MEMORANDUM

TO: Proposed Rule: Safeguarding Advisory Client Assets
(IA-6240; File No. S7-04-23)

FROM: John Cavanagh
Senior Counsel, Division of Investment Management

RE: Meeting with Representatives of AGC

DATE: August 29, 2023

On August 29, 2023 staff from the U.S. Securities and Exchange Commission ("SEC") held a meeting with representatives of the Association of Global Custodians ("AGC").

Participants included SEC staff from the Division of Investment Management: Melissa Roverts Harke, Christopher Staley, Holly Miller, Samuel Thomas, Janet Jun, John Cavanagh, Matthew Williams, Jenson Wayne, and Michael Republicano; from the Division of Economic and Risk Analysis: Ross Askanazi and Ulas Alkan; and the following representatives of AGC:

- Steve Wager, Chair, Americas Focus Committee for AGC; Royal Bank of Canada
- Katherine Petcher, Royal Bank of Canada
- Walt Palmer, BNP Paribas
- Elizabeth Luciano, BNP Paribas
- Rosanna Mah, HSBC
- Jitendra Somani, HSBC
- Beatriz Molina, BNY Mellon
- Louis Schwartz, Northern Trust
- Kameron Hillstrom, Baker McKenzie
- Juan Gonzalez, Baker McKenzie
- John Conroy, Baker McKenzie

Among other things, the participants discussed the SEC's proposal titled "Safeguarding Advisory Client Assets," set forth in Release No. IA-6240 (Feb. 15, 2023). Attached as Appendix A hereto is a copy of AGC's presentation that was discussed during the meeting.

Appendix A

U.S. Proposed Custody Rule

SEC / Association of Global Custodians

August 29th, 2023

Association of Global Custodians

ASSOCIATION OF GLOBAL CUSTODIANS

Executive Summary

Overview

- As with other financial industry stakeholders, the Association of Global Custodians ("AGC") member banks have concerns with the Proposed Rule on Safeguarding Investment Adviser Client Assets; if not modified, member banks are concerned that it could substantially impair bank liquidity, settlement processing (including payment flows), credit intermediation and the efficient operation of financial markets
- The SEC has acknowledged that key provisions introduced represent a, "substantial departure from current industry practice," a "substantial expansion" of custodial obligations, and impose contractual requirements that are otherwise "rare"
- We feel that the existing Custody Rule is functioning in an effective manner and as a result does not require a substantial rework. We also believe that a rule regulating registered investment advisers should not have the effect of fundamentally redesigning how bank custodial services are provided, particularly as it relates to how Custody banks treat client cash.

Today's Focus

- To discuss our members' views as it related to traditional custody, including:
    - New requirements a bank must satisfy to be a qualified custodian (specifically holding client assets in segregated and bankruptcy remote accounts) and how that relates to client cash
    - New requirements that a qualified custodian (i) not be excused from its obligations to the client as a result of any sub-custodial, securities depositories, or other similar arrangement; and (ii) screen client transactions post-trade for investment mandate compliance
- To discuss our views as it relates to digital asset custody, including the interplay with SEC Staff Accounting Bulletin (SAB) 121

Summary of Custodian Banks' Position (1)

Association of Global Custodians

Areas	Topics of Concern	Background	Recommendation for Consideration
Traditional Custody	• New requirements a bank must satisfy in order to be deemed a qualified custodian ("QC"), specifically, holding client assets in segregated, bankruptcy remote accounts.	• The Proposal's segregation requirement does not distinguish client cash from client securities and other non-cash assets • Requiring banks to hold client cash off-balance sheet in segregated bankruptcy protected accounts with a third party is a fundamental shift in practice; banks hold cash on-balance sheet as a deposit liability • Holding client cash as required by the Proposal will create enormous complexity in cash management, reduce the provision of liquidity to clients, hinder STP transaction processes, while not reducing risk for investors, but just shifting it to other, often less well-capitalized institutions (as compared to global custodians)	• Adequately regulated and capitalized banks and FFI's should be exempted from the requirement to segregate cash
	• New requirements that will extend the requirements to hold fund, securities, or other assets in custody • Ability of QC's to deem certain assets as being held "in-custody"	• Under the Proposal the qualified custodian must maintain "possession or control" of client assets. The proposal extends the safeguarding requirements to all "client assets" held in client portfolios. • Broadening the definition of "asset" captures many assets that are deemed as positions held in a client's account, most notably (i) crypto-assets and (ii) certain asset classes that are impossible or infeasible to hold in custody (such as over-the-counter derivatives, bank loans, foreign exchange transactions, and other assets that are bilateral contractual obligations; global custody banks are likely to conclude that it is not possible to take possession or control of this type of positions).	• Asset classes that are impossible or infeasible to hold in custody should be exempted from the custody requirements

