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May 8, 2023

Submitted Via E-Mail to rule-comments@sec.gov

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

Re: ***SEC Notice of Proposed Rulemaking, "Safeguarding Advisory Client Assets" [Release No. IA–6240; File No. S7–04–23]***

Dear Ms. Countryman:

I. Introduction

The International Swaps and Derivatives Association ("**ISDA**")[1] respectfully submits this comment letter on *Safeguarding Advisory Client Assets* ("**Proposed Rule**") published by the U.S. Securities and Exchange Commission ("**SEC**" or "**Commission**") on March 9, 2023. Investment advisers registered with the SEC ("**Investment Advisers**") routinely enter into derivatives transactions on behalf of their clients for investment purposes and to perform the critical risk management functions of hedging or mitigating risks. Several aspects set forth in the Proposed Rule would, if finalized, not only threaten the ability for Investment Advisers and their clients to utilize derivatives, but also have broader impacts on the cleared and uncleared derivatives markets.

The Proposed Rule substantially expands the definition of "assets" in an overly broad manner without acknowledging or analyzing the ramifications in the affected markets, which are already subject to extensive regulatory oversight. This comment letter emphasizes the destabilizing impact that the Proposed Rule would have on the use of cleared and uncleared derivatives by Investment Advisers and the broader impacts on the derivatives markets. Additionally, this comment letter addresses the impacts of the Proposed Rule on certain other products that fall within the broad definition of "assets" such as commodities, repurchase agreements and stock loan agreements. However, notwithstanding the letter's discussion of specific products, ISDA respectfully urges the Commission more generally to reconsider the "kitchen sink" approach it has taken with the definition of "assets" – effectively forcing the industry to go through every product to identify and analyze the impacts on various markets to justify products that should not be "assets" – in favor of a clear and well-considered proposal describing how any specific products and transactions beyond "funds and securities" would benefit from the additional stringent requirements contemplated in

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

the Proposed Rule. Indeed, the negative impacts that the Proposed Rule would have on the derivatives and other markets described herein demonstrate why the Commission's broad approach warrants reconsideration.

This comment letter addresses a few key areas of concern of ISDA and its members related to the derivatives markets that are raised by the Proposed Rule, including the broad expansion of the definition "assets" and its impacts on: (1) Investment Advisers' ability to use derivatives and the current structure of derivatives markets; (2) Investment Advisers' ability to enter into cleared swaps and futures on behalf of their clients; (3) the use of derivatives in connection with separately managed accounts and prime brokers; (4) securities financing transactions and commodities transactions; and (5) the ability of Investment Advisers to be competitive with non-U.S. asset managers or other advisors that are not SEC registrants.

II. The Expanded Scope of the Definition of "Assets" Would Have Negative Consequences on Derivatives Market Structure and Investment Advisers' Ability to Use Derivatives for Their Clients

A. The Overbroad Definition of "Assets" Encompasses Products That Do Not Require the Protections of the Proposed Rule

The Proposed Rule's expanded scope of the current custody rule from "funds and securities" to all client "assets" (which would include "other positions held in a client's account") represents a sea change in the types of transactions that would be subject to the Proposed Rule as compared with the current custody rule. For example, "assets" would now include "financial contracts held for investment purposes, collateral posted in connection with a swap contract on behalf of the client, and other assets that may not be clearly funds or securities covered by the current rule."[2] The Proposed Rule defines "assets" so expansively that it would cover bilateral over-the-counter ("**OTC**") derivatives (including bilateral OTC security options and security-based swaps, bilateral OTC securities forwards and bilateral OTC derivatives (non-securities)) as well as cleared derivatives (futures, options on futures and cleared swaps and security-based swaps). Additionally, other products such as security financing transactions and commodities would fit within the sweeping definition. Further, collateral posted in connection with these products would fall within the Proposed Rule's definition of "assets" as the SEC has explained is its view under the current custody rule.[3]

