

## MEMORANDUM

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

**FROM:** Janet Jun  
Senior Counsel, Division of Investment Management

**RE:** Videoconference with Representatives of AGC

**DATE:** November 9, 2023

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On November 9, 2023, staff from the U.S. Securities and Exchange Commission (“SEC”) held a videoconference with representatives of the Association of Global Custodians (“AGC”).

Participants included SEC staff from the Division of Investment Management: Sarah ten Siethoff, Melissa Rovers Harke, Christopher Staley, Holly Miller, Samuel Thomas, Alexander Haer, Janet Jun, John Cavanagh, Matthew Williams, Jenson Wayne, and Michael Republicano; from the Division of Economic and Risk Analysis: Ulas Alkan; and representatives from AGC:

- Natalie Berkecz, Global Head of Regulatory Product, Northern Trust
- Kelly Dibble, Director of Public Affairs and Government Relations, Northern Trust
- Robert McKeon, Managing Director, State Street
- Beatriz Molina, Managing Director, BNY Mellon
- Walt Palmer, Director, BNP Paribas
- Marian Florio Persico, Associate General Counsel and Director, Citibank
- Howard Rapley, Global Product Lead, Securities Services, Northern Trust
- John Siena, Associate General Counsel, Co-Head of Regulatory Strategy, Brown Brothers Harriman
- Steven Wager, Head of Custody Product, RBC
- John Conroy, Principal, Baker McKenzie
- Juan Gonzalez, Partner, Baker McKenzie
- Kameron Hillstrom, Associate, 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

## *Roles of Securities Custodians*

Securities custodians play an important role in the global financial system by providing to investors:

- access to entitlements in securities issued by companies throughout the world, as well as -
- services necessary to give effect to investors' rights in these securities, including facilitating settlement of their sale and purchase and the exercise of voting rights, rights offerings, payment of dividends and income, processing of reclaims for withheld taxes.

A very large portion of the services that securities custodians typically provide are performed for investors on a cross-border basis, requiring a chain of trusted intermediaries providing the necessary linkages to enable investors in one jurisdiction to purchase, own and exercise rights with respect to securities in another jurisdiction.

Securities custodians also facilitate the availability of collateral arrangements which have become increasingly important for capital markets in view of the increasing need for financial collateral taking the form of investment securities.

## *What matters*

Client assets are “segregated” to ensure they are ringfenced and available should an intermediary in the chain of custody be rendered insolvent.

But ...

- What does “segregation” mean?
- What kind of segregation?

## *What is a Security?*

- Shares: SH commits to pay capital to issuer; issuer commits to pay dividends and grant participatory rights
- Bonds: Bondholder commits to lend money (principal) and issuer commits to pay regular interest (yield) and repay principal at maturity date
- Both personal claims – “claims in contract”?
- Crucial concept in history of development of capital markets: physical certificates created a **property interest** – “movable tangible property”
  - This facilitated transferability on purchases and sales
  - Crucial to build scale in raising capital and for trading in secondary markets