Summary of Custodian Banks' Position (2)

ASSOCIATION OF GLOBAL CUSTODIANS

Areas	Topics of Concern	Background	Recommendation for Consideration
Traditional Custody	• New requirements that QCs not be excused from their obligations to the clients as a results of any sub-custodian, securities depository, or other similar arrangements	• The Proposal disregards structural differences between depositories and sub-custodians. In particular, use of a securities depository is a consequence of an investor's decision to invest in securities in a particular market that are immobilized in that depository. There is no element of choice on the part of the custodian or sub-custodian • Regarding sub-custodians, the Proposal makes no distinction between risk which can be controlled by the QC, such as the selection and monitoring of subcustodians, and all other systemic, geopolitical, economic, structural and market risks that exist regardless of the care that is provided by the custodian in selecting an agent in that market	• The Commission should exclude custodian liability for depositories' losses from the requirements • The Commission should exclude custodian liability for sub-custodians' losses that result from causes beyond the custodian's control
	• New written agreement requirements between the adviser and QC, specifying the adviser's level of authority	• It is the investor who is best positioned to monitor the transactional activity of its assets management by an investment manager • At a minimum, this requirement will severely hinder the ability to support T+1, increase settlement risk and lead to slower processing times for clients	• The Commission should reinforce the internal control framework and regulatory oversight over RIA activities, and not hold qualified custodians responsible for monitoring whether instructions received from investment advisers are within the scope of the adviser's authority

Summary of Custodian Banks' Position (3)

Association of Global Custodians

Areas	Topics of Concern	Background	Recommendation for Consideration
Digital Asset Custody	• The proposal is silent on the SEC Staff Accounting Bulletin No. 121 ("SAB 121")	• SAB 121 requires a global custody bank holding crypto currency on behalf of a client to recognize both an asset and a liability on the bank's balance sheet • The UCC already addresses the application of the concept of "control" to crypto and other digital asset	• The Commission should consider the impact of SAB 121 on the willingness of global custody banks to provide custody for these assets • Any attempt by the Commission to bring digital assets into the custody framework should proceed from the concepts already embedded in the UCC

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Appendix

Disclaimer The processes depicted in the following slides do not reflect a particular financial institution. They have been created to be sufficiently to cover most institutions consistent with current market practices. Their purpose is to illustrate simply and comprehensively the challenges identified as the consequence of the proposed regulatory change.