In the Proposed Rule, the Commission highlights the "new and different ways for client assets to be placed at risk of loss, theft, misuse, or misappropriation that may not be fully addressed under the current rule."[4] However, the expanded definition of "asset" in the Proposed Rule would bring into scope certain financial products, including derivatives and related collateral, that do not pose the type of risks that the Proposed Rule seeks to address and are already subject to extensive U.S. regulation. OTC derivatives transactions entered into by Investment Advisers on behalf of clients are marked-to-market daily, fully collateralized, either an asset or liability of the client of the Investment Adviser (depending on market movements), and, as contractual rights, are not easily susceptible to misappropriation. Indeed, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") and the SEC, Commodity Futures Trading Commission ("**CFTC**") and the U.S. federal prudential banking regulators (the "**Prudential Regulators**") regulations thereunder provide for the robust regulation of derivatives, including the mandatory exchange of variation and initial margin between financial counterparties for uncleared derivatives, mandatory

[2] Proposed Rule, Safeguarding Advisory Client Assets, 88 Fed. Reg. 14,672, 14,679 (Mar. 9, 2023).
[3] *See* Custody Rule FAQs, Question II.10, *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.
[4] 88 Fed. Reg. at 14,675.

clearing of certain derivatives, business conduct standards and regulatory and real-time public reporting of such transactions. As the SEC has previously noted, Title VII of the Dodd-Frank Act established a new regulatory framework for OTC derivatives subject to the jurisdiction of U.S. regulators.[5] In particular, Title VII amended the Securities Exchange Act of 1934 and the Commodity Exchange Act to require the Commission, the CFTC and the Prudential Regulators to prescribe margin requirements for uncleared derivatives. This regulatory overhaul of the margin requirements for uncleared swaps and the broader efforts to reform the OTC derivatives markets occurred in the context of global regulatory efforts.[6] The Proposed Rule does not account for the existing protections of this regulatory framework, would be inconsistent the policy goals of the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") global framework for uncleared margin requirements for derivatives,[7] and adds layers of incompatible and unnecessary requirements.

B. The Proposed Rule Is Inconsistent with the Bilateral Nature of Uncleared Over-the-Counter (OTC) Derivatives Transactions

Bilateral derivatives transactions entered into by an Investment Adviser are financial contracts between a client of an Investment Adviser and a swap counterparty. Often such transactions are governed by a Master Agreement published by ISDA ("**ISDA Master Agreement**"). The bilateral nature of these agreements is fundamental. In OTC derivatives transactions that are not required to be cleared or are not cleared voluntarily, the client of an Investment Adviser and swap counterparty are parties to the transaction for the life of the trade and therefore are responsible for making payments or deliveries to one another under the terms of the applicable transaction. The value of a bilateral derivatives transaction fluctuates, and because of the treatment of the counterparties under existing margin regulations for uncleared swaps and security-based swaps, such transactions are generally required to be collateralized daily.[8]

Although the payment and delivery obligations are bilateral, custodians play a role in the current market for bilateral derivatives. For example, with respect to variation or initial margin that is required to be segregated at a custodian by law (in the case of regulatory initial margin under rules promulgated by the CFTC and Prudential Regulators) or requested by a counterparty (in the case of variation margin, excess/non-regulatory initial margin, or initial margin under the SEC rules), collateral is held by a third-party custodian in a segregated account. However, even where such collateral is segregated at a third-party custodian, neither the ISDA Master Agreement between the counterparties nor any transaction thereunder is held in custody. Indeed, the account control agreement governing the pledge of collateral often makes explicit that the custodian has no responsibility concerning the ISDA Master Agreement (including any Credit Support Annex governing collateral terms). Subjecting bilateral derivatives transactions to the requirements of the Proposed Rule would effectively end the bilateral nature of the uncleared derivatives

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[5] *See* Final Rule, Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 Fed. Reg., 43,872, 43872 (Aug. 22, 2019); *see also* Section 764 of the Dodd-Frank Act.

[6] *See, e.g.*, 84 Fed. Reg at 43979.

