Statement for the Record

On Behalf of the

American Bankers Association

before the

House Financial Services Committee

April 18, 2023

The American Bankers Association (ABA) appreciates the opportunity to provide a Statement for the Record for this hearing, "Oversight of the Securities and Exchange Commission." ABA is the voice of the nation's $23.6 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $19.2 trillion in deposits, and extend $12.2 trillion in loans.

ABA appreciates the Committee's decision to hold this oversight hearing, which we understand is intended to review and assess the announced goals and recent regulatory actions of the Securities and Exchange Commission (SEC). We believe that the SEC plays a critical role in protecting investors, in maintaining fair, orderly, and efficient markets, and in facilitating capital formation. Unfortunately, the SEC has departed from those objectives by rewriting a broad range of rules governing institutional and retail brokerage, advice, and investing, often with no prior reaction or input from affected parties or from the general public, threatening the very fabric of the smooth and proper functioning of the financial markets. We look forward to the Committee's deliberations at this hearing and its subsequent actions to address these areas of concern.

The SEC has recently proposed[1] a complex and overly broad rule that would result in a fundamental shift in the bank custody model, to the detriment of markets and investors, including the retail investing public. The banking industry provides many essential economic and market functions, including the provision of custody services that are critical to the functioning of the U.S. and global financial markets. Banks have long offered safe, well-managed, and regulated custody services, providing a key source of efficiency to the financial ecosystem and ensuring high levels of investor protection. Yet, the SEC neither considers or accommodates the safety and soundness of the existing bank custody model, nor does it highlight specific deficiencies in this model. ABA is concerned that the SEC has not issued a problem statement with the well-established bank custody model that warrants broad structural changes to how custody banks provide traditional custody services. The ABA is also concerned that the proposed rule's requirements as to digital asset custody will limit, in practice, the ability of custody banks to actually offer digital asset custody services at scale.

More broadly, ABA continues to be concerned about the volume of significant rulemaking that the SEC is undertaking with implications for the banking industry, with very limited comment periods and with no publicly stated discernment from SEC staff on the cumulative impact these concurrent, major rulemakings – once finalized – will have on financial markets and on SEC-

[1] 88 FR 14,672 (March 9, 2023).

regulated persons and entities. To the extent impacts are mentioned in the SEC Proposal, many are premised on incorrect assumptions regarding current practices and the state of the law. We believe that these incorrect assumptions mean the SEC has failed to appreciate the scope and scale of the actual impact of the proposed rule on the custody of customer assets or whether custody in some cases could be provided at all.

Overview of custody services

Custody banks provide services to institutional investors, including asset managers, mutual funds, retirement plans, insurance companies, governments, corporations, endowments, other financial institutions, or large private investors. Typically, custody services include the settlement, safekeeping, payments & liquidity services, and asset servicing (e.g., tax services, corporate action processing etc.) at scale across multiple markets globally and at relatively low cost. These services are provided either directly or through other intermediaries to institutional investors to help support their goals associated with protecting the wealth and financial stability of their end investor clients, including those saving for retirement and retail investors more broadly.

The custody relationship is driven by a contractual arrangement between custody banks and institutional investors, which sets out the scope of the various services that will be provided, the standard of care that the custody bank will exercise in carrying out its duties, and the governing law of the contractual relationship.[2] The custody function is designed to protect investor assets from misappropriation or loss, and to provide investors with access to markets globally. The securities held in custody belong to the client and are segregated from the custody bank's own assets to ensure that they are bankruptcy remote in the event of insolvency. As such, client securities cannot be used to satisfy the claims of the custody bank's creditors. Broker-dealers and futures commission merchants are also permitted to offer custody services, but they do so with different supporting regulatory regimes than custody banks and indeed, many institutional investors prefer to use custody banks to safeguard their assets.

Industry practice relating to the safekeeping of client securities has developed over time, based on the requirements of Article 8 of the UCC and the obligations found in Rule 206(4)-2 of the Investment Advisor Act of 1940 ('custody rule') and Section 17(f) of the Investment Company Act of 1940 (viewed as the 'gold standard' for custody).[3]

[2] This structure is supported by Article 8 of the Uniform Commercial Code (UCC), where custodians are treated as 'securities intermediaries'; Article 8-503(a) provides that financial assets held by a securities intermediary for customers ('entitlement holders') are not property of the securities intermediary (i.e. custodian) and are not subject to claims of creditors of the securities intermediary.[2] Under Article 8-102(9), a 'financial asset' includes any property that is held by a securities intermediary for another person in a 'securities account' if the parties have expressly agreed that the property is to be treated as a financial asset under Article 8.