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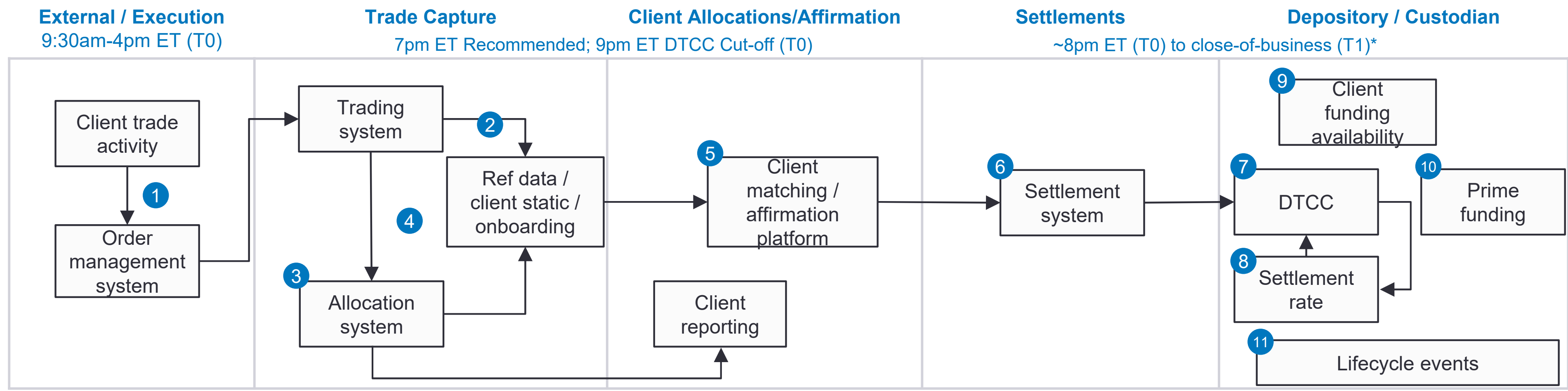
Securities Processing Flow: Post-T+1 Settlement

The transition to T+1 settlement will introduce significant changes across the trade lifecycle. The diagram outlined below depicts a high-level process flow and the key challenges and dependencies expected following the transition to T+1.



Challenges and dependencies with accelerating workflows to conclude in 1 business day

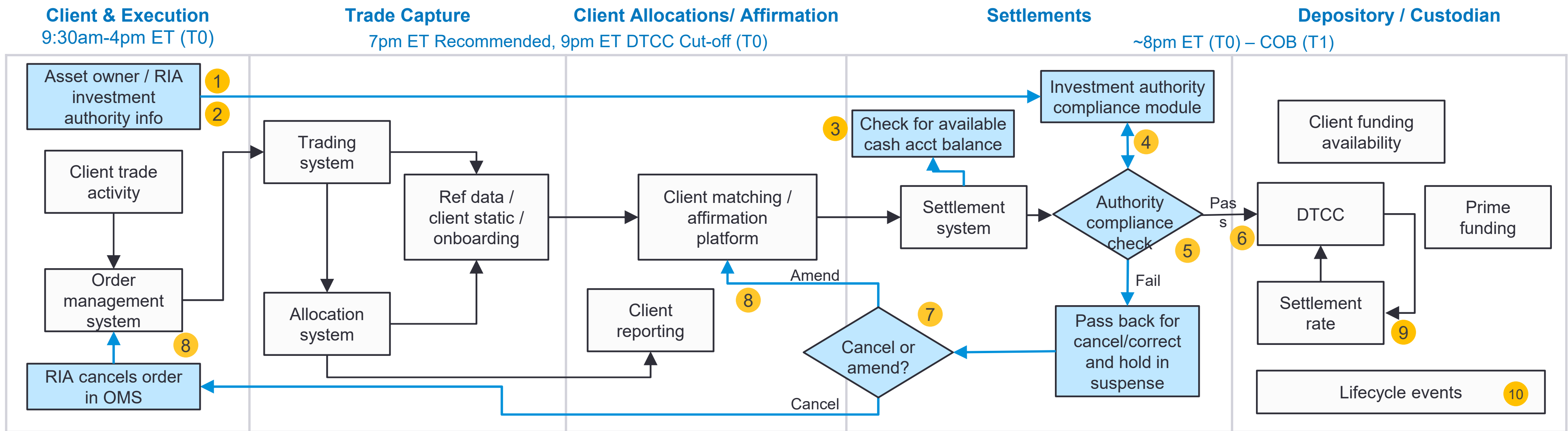
1. Dependency on accurate trade execution data
2. Tech updates to ensure DTC setting product defaults to T1 value date ("VD")
3. Maintaining high CTM submission rate on trade date ("TD")
4. Service level agreements are being adjusted to meet T+1
5. Clients affirming trades on TD
6. Changes to settlement batch times
7. Changes in DTCC reporting times
8. Firms actively monitor global settlement rates
9. Ability for clients to fund their custodians for settlement
10. Availability of timely/accurate funding projections for cash and stock
11. Compressed timelines for buy-ins, stock lending returns, margin, clients supporting lifecycle events from different time zones