[7] *See* BCBS/IOSCO, "Margin requirements for noncentrally cleared derivatives" (April 2020); *see also* BCBS/IOSCO, "Margin requirements for noncentrally cleared derivatives" (September 2013).

[8] Investment Advisers and, generally, their clients are "financial end users" as defined in the CFTC and Prudential Regulator margin rules for uncleared derivatives and are subject to margin requirements when trading with a swap dealer or security-based swap dealer, as applicable. *See, e.g.*, 17 C.F.R. § 23.151; 17 C.F.R. § 240.18a-3; 12 C.F.R. § 45.2. (The SEC's margin rules do not use the term "financial end user" and instead provide an exemption for "commercial end users," but the outcome is the same with respect to Investment Advisers).

markets for clients of Investment Advisers. The role played by custodians currently is substantially less intrusive than what is envisioned by the Proposed Rule.

While we interpret the Proposed Rule not to require Investment Advisers to maintain "assets" at a qualified custodian ("**QC**") that is an unaffiliated third party of their OTC derivatives counterparty, the Proposed Rule would likely make it impracticable for one party to an OTC derivatives transaction to also satisfy the Proposed Rule's requirements that are applicable to the QC, including but not limited to the indemnification and segregation requirements. The inability of a swap counterparty to perform the functions of a QC under the Proposed Rule would seem to necessitate the introduction of a third-party.

Further, the Proposed Rule would clarify that a QC "does not "maintain" a client asset for purposes of the rule if it does not have "possession or control" of that asset."[9] Requiring a QC to have possession and control of a bilateral derivatives transaction would fundamentally alter the *bilateral* nature of derivatives transactions (and related negotiations). If the Proposed Rule were applied to bilateral OTC derivatives contracts such that an Investment Adviser was required to maintain its bilateral derivatives with a QC, the QC would have to maintain "possession and control" of such financial contracts, which means participating in any change in beneficial ownership of such "assets."[10] It is difficult to conceive how this would work in practice. For bilateral OTC derivatives, the client's "asset" is the value of a contractual right rather than a position held in an account. An Investment Adviser would also need to enter into written agreements with and receive certain assurances from the QC regarding indemnification, insurance, and account title, among other things, which would further complicate and frustrate bilateral negotiations.

To comply with the Proposed Rule, Investment Advisers would seemingly be dependent on QCs agreeing to be party to each ISDA Master Agreement and trade confirmation (notwithstanding that the Investment Adviser's client and the swap counterparty are the actual parties to the derivatives relationship). This would transform the traditional role of a custodian, making it an overseer of bilateral derivatives markets by entrusting it with the power to delay, alter, or even veto transactions or amendments, which would materially alter the nature of swap transactions between such counterparties. In this role, a QC would be undertaking substantially more responsibility than under its current business activity. Not only would such involvement by the QC represent a fundamental departure from current market practice for bilateral derivatives transactions entered into by Investment Advisers on behalf of clients, but it would also depart from market practice for tri-party custodial arrangements. Currently, the custodian is not party to the ISDA Master Agreements (or amendments thereto) or any trade confirmation under such ISDA Master Agreement, as the relationship between counterparties and their obligations to each other under the terms of their OTC derivatives agreement are distinct from those of the custodian. QCs may therefore be reluctant to become a signatory as it potentially increases obligations and risk for them (without any compensatory benefit). Additionally, the Proposed Rule could require amendments to existing derivatives documentation that could conflict with previously agreed-to terms and require extensive negotiation.

For the reasons discussed above, ISDA urges the Commission to expressly exclude bilateral derivatives transactions and related credit support (discussed in Section II.C below) from the definition of "assets" set forth in the Proposed Rule.

C. The Proposed Rule's Definition of "Assets" Would Encompass Collateral Posted in Connection with Uncleared OTC Derivatives

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[9] 88 Fed. Reg. at 14,677.