[3]The legislative history of the '40 Act indicates that banks were viewed as appropriate custodians for mutual fund assets and that there was no effort to impose specific, additional requirements on bank custodians, likely reflecting the view that the existing regulatory regime for banks would adequately safeguard mutual fund assets.

The SEC's proposal does not accommodate the custody bank model

As part of their service, custody banks provide various banking services to their custody clients, such as intraday and overnight liquidity and FX services to help clients smoothly manage investment activities, and to reduce their settlement risk such as access to Continuous Linked Settlement for FX. Custody banks accept cash that arises in connection with the provision of custody services. The cash, which banks treat as a general deposit, is a necessary byproduct of the clients' investment activity and generally represents a small proportion of the total value of assets held in custody. Unlike clients' securities holdings, however, cash is reflected on the balance sheet of the custody bank as a deposit liability, just as with any bank deposit.

Under the SEC proposal, a bank wishing to serve as a "qualified custodian" for investment advisor client assets, would need to segregate client cash in an account whose terms 'identify clearly that the account is distinguishable from a general deposit account' so that client assets (including cash) are protected 'from creditors of the bank in the event of their insolvency or failure.' In essence therefore, the SEC proposal does not differentiate between deposits, which banks are uniquely capable of holding on their balance sheets, and securities, which are always segregated from proprietary assets. Altering the current bank custody model in this way would be very disruptive to the orderly functioning of the US markets, introduce new risks to the financial system and materially increase investor costs.

Deposits are the primary funding source of traditional bank lending and of custody related services that are critical drivers in the stability and efficiency of our financial markets. Any reduction in custody banks' deposit base would quickly impact markets and investors in the form of reduced credit and liquidity, undermining the goal of market efficiency and undercutting access to the capital markets. These impacts are likely to be significant and would also undermine the economics of the custody business model – which relies on narrow revenue margins – with profound implications for the United States and global financial markets. If finalized, the SEC's proposed rule would deeply impact the global competitiveness of US investment advisers and US custody banks, which are among the largest and most successful providers in the world. Moreover, for those banks who provide custody services as part of a broader range of businesses, these deposits may also be deployed to support the US economy, through providing financing to corporations, federal, state and local governments, and to individuals with loans for homes, autos, and growing a small business.

Modern custody banking services have been offered for 80+ years, with enormous success. The success of this model and the critically important role of custody banks in global markets should be encouraged rather than undermined by regulation.

The regulation of banks is not within the SEC's mandate

Custody banks are subject to stringent prudential regulation, including capital, liquidity, stress testing, and other financial resiliency requirements; cyber security and other operational resiliency obligations, recovery and resolution planning mandates; and anti-money laundering and financial crimes regulation. Moreover, custody banks are subject to ongoing supervisory oversight and review by dedicated teams of on and off-site examiners. To comply with both regulations and supervisory expectations, custody banks have implemented and operate robust

risk management and control frameworks which address, among other matters, the monitoring and management of capital and liquidity, counterparty due diligence practices, information systems and controls, third-party risk management practices, and the maintenance of AML and other financial crimes compliance infrastructure.

Even if cash deposits of investment advisor clients could be insulated from the failure of a custody bank, the claims of these depositors would then rank ahead of the claims of ordinary retail depositors and the FDIC in the event of a bank insolvency. In essence therefore, the proposed rule would create a special depositor preference for institutional and high net worth investors that utilize an investment advisor. This 'super class' of bank creditors would stand ahead of other depositors, raising the cost of resolving a failed depository institution and ultimately putting institutional investors ahead of retail deposit holders. In fact, the proposed rule directly contradicts the Federal Deposit Insurance Act. The SEC lacks statutory authority to impose standards on the administration of bank insolvency and receivership, and may not do so through rulemaking. Moreover, the authorization and supervision of banks (including custody banks) lies with OCC, the Federal Reserve and in some cases state regulators.

The SEC's proposal would shift risk to custody banks on matters beyond their control

The SEC's proposal would require a custodial bank to provide investment advisers "reasonable assurances in writing" that it will exercise "due care in accordance with reasonable commercial standards in discharging its duty as custody bank and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss." Further, the proposal would require the custodial bank to indemnify the adviser with relevant insurance arrangements with respect to the custodial bank's own negligence. As the proposal does not allow "sub-custodial, securities depository, or other similar arrangements" to excuse a custodial bank from its safeguarding obligations, it could also force a custodial bank to be liable for the misconduct of these entities. This is most apparent for depositories, which are highly regulated public market infrastructures servicing the entire market, and which custody banks have no control over or ability to select. Although some of these requirements may appear reasonable on their face, their collective effect could be a significant, and inappropriate, shifting of risk from investment advisers to custody banks.