**Note: Times are indicative and not specific to any specific firm. Settlement timeframes can vary*

Association of Global Custodians

Securities Processing Flow: Post-Safeguarding Rule

In addition to the changes resulting from the T+1 transition, the Safeguarding Rule's requirement to monitor advisers' authority would create incremental challenges in firms' ability to settle transactions in a timely manner. Key challenges and dependencies are outlined below:



Incremental challenges & dependencies related to SEC safeguarding rule compliance check

1. Dependency on Asset Owner / RIA to provide and maintain timely & accurate investment authority information
2. Potential for heightened operational challenges for certain investor types that require a third-party manager
3. Confirm client has available funds to settle transaction, resulting from requirement to segregate cash balances (*see slide 10 for more details*)
4. Complex investment authority compliance engine build
5. Change to operating model: late night shifts and additional personnel to review transactions before processing with new skillsets required
6. Additional investment authority compliance check will delay settlement in an already compressed T+1 timeline
7. For trades that are not in compliance, new data feeds and processes needed to pass trades back to brokers / RIAs
8. New processes required for broker-dealers and RIAs to review breaches and either amend or cancel trades
9. Increased fails due to investment compliance breaches
10. This flow does not include challenges for other lifecycle or related transaction activity such as corporate actions, related FX activity, securities lending, etc.

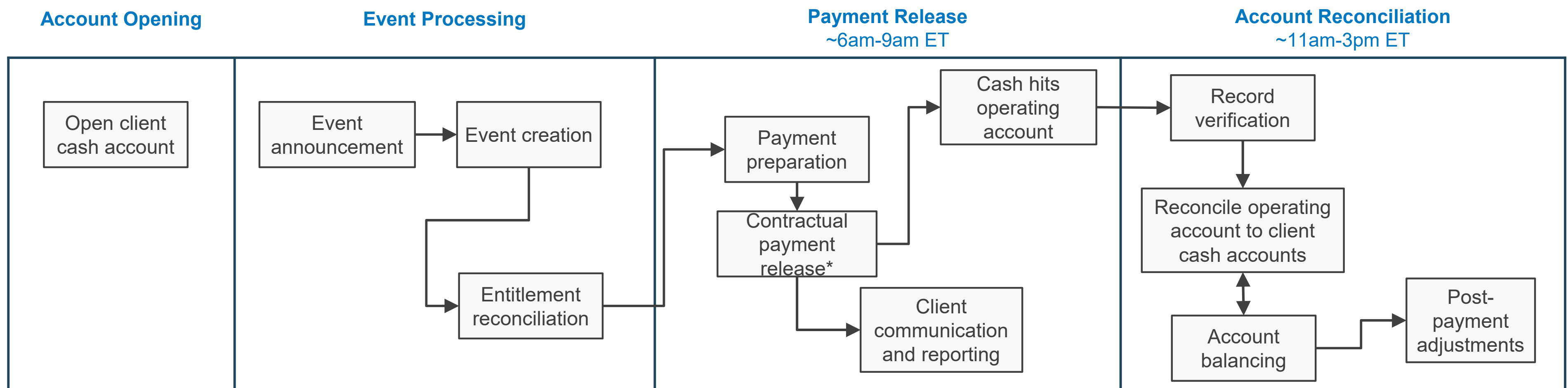
**Note: Times are indicative and not specific to any firms. Settlement timeframes can vary*

Key changes related to monitoring advisers' authority

Association of Global Custodians

Income Processing Flow: Current State

In the current state of the income processing flow in most markets, custodians advance income payments to clients before the start of the trading day, usually between 6am and 8am, ensuring the availability of funds for use by investors on that trading day.