[10] *Id.*

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Investment Advisers are generally subject to U.S. regulations requiring the exchange of variation and initial margin for uncleared swaps and security-based swaps that they execute on behalf of clients.[11] If adopted, the expanded definition of "assets" in the Proposed Rule would require clients of Investment Advisers to post all collateral in connection with their uncleared OTC derivatives (including variation margin and initial margin not currently subject to mandatory segregation) into segregated accounts. As described above, these segregated accounts would need to be held at a QC and pledged to the client's swap counterparty.[12] The Proposed Rule's application to collateral posted in connection with uncleared OTC derivatives introduces a burdensome – and superfluous – set of requirements to an already heavily regulated marketplace. These changes, if adopted, would be a substantial departure from market practice and the uncleared swap and security-based swap margin rules implemented under the Dodd-Frank Act. For example, in addition to requiring segregation where U.S. and global regulators declined to implement such requirements, such a segregation requirement would also remove the ability for swap counterparties to rehypothecate variation margin and initial margin not currently subject to mandatory segregation (*i.e.*, as permitted in the SEC's margin regulations). This result runs contrary to the uncleared swap and security-based swap margin rules of the CFTC, the SEC, and the Prudential Regulators, none of which requires segregation of variation margin or independent amount. All relevant U.S. regulators permit rehypothecation of variation margin and, as described further below, the SEC permits rehypothecation of initial margin.

U.S. and global regulators have declined to require variation margin to be segregated for many reasons, but they have done so fundamentally because variation margin of OTC derivatives represents the "current exposure"[13] of the transaction. The pledgor is not entitled to the return of such collateral in the event of the secured party's insolvency, and therefore segregating variation margin from the assets of the secured party does not afford the pledgor with meaningful protection. U.S. regulators' decision to allow rehypothecation of variation margin is consistent with Requirement 5(iii) in the final policy framework establishing minimum standards for margin requirements for non-centrally cleared derivatives as agreed by BCBS and IOSCO: "Cash and non-cash collateral collected as variation margin may be re-hypothecated, re-pledged or re-used."[14] The Proposed Rule's treatment of variation margin, therefore, is incompatible with both U.S. and international standards.

With respect to initial margin for uncleared security-based swaps, the SEC recognized that "[e]xisting market practice under the baseline is for dealers generally not to segregate initial margin related to OTC derivative transactions" and declined to require segregation of initial margin.[15] The SEC carefully and

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[11] *See* fn. 5 and fn. 8, *supra*. Importantly, current margin regulations – unlike the Proposed Rule – apply to registrants (swap dealers and security-based swap dealers) directly and only indirectly to Investment Advisers (as a consequence of their trading OTC derivatives with registrants). Placing the regulatory burden on Investment Advisers directly represents a substantially new approach to margin requirements in OTC derivatives markets and is at odds with the framework for swaps and security-based swaps set out in Sections 731 and 764 of the Dodd-Frank Act, respectively.

[12] To the extent that an Investment Adviser currently has arrangements in place for segregating margin, they do not necessarily satisfy the requirements of the Proposed Rule and would need to be reevaluated.

[13] *See, e.g.*, 84 Fed. Reg. at 43910. (In the context of listed products, variation margin represents settlement payments, which would also not be subject to obligatory return).

[14] BCBS-IOSCO, "Margin requirements for non-centrally cleared derivatives," p. 20 (April 2020), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD651.pdf.

[15] 84 Fed. Reg. at 43,984. Unlike the SEC, the CFTC and the Prudential Regulators require segregation of initial margin. However, an Investment Adviser's compliance with the CFTC's or Prudential Regulators' margin regulations for initial margin may not satisfy the requirements of the Proposed Rule (in particular, with respect to the reasonable assurances required to be obtained) even though there is substantial overlap between the policy objectives of such regulators' margin regulations and the Proposed Rule.