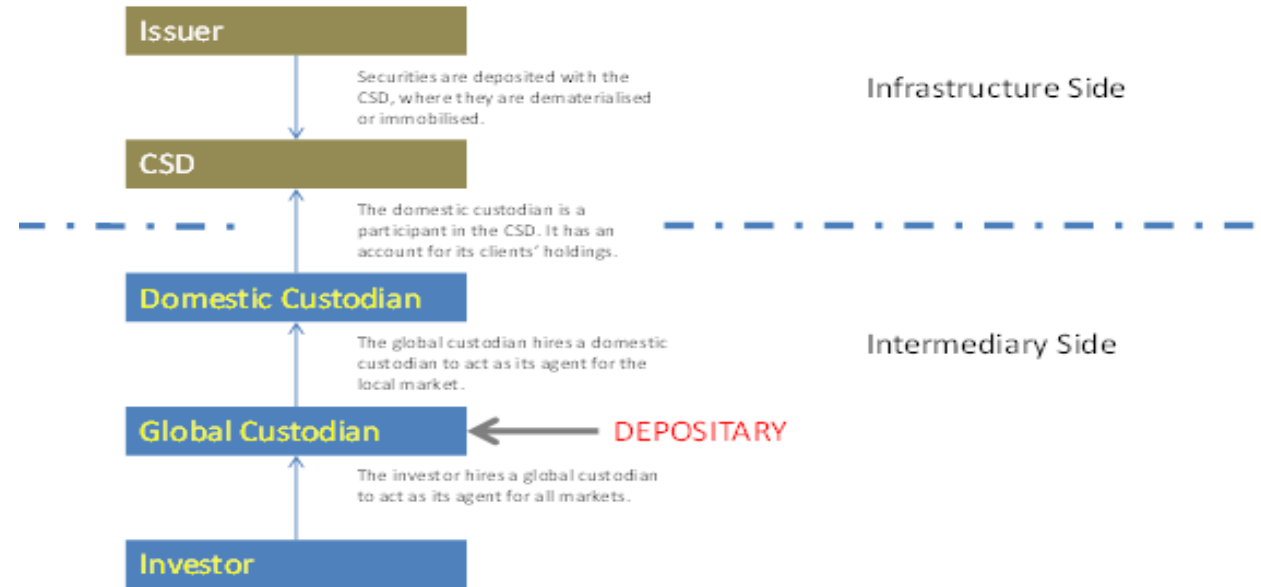
## *Important property law concepts*

- Certificates protected acquirer where a seller is not actually entitled to sell (“good faith acquisition”)(See UCC 8-511).
- Issuer was entitled to rely on the holder as owner
- Net effect: original obligation to pay sums of money btw investor and issuer were converted to “property” rights – not just solely a contractual obligation under companies law (“corporate law” in the U.S.):
  - Obligations of issuers depended on identifying who the “owner” actually is, which depended on property rights concepts.
- *This where “custodians” came into the picture*

## *“Property” concepts applicable to dematerialised (“book-entry”) securities*

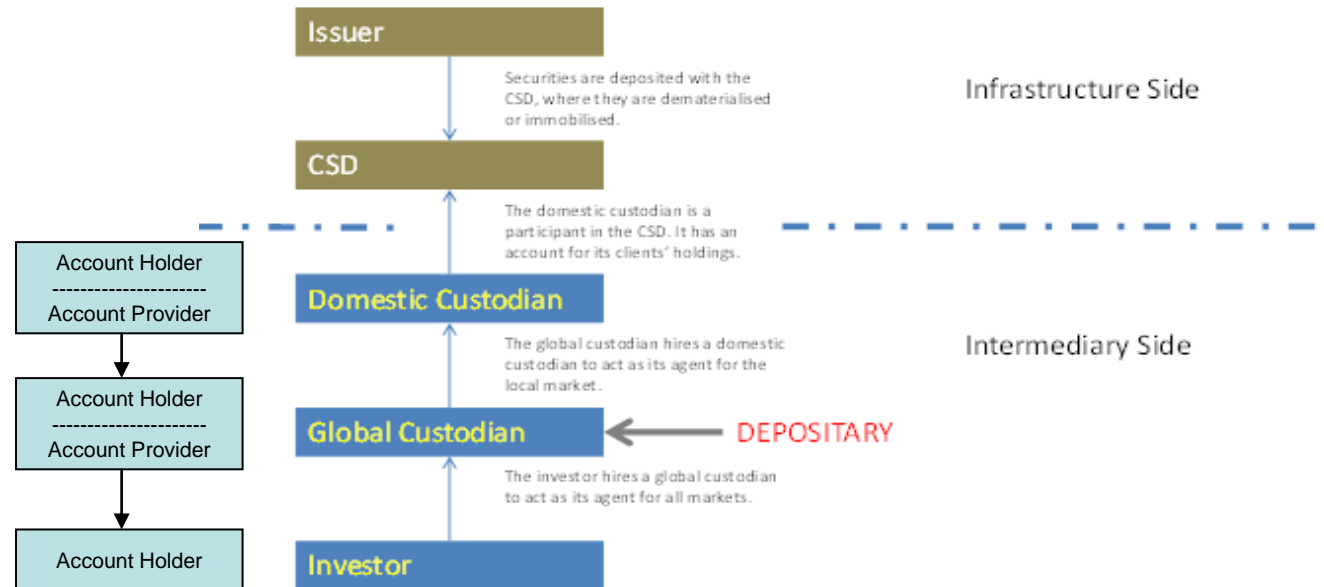
- Reliance placed on electronic records maintained by Central Securities Depositories (CSDs) and securities intermediaries in the “chain of custody”.
- Securities in issue initially deposited with CSD: legal and beneficial rights in them are described by national law (in the U.S., this is UCC Article 8 as adopted by the states).
  - UCC Article 8 did away with original English “property rights” concepts beginning in the ‘80s, adopting in their place a *sui generis* concept of “securities entitlements”,
  - Securities entitlements are a “bundle of rights” including both proprietary and personal claims against “securities intermediaries”, however certain protections are built into the Art. 8 in order to ensure customer protection against insolvency of the intermediary securities (see further below for more detail)
  - UCC Article 9 – covering security interests – was also revised to accommodate rights in securities entitlements (here, too, custodians play a crucial role in control agreements, etc).
- Securities intermediaries (custodians) provide investors with access to property rights in the securities through a “chain of custody” leading to the CSD.