Benefits related to the current state income processing flow

- Custodian banks typically offer contractual income payments for release to clients early in the morning for high quality markets and issues; these services:
  - streamline clients' ability to utilize intraday liquidity to fund activities
  - spread settlement activity across the trading day
- The current state allows custodian banks to maintain strong balance sheets, which provides the following benefits related to income processing:
  - enables the ability to provide contractual payment credit facilities which are credit intensive
  - generates overnight interest which in turn leads to lower fees for clients

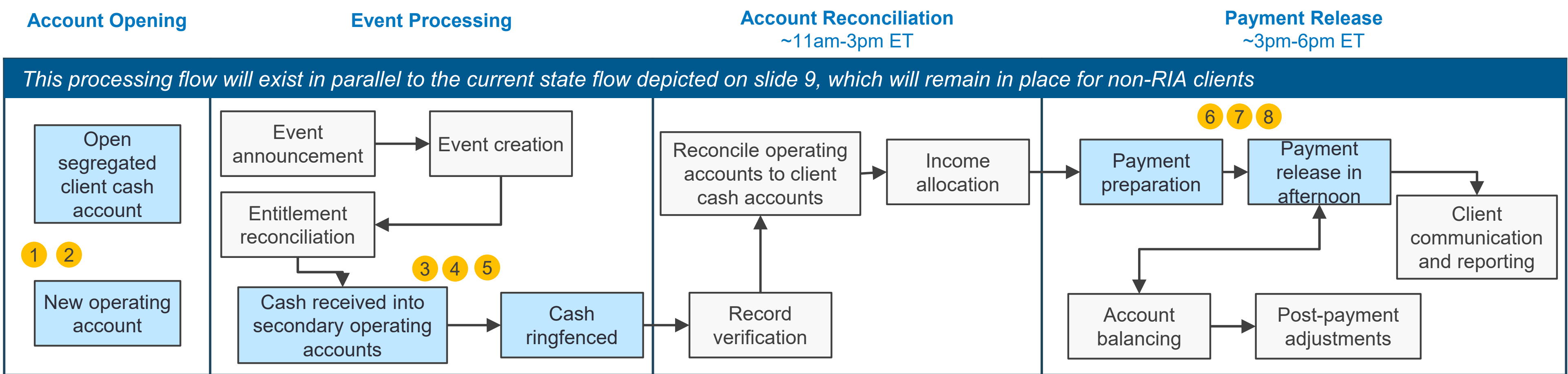
Considerations related to T+1 settlement implementation

- T+1 may impact custodian banks' ability to reconcile and validate entitlements processing for trades that did not settle within required timeframes (e.g., failed trades, settlement delayed beyond T+1)

**Custodians reserve the right to reverse payment if funds are not received*

Income Processing Flow: Post-Safeguarding Rule

For clients subject to the SEC safeguarding advisory client assets rule[1], the income processing flow has a different sequence of events, with none of the income-related cash available for use by investors prior to account reconciliation.



Incremental challenges & dependencies related to segregation of cash

1. Increased cost of establishing / maintaining separate accounts for RIA relationships
2. Investment in new technology builds
3. Development of new compliance process for segregation adherence
4. New risk and controls (e.g., overdraft controls) required
5. Technology and processes to handle financing of off-balance sheet cash
6. Incremental strain on T+1 timeline due to operational complexities
7. Reduction in market liquidity[2]
8. Delays in payment release impacting clients' ability to trade, pushing settlement to end-of-day

Additional challenges if cash is segregated at a third-party bank

- New operational procedures and legal agreements required
- Additional strain on T+1 timeline due to operational difficulties (e.g., transfer verification and confirmation, additional account reconciliations, technological integration, reporting and compliance requirements)
- Processing delays for transactions
- Increased investor fees due to loss of revenue on deposits

[1] *This flow assumes that the proposed rule does not require cash to be segregated at a third-party bank*
[2] *In the first quarter of 2023, six AGC member banks settled 2.1 million transactions daily in over 100 markets*

Key changes related to requirement to segregate cash