deliberately decided to take a different approach from the CFTC and Prudential Regulators on this point, and the Proposed Rule is not the appropriate occasion to override such decision. Further, achieving the significant changes envisioned by the Proposed Rule would be extremely burdensome as it would require an Investment Adviser to enter into a tri-party account control agreement among the QC, client, and the swap counterparty to perfect the swap counterparty's security interest in the collateral. As a practical matter, it is not apparent that swap counterparties (or QCs) would agree to these changes regarding collateral. Reluctance by swap counterparties to agree to these terms could limit the number of swap counterparties available to clients of Investment Advisers and therefore cause them to face more concentrated credit risk, the inability to effectively carry out their risk management programs and, potentially, result in higher transaction costs. Segregation of variation margin would bring with it increased transaction costs and less favorable pricing and, in turn, lead to a decrease in returns and an increase in hedging costs for the client.[16]

For the reasons discussed above, ISDA urges the Commission to exclude variation margin and initial margin (whether or not currently subject to mandatory segregation) posted or exchanged in connection with bilateral OTC derivatives from the definition of "assets" or, alternatively, provide a safe harbor from the Proposed Rule for compliance with the existing margin regulations for uncleared swaps promulgated by the SEC, CFTC, and Prudential Regulators, as applicable.

III. The Proposed Rule Creates Significant Challenges and Uncertainty for Investment Advisers Entering into Futures and Cleared Swaps on Behalf of Their Clients

Listed exchange traded commodity futures contracts (or options thereon) and cleared swaps would be subject to the Proposed Rule's requirement under the expanded definition of "assets." Futures and cleared swaps are held through futures commission merchants ("**FCMs**");[17] however, FCMs may not be able to act as QCs with respect to these cleared derivatives contracts that would be required to be maintained by a QC under the Proposed Rule. Under the current custody rule, FCMs are QCs only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of commodity futures contracts (or options thereon). The Proposed Rule leaves a gap for the ability of an FCM to act as a QC with respect to transactions and related collateral held by an FCM in relation to cleared swaps and futures because the Proposed Rule applies to "other positions held in the client's account" at an FCM, but the Proposed Rule does not include a corresponding expansion of an FCM's role as custodian with respect to the broader definition of "assets." Investment Advisers that trade futures and cleared swaps on their clients' behalf through FCMs would be prevented from doing so under the Proposed Rule because FCMs would not qualify as QCs for such purposes.

While the Proposed Rule sets out a framework for FCMs to be QCs, in practice FCMs would not be able to satisfy the criteria with respect to cleared swaps, futures, and related collateral. Under the CFTC's FCM rules, an FCM generally cannot accept as collateral an account of an FCM client that is segregated at a custodian.[18] So, when an FCM is dealing with an Investment Adviser, the Investment Adviser's customers may have their collateral segregated at different custodians, which means that the FCM would not be able

[16] We note that although Section 17(f) of the Investment Company Act of 1940 requires posting of margin in a segregated account with a third-party custodian, that protection is aimed at protecting retail investors in mutual funds.

[17] Under current market practice, cleared derivatives positions are held through an FCM, which minimizes an Investment Adviser's ability to misappropriate assets.

[18] *See, e.g.,* Amendment of Interpretation, 70 Fed. Reg. 24,768 (May 11, 2005); Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336 (Feb. 7, 2012).

to take "possession or control" and so would not qualify as a QC under the Proposed Rule. Thus, there is a conflict between the CFTC's robust regulatory framework for FCMs and the Proposed Rule's inclusion of futures and cleared swaps in the definition of "assets." In addition, the segregation requirements of the Proposed Rule do not comport with current practice – and regulation – of FCMs in which funds are held in an omnibus account for all customers. Accordingly, if the Proposed Rule were to be adopted without modification, Investment Advisers could not trade cleared swaps or futures (other than security futures), on behalf of their clients.