# Typical schematic for intermediated securities holdings





# Applying the language of the Geneva Securities Convention

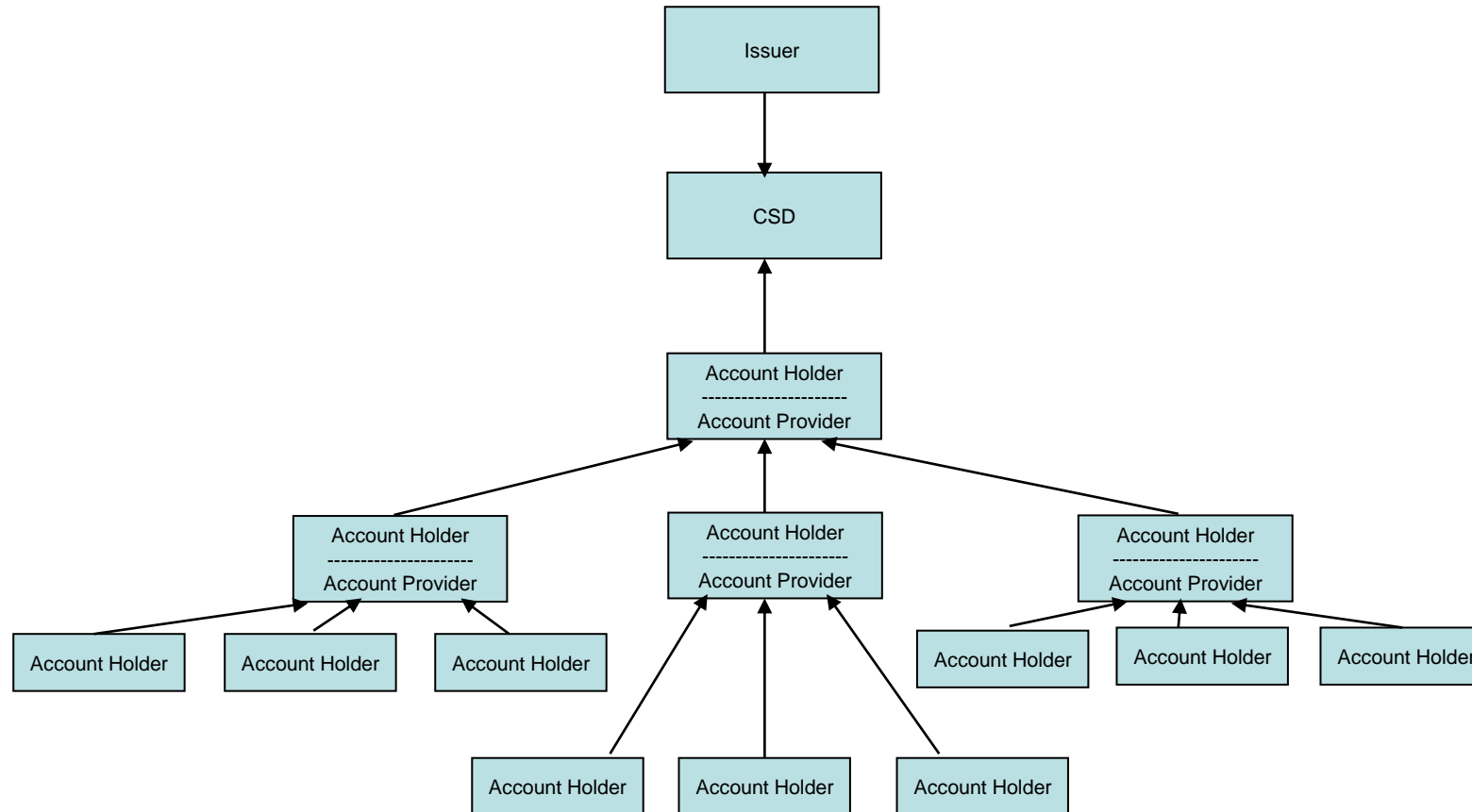


- Intermediaries may be both an “Account Holder” and an “Account Provider” simultaneously with respect to the same securities in issue
- CSDs and intermediaries in chain of custody may be located in different jurisdictions, each subject to its own national law.

## *“Property” concepts applicable to dematerialised (uncertificated/“book-entry”) securities*

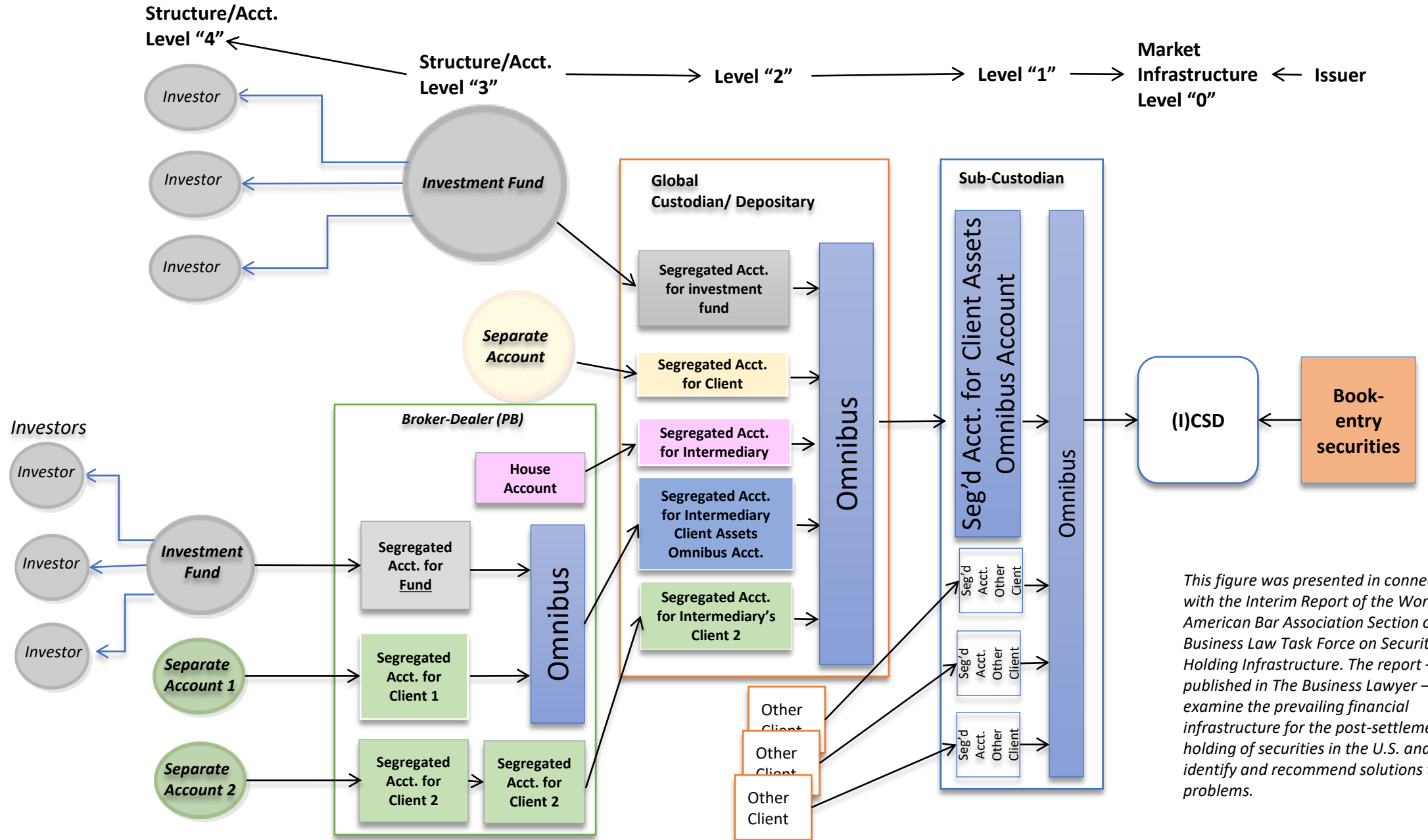
- There is no “certificate” (other than at the CSD, depending on local law);
- Securities in issue initially “deposited” with CSD: legal and beneficial rights in them are described by national law (New York law in the case of DTC, supported by the rules of the CSD).
- Securities intermediaries provide investors with access to property rights in the securities through a “chain of custody” leading to the CSD.
- *But*, CSDs and intermediaries in chain of custody may be located in different jurisdictions, each subject to its own national law.

