that may be subject to higher risk of theft, loss, or misappropriation.

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It appears that the Commission intended to impose the trade-by-trade verification requirement on certain physical assets, such as precious metals, physical commodities, and real estate, that may not be able to be or commonly are not held by qualified custodians; and other assets that may trade rarely or in a manner that is opaque or has fewer controls to safeguard against the risk of theft, loss, or misappropriation.[18] However, the Commission paints with a broad brush all instruments that have an extended settlement cycle, attributing the same risks of theft, loss, or misappropriation to diverse asset classes. The Commission even suggests that Loan Interests are similar to those assets in ways that could make them susceptible to theft, loss, or misappropriation by an adviser.[19] This position reflects a profound misunderstanding of the heavily controlled process through which Loan Interest transactions settle and a disregard for the significant expense imposed by a superfluous verification. Trade verification is already performed by other third parties (which are sophisticated and experienced participants in the market for Loan Interests) and need not be replicated. Loan Interests are not analogous to, and do not have a history of theft, loss, or misappropriation similar to, the assets that are the focus of the Proposal. We understand that the Commission's rationale for requiring an active role by the custodian is to ensure protection of client assets. But the distinct roles of the Administrative Agent, trustee, collateral administrator and fund administrator, along with operational controls in the settlement of Loan Interests should address the concern that an adviser could misappropriate assets. Trade-by-trade verification by an independent public accountant would only duplicate processes that service providers are already performing in Loan Interest transactions.

[18] Proposing Release at 14704-06; 14736.

[19] *Id*. at 14680 ("The adviser, for instance, could use its discretionary authority over a client's assets to instruct an issuer's transfer agent or administrator (*e.g.*, the administrator for a loan syndicate) to sell its client's interest and to direct the cash proceeds of the sale to an account that the adviser owns and controls, thereby depriving the client of ownership, unbeknownst to the client or its qualified custodian.").

As a result, an impractical protocol and significant and unnecessary costs would be imposed on advisory clients that have Loan Interests in their portfolios if those interests trading and settling according to their normal process are subject to an accountant verification process. Therefore, we urge the Commission to recognize that the process for trading and settling Loan Interests incorporates robust controls and, in conjunction with the role of service providers, provides sufficient protection of client assets without an additional verification of each trade by an independent public accountant.

Sincerely,

Elliot Ganz
Head of Advocacy, Co-Head Public Policy