ISDA urges the Commission to exempt cleared derivatives contracts and related collateral that are held through FCMs from the Proposed Rule. FCMs are foundational to the cleared derivatives markets and are heavily regulated by the CFTC and the National Futures Association. In the alternative, the CFTC would need to change the definition of QC to expressly permit any FCM to act as a QC for all such "assets." Even if the CFTC were to permit FCMs to come into compliance with the Proposed Rule, the indemnification requirement and changes to segregation set forth in the Proposed Rule would likely result in the futures industry repricing its services and increasing customer costs without any corresponding increase in protection for the customer.

IV. The Proposed Rule Would Have Significant Negative Impacts on Investment Advisers That Provide Services (Including Derivatives Trading) to Separately Managed Accounts ("SMAs"), Including SMAs for Which the Investment Adviser Does Not Trade Derivatives

Discretionary authority to trade client assets (*i.e.*, the authorization or permission to instruct a client's custodian to purchase and sell assets for the client) is an arrangement that would constitute "custody" under the Proposed Rule. As a result, Investment Advisers managing SMAs would be required to follow all of the Proposed Rule's requirements, including entering into a written agreement with the client's custodian, ensuring that the client's custodian has custody of any trading arrangements that the Investment Adviser enters into on behalf of the SMA and any swap collateral posted in connection therewith, and potentially engaging an independent public accountant to conduct a surprise annual examination. Such requirements would impose significant new operational and compliance burdens for Investment Advisers with respect to their SMA clients which would, as a result, reduce returns and increase costs for hedging with respect to such clients. Accordingly, ISDA urges the Commission to modify the definition of "custody" to exclude the discretionary authority to trade client assets.

V. The Proposed Rule's Application to Prime Brokerage Arrangements Is Likely to Raise Transaction Costs Substantially

Under existing SEC regulations, broker-dealers are permitted to rehypothecate customer assets subject to limits imposed under SEC broker-dealer regulations. However, the Proposed Rule's reasonable assurances requirement appears to prohibit a broker-dealer that is acting as a QC from exercising those rights.[19] The Proposed Rule's requirement that the Investment Adviser obtain reasonable assurances in writing from the custodian that the custodian will, among other things, segregate client assets from the custodian's own assets and liabilities would appear to be incompatible with the exercise of such rights by a broker-dealer that is acting as a QC. Broker-dealers rehypothecate client assets in order to finance margin extended to clients. Preventing rehypothecation seems likely either to significantly increase the fees and rates charged

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[19] *See* 88 Fed. Reg. at 14,695, n.171. (Noting that "[t]he proposed segregation requirements are drawn from rule 15c3–3 of the Exchange Act, which requires broker-dealers to safeguard their customer assets and keep customer assets separate from the firm's assets, to prevent investor loss or harm in the event of the broker-dealer's failure.")

by broker-dealers to clients (negatively impacting returns) or to make margin financing unavailable to some clients. Accordingly, ISDA requests that the Commission make clear its intent to permit broker-dealers to rehypothecate client assets in a manner consistent with existing SEC regulations and market practice.

We note that the Commission has provided an exception for client consent in proposed regulation 275.223-1(a)(1)(ii)(E) for the prohibition on any right, charge, security interest, lien or claim, yet has neglected to provide a similar exception for the requirement in proposed regulation 275.223-1(a)(1)(ii)(D)'s requirement to segregate assets. Both of these proposed requirements go hand-in-hand as they relate to a secured party's rights over collateral, and apply beyond Exchange Act Rule 15c3-3. The SEC should provide a comparable exception to proposed regulation 275.223-1(a)(1)(ii)(D) to the extent a client of an Investment Adviser has consented to or authorized such rehypothecation arrangements in writing.