# Pyramidal structure of omnibus accounts



*This figure is simplified for discussion purposes and should not be relied upon as dispositive: it elides various elements such as nominees, registrars, transfer agents, etc.*

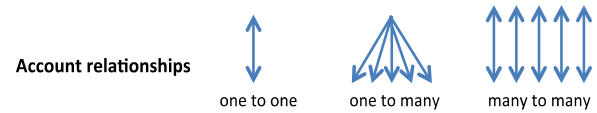
# End-to-End Structure of Holdings



*This figure was presented in connection with the Interim Report of the Work of the American Bar Association Section of the Business Law Task Force on Securities Holding Infrastructure. The report – to be published in The Business Lawyer – will examine the prevailing financial infrastructure for the post-settlement holding of securities in the U.S. and identify and recommend solutions to problems.*

# Segregation Types Depicted

	Omnibus	Subcustodian segregated	CSD segregated
CSD	Omnibus ↑↓	Omnibus ↓ ↓ ↓ ↓ ↓	Segregated ↑ ↑ ↑ ↑ ↑
Intermediary	Omnibus ↓ ↓ ↓ ↓ ↓	Segregated ↑ ↑ ↑ ↑ ↑	Segregated ↑ ↑ ↑ ↑ ↑
Last Intermediary	Client segregated ↑ ↑ ↑ ↑ ↑	Client segregated ↑ ↑ ↑ ↑ ↑	Client segregated ↑ ↑ ↑ ↑ ↑
Investor	Segregated by legal entity	Segregated by legal entity	Segregated by legal entity



## *Segregation – what matters?*

“Segregation” of arrangements made by an intermediary (“Intermediary A”) in its books and records that are intended to ensure that:

1. its customers’ book-entry securities will not be treated as the property of Intermediary A and used to meet the claims of creditors of Intermediary A, which is generally achieved by keeping records to identify book-entry securities as belonging to each of its customers;
2. if Intermediary A’s customer is also an intermediary (“Intermediary B”), the book-entry securities of Intermediary B’s customers will not be treated as property of Intermediary B (nor are they the property of Intermediary A) and are protected from the creditors of not just of Intermediary A but also of Intermediary B; and
3. each customer’s book-entry securities will not be treated as the property of any other customers and are protected from the creditors of those other customers (however, “customers” are only the direct customers of each intermediary: in the example above, a customer of Intermediary B is not considered a “customer” of Intermediary A).

# *UCC Article 8 protections (inter alia)*

## Section 8- 503(a)

To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary . . .

## Section 8- 503(b)

An entitlement holder's property interest with respect to a particular financial asset under subsection (a) is a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset.

## Section 8- 504

(a) A securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset. The securities intermediary may maintain those financial assets directly or through one or more other securities intermediaries.

(b) Except to the extent otherwise agreed by its entitlement holder, a securities intermediary may not grant any security interests in a financial asset it is obligated to maintain pursuant to subsection (a).

(c) A securities intermediary satisfies the duty in subsection (a) if:

(1) the securities intermediary acts with respect to the duty as agreed upon by the entitlement holder and the securities intermediary; or

(2) in the absence of agreement, the securities intermediary exercises due care in accordance with reasonable commercial standards to obtain and maintain the financial asset.