The SEC has provided insufficient economic impact analysis

The SEC has not conducted a complete or accurate evaluation of the economic consequences of the proposed rule. The proposed rule states that "the Commission is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges of costs."[4] The omission of any discussion of the operational, systemic, and financial effects of the proposed rule is highly problematic and suggests that the consequences are significant and are likely to heavily weigh against the adoption of the rule as proposed. Among those, the complete absence of any economic evaluation of changes to the cash account model and the custodian indemnification requirements, both of which are very impactful, is noted and needs to be addressed. The SEC must remedy this data gap before it proceeds with any rulemaking.

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[4] 88 FR 14,732 (March 9, 2023)

The cumulative impact of SEC rulemakings is unknown

The SEC has taken on an ambitious, unrelenting volume of rulemakings, simultaneously tackling issues that could result in significant shifts in financial markets. Moreover, these initiatives often have broad implications for prudentially regulated entities and there is very little indication that the SEC has coordinated with their banking agency counterparts to ensure appropriately designed policy solutions. These include proposals and requests for information regarding:

- Shortening the settlement cycle;
- Climate-related disclosures;
- Special Purpose Acquisition Companies (SPACS);
- Money market fund reforms;
- Short sale reporting proposal;
- Securities lending proposal;
- Applying new rules to digital engagement practices (request for information);
- Broad new disclosure obligations for private funds and requirements for fund advisers;
- Amendments to Commission Rule 3b-16 (the definition of "Exchange") and Regulation ATS for ATSs that trade U.S. government securities, NMS stocks, and other securities;
- New cybersecurity risk management rules;
- First time reporting obligations for security-based swaps (SBS);
- New anti-fraud/anti-manipulation requirements for SBS;
- First time reporting obligations for large SBS positions;
- Further defining the terms dealer and government securities dealer along with related registration requirements; and
- Significant amendments to beneficial ownership reporting rules
- Establishment of a federal "best execution" standard for customer securities transactions

Given the significance of this suite of proposed changes, it is unclear to anyone – including the SEC – how markets will react and evolve, and how market participants will perform if these proposals are implemented. Furthermore, it is also unclear whether these changes will lead to inconsistent, duplicative, and/or conflicting regulatory requirements. As a number of trade associations have repeatedly pointed out to Chairman Gensler,[5] sufficient time for meaningful public input into individual proposals given the possible interconnectedness of these proposals is vitally important for initiatives of broad applicability that ultimately could have a significant impact on savers, investors, capital formation, and economic growth.

As an example, the SEC's proposal on climate-related disclosures goes far beyond the SEC's mandate to protect investors. It ignores the long-held definition of materiality and it requires systems that are simply not scalable to the size and complexity of the registrant. As ABA has

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[5] Joint Trade Association Letter to the SEC Importance of Appropriate Length of Comment Periods https://www.aba.com/-/media/documents/letters-to-congress-and-regulators/jointltrsec20220405.pdf?rev=04788376baf54d67811586df009053a9; Joint Trade Association Letter to the SEC to Request an Extension of the Comment Period for the Safeguarding Advisory Client Assets proposal. https://www.aba.com/advocacy/policy-analysis/sec-extension-advisory-client

noted in comments[6] on the proposal, a final rule must also limit disclosure requirements for Scope 3 greenhouse gas emissions to those material to a registrant's publicly announced climate-related goals and it should provide sufficient safe harbors and transition time, given the nascent state of climate-related financial risk management. As it is unclear how specific greenhouse gas information will provide benefits to investors that exceed its significant costs, the changes necessary to the proposed rule to address these issues will require withdrawal and reproposal of the rule.

Conclusion

America's banks are committed to competitive, secure, and efficient markets. Custody banks are critical to market functioning and investor protection, acting as a key source of efficiency, expertise, and stability to global financial markets. Once again, we are pleased to provide these comments to the Committee and our members stand ready to provide their perspectives on any of the comments raised.

[6] ABA comment letter to the SEC on the proposed rule, The Enhancement and Standardization of Climate-related Disclosures for Investors. https://www.aba.com/advocacy/policy-analysis/letter-to-sec-on-climate-related-disclosures-proposal