VI. The Proposed Rule's Application to Other Products Raises Similar Concerns

A. Securities Financing Transactions ("SFTs")

Repurchase agreements and stock loan agreements – SFTs – are important financing tools that provide critical liquidity to global markets. Investment Advisers can use SFTs on behalf of their clients, as do many market participants globally. The Proposed Rule threatens to upend market practice for SFTs without providing any meaningful incremental benefit. For example, the collateral pledged under a stock loan agreement or transferred in a repurchase transaction is held in safekeeping by a custodian, lending agent or tri-party agent and should already be covered by the application of the current custody rule to "funds and securities." The Proposed Rule, by contrast, has the potential to substantially alter the contractual and structural arrangements governing the posting of collateral, whether it is held bilaterally or by tri-party arrangements. Moreover, where rehypothecation of collateral is available in the bilateral repo market into the tri-party repo market, the application of the Proposed Rule is likely to result in higher financing costs.[20]

The Proposed Rule's application to SFTs would present many of the same problems as its application to the bilateral OTC derivatives market described above. In particular, adoption of the Proposed Rules would likely raise transaction costs and result in less favorable pricing of SFTs, at a time when other regulatory change aimed at ensuring safety and soundness of the markets is also likely to increase transaction costs and administrative burdens on all market participants, which would tend to negatively impact accessibility of these markets for all but the largest market participants. ISDA encourages the SEC to exempt SFTs from the Proposed Rule's definition of "assets."

B. Commodities

Unlike the current custody rule, physical commodities (including but not limited to wheat and lumber) are within the scope of the Proposed Rule. Although Investment Advisers may be able to rely on the exception for physical assets unable to be maintained with a qualified custodian, this would only follow a determination that no custodian is available.[21] In some cases there is a presumption against the possibility of any such determination. For example, the Proposed Rule notes that such determination would be "difficult" with respect to certain physical commodities such as gold bullion and other precious metals since

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[20] *See* Repo Runs: Evidence from the Tri-Party Repo Market, Adam Copeland, Antoine Martin, and Michael Walker, Federal Reserve Bank of New York Staff Reports, no. 506, at pp. 9, 22 (https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr506.pdf).

[21] *See* 88 Fed. Reg. at 14,707.

a QC can hold such physical commodities.[22] Even where such a determination can be made, it would require the development of policies and procedures and a written agreement with a public accountant, and it would subject the Investment Adviser to surprise examination or audit. For physical asset markets that trade often, such as the energy markets, it would likely be extremely difficult for Investment Advisers to find auditors to verify each transaction. The costs of doing so would be prohibitive, and that assumes there are enough auditors in the United States to do so. These are not trivial impositions, and they represent an enormous shift in responsibilities and presumptions for any Investment Adviser that would continue to trade physical commodities under the regime envisioned by the Proposed Rule. In addition to changing the set of obligations and potential liabilities of any QC holding such physical commodities, as described above, the very nature of these physical commodities makes them less susceptible to loss, theft, misuse, misappropriation, or the Investment Adviser's financial wherewithal, including the Investment Adviser's insolvency.

Transactions and related collateral in intangible commodities such as renewable energy certificates and other environmental commodities, which are subject to CFTC enforcement authority, are also subject to the Proposed Rule's expansive definition of "assets." Subjecting intangible commodities to the Proposed Rule introduces the same concerns raised with respect to the bilateral derivatives transactions and SFTs – namely, upending market practice, increasing costs, and creating an outsize role for QCs. Moreover, transactions in commodities are already subject to the CFTC's enforcement oversight. Accordingly, ISDA urges the Commission to exclude commodities from the definition of "assets" under the Proposed Rule.

VII. The Proposed Rule Disadvantages Investment Advisers Relative to Foreign Advisers and Other Advisers Not Registered with the SEC

As explained in Section II.C above, the Proposed Rule would effectively override the existing U.S. margin requirements for uncleared derivatives, as well as foreign jurisdictions' regulations. Adopting the Proposed Rule would increase the cost of collateralizing derivatives trades in the United States relative to other jurisdictions. As a result, clients of Investment Advisers would be at a disadvantage trading derivatives with swap dealers and security-based swap dealers registered with the CFTC and SEC, respectively. Such dealers would be required to segregate all collateral posted by Investment Advisers on behalf of clients, which is more restrictive than the existing global regulations prescribe. In addition, Investment Advisers will be subject to stricter requirements – and likely receive worse pricing – from swap dealers and security-based swap dealers than would CFTC-registered commodity trading advisors that are not dually registered as Investment Advisers, even when trading identical products.[23]

Many Investment Advisers have custody of their clients' accounts at foreign financial institutions ("**FFIs**") under the current custody rule. The imposition of seven new requirements on FFIs to continue to qualify as QCs will likely result in the disqualification of some firms currently providing custody under the current rules.[24] In particular, the fourth condition (requiring "the FFI to hold financial assets for its customers in accounts designed to protect such assets from creditors of the FFI in the event of the insolvency or failure

[22] *See* 88 Fed. Reg. at 14,707, n.231.

[23] There may be additional implications and market dislocations. Specifically, certain broker-dealers may be contemplating registration as Investment Advisers in connection with "hard dollars received." See Securities Industry & Financial Markets Ass'n, SEC No-Action Letter (Oct. 26, 2017), https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

[24] *See* 88 Fed. Reg. at 14,683-85. Critically, the ability of U.S. branches of foreign banks to act as QCs is imperiled by the Proposed Rule.

of the FFI") will require substantial due diligence, likely including a legal opinion, and may categorically exclude FFIs in certain jurisdictions from serving as QCs. ISDA urges the Commission not to adopt to the proposed enhancements the definition of Foreign Financial Institution.

VIII. Cost Benefit Analysis Substantially Underestimates the Burden of Maintaining Financial Contracts with a Qualified Custodian and Segregating Variation Margin and Initial Margin Not Otherwise Subject to Mandatory Segregation

The SEC's cost-benefit analysis severely undercounts the amount of time that would be needed to negotiate agreements with QCs. Industry experience with initial margin segregation requirements indicates that establishing custodial relationships can absorb months if not years of planning and significant resources. As discussed above, the broad application of the Proposed Rule's definition of "assets" would cause significant burdens not only on Investment Advisers to renegotiate and enter into new contracts, such as account control agreements, but would also place significant burdens on QCs, the Investment Advisers' clients, and other financial institutions. Further, the sweeping implications of the Proposed Rule would fundamentally alter several aspects of the derivatives market structure, which could have knock-on effects, including, for example, on Americans that rely on Investment Advisers to manage their retirement funds.

In addition, the SEC omits any discussion or consideration of the protections already afforded under existing regulations. Neither ISDA nor its members is aware of any deficiency with the current regulation of derivatives, SFTs, and commodity transactions. Investment Advisers trading derivatives, SFTs, or commodities on behalf of clients do so within the confines of a heavily regulated market (which regulations have increased substantially at the direction of Congress in accordance with the Dodd-Frank Act).

As such, the benefits are not clear with respect to why a new regulatory framework is needed, especially one that increases costs and complexity, fits awkwardly with current SEC regulations and those of other regulators, and does not take account of their benefits (as described above). Asset managers other than Investment Advisers that advise clients on derivatives, SFTs, and commodity transactions stand to benefit most from the adoption of the Proposed Rule, while clients of Investment Advisers will gain little.

IX. Conclusion

We appreciate the opportunity to submit our comments in response to the Proposed Rule. Our members are strongly committed to maintaining the safety and efficiency of the U.S. financial markets and ensuring the efficiency of a robust and functional derivatives markets. We believe that in its current form the Proposed Rule would have significant negative impacts on the orderly operation of markets. We look forward to further engagement with the Commission on these important issues. Please do not hesitate to contact Christopher Young, Head of U.S. Public Policy, at (202) 683-9339 should you have any questions.

Sincerely,

Scott O'Malia
Chief Executive Officer
International Swaps and Derivatives Association, Inc.

cc: The Hon. Gary Gensler, SEC Chairman

The Hon. Hester Peirce, SEC Commissioner

The Hon. Allison Herren Lee, SEC Commissioner

The Hon. Caroline Crenshaw, SEC Commissioner

The Hon. Mark Uyeda, SEC Commissioner

Mr. William Birdthistle, Director, Division of Investment Management