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VIA ELECTRONIC MAIL

May 8, 2023

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

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

Dear Ms. Countryman:

On February 15, 2023, the Securities and Exchange Commission ("SEC" or "Commission") proposed to amend and redesignate Rule 206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940 ("Advisers Act") as Rule 223-1 under the Advisers Act ("Proposed Rule"), which would be retitled "Safeguarding Client Assets", as well as companion amendments to Rule 204-2 under the Advisers Act (the "Recordkeeping Rule") and Form ADV under the Advisers Act (collectively, the "Safeguarding Proposal"). The Safeguarding Proposal was published in the Federal Register on March 9, 2023.[1]

Eversheds Sutherland is submitting this comment letter on behalf of several of its clients which serve as custodians to retail advisers (collectively, "Retail Adviser Custodian Consortium" or "Consortium"). More specifically, this group serves as custodians to registered advisers which provide a range of investment advisory services, including discretionary advisory services, to a variety of retail clients ("Client Advisers").

Summary of the Proposed Amendments

While the SEC's treatment of digital assets in the Safeguarding Proposal has attracted much of the public's focus, the Safeguarding Proposal would have far broader impacts on registered investment advisers, custodians and auditors if enacted. Among other things, the Safeguarding Proposal would:

- expand the scope of assets subject to the Proposed Rule to encompass all assets regardless of whether they are funds or securities, including crypto assets, derivatives and physical assets;

[1] *Safeguarding Advisory Client Assets*, Investment Advisers Act Rel. No. 6240 (Feb. 15, 2023), 88 FR 14672 (Mar. 9, 2023) (File No. S7-04-2023) (available at https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf) ("Proposing Release").

- greatly increase the number of investment advisers deemed to have custody of client assets by treating discretionary authority as a form of custody;
- require investment advisers to enter into contracts with qualified custodians holding their clients' assets ("qualified custodians") that include various specified terms;
- require investment advisers to obtain "reasonable assurances" in writing that qualified custodians will provide certain "minimum investor protection elements" for their clients;
- require client custodians to obtain internal control reports from independent auditors annually (regardless of whether they have related person custody) and provide them to the investment advisers who have custody of the client assets they maintain;
- narrow the scope of the Custody Rule's exemption for so-called "privately offered securities," but also expand its scope so that physical assets can qualify;
- require investment advisers to maintain a host of new records relating to the custody of their clients' assets pursuant to certain amendments to Rule 204-2 under the Advisers Act; and
- require advisers to disclose additional information on Form ADV relating to their custody practices, including, among other things, their basis for having custody of client assets.

Comments on the Proposed Amendments

The Consortium's comments address whether there is a true necessity for the Safeguarding Proposal, and whether the Safeguarding Proposal's projected impact on investor protection is appropriately aligned with the anticipated substantial burden and cost for investment advisers and custodians to come into compliance. The Consortium's letter focuses on four specific areas which are summarized below. We believe each of these areas deserve further examination.

- The Safeguarding Proposal's new custodial protection requirements would significantly increase costs for advisers and custodians. These requirements would apply not only to assets over which an adviser has discretionary authority, but also to assets over which an adviser may deduct fees or has a standing letter of authorization.

- The expansion of the definition of custody to include discretionary authority, along with the obligations that would apply to advisers and custodians with respect to these assets, would significantly increase costs for advisers and custodians. We expect that a significant percentage of these costs would be passed on to retail clients – costs that do not appear to be justified by any significant incremental investor protection benefit.

- The economic analysis conducted by the SEC is flawed. We believe the Safeguarding Proposal would result in substantial burdens on SEC-registered investment advisers and custodians without a corresponding investor protection benefit.

- If adopted, the SEC should provide a 24-month compliance and transition period for all advisers.

We also endorse the comments regarding the Safeguarding Proposal included in the letter of the Investment Adviser Association dated May 8, 2023, and the letter of the Securities Industry and Financial Markets Association Asset Management Group dated May 8, 2023.

I. The Safeguarding Proposal's Custodial Protection Requirements Would Significantly Increase Costs for Advisers and Custodians With No Significant Investor Protection Benefits.

One of the most significant changes in the Proposed Rule is the proposed requirement that investment advisers maintain their clients' assets with a qualified custodian pursuant to a written agreement with the custodian. The Proposed Rule would require that custody agreements contain at least the following four provisions:

- a requirement that the custodian "provide promptly, upon request, records relating to the clients' assets held in the account at the qualified custodian" to the SEC or auditors conducting examinations in keeping with the Proposed Rule;
- a specification regarding the investment adviser's level of authority to effectuate transactions in its client's account;
- a requirement that the custodian provide account statements to both the investment adviser and its client on whose behalf the custodial account is kept; and
- a requirement that the custodian annually obtain and provide to the adviser a written internal control report containing the opinion of an independent public accountant regarding the adequacy of the custodian's controls.

The Proposed Rule would also require the investment adviser to arrive at a reasonable belief that the qualified custodian has implemented these provisions from the required agreement.

Beyond these provisions, the Proposed Rule would also require an investment adviser to obtain from the qualified custodian "reasonable assurances" in writing, and maintain an ongoing reasonable belief of compliance with such reasonable assurances, that the qualified custodian responsible for maintaining the client's assets will provide certain "minimum investor protection elements" for advisory clients, including that the custodian will:

- exercise due care (in accordance with reasonable commercial standards) in discharging its duty as custodian, and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other, similar types of losses;
- indemnify the client against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct;
- not be excused from its obligations to the client as a result of any sub-custodial or other similar arrangement;
- clearly identify and segregate client assets from the custodian's assets and liabilities;
- not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed upon or authorized by the client in writing; and
- keep records related to the client's assets.

We note that these requirements would apply not only to advisers who are deemed to have custody of client assets under the current Custody Rule, but would also apply to advisers who would be deemed to have custody by virtue of their discretionary authority. The proposed requirements would represent a significant time and cost burden upon Client Advisers and Consortium members while delivering minimal investor protection benefits relative to current practice. We further expect that Consortium members will seek to pass on to Client Advisers and retail custodial clients.

In our view, there are several reasons why this proposal is wholly unnecessary. Even in instances in which an adviser may have custody under the current Custody Rule, these requirements would represent a sea change in business practices, which is likely to create increased expenses for advisers and custodians, who, in turn, are likely to seek to pass through as much of the increased expense to clients as is possible. And while it may be desirable in theory for custodians to enter into an agreement with investment advisers that would include the four required provisions and for advisers to obtain the requisite reasonable assurances from custodians, the SEC has failed to produce any empirical evidence that demonstrates actual, tangible harm to clients because these protections were not in place.

The SEC also appears not to have contemplated the possibility that, in instances in which a custodian's primary regulator is not the SEC, the primary regulator may be unwilling to permit the custodian to agree to these provisions, or may impose its own added restrictions on custodians that do agree to these provisions and reasonable assurances. For example, a primary regulator that is concerned with the safety and soundness of a custodian may determine that the liability standards that the SEC seeks to impose would require the custodian to hold additional regulatory capital by virtue of its increased contingent liabilities.

Consortium members believe that coordination between the SEC and a custodian's primary regulator is desirable from the standpoint of good regulatory practice. In this regard, we note that more than 40 years ago, Congress enacted legislation to encourage various financial regulators to coordinate with one another.[2] More recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") created the Financial Stability Oversight Council ("FSOC"). The Dodd-Frank Act assigned to FSOC several responsibilities to monitor and promote financial stability, including facilitating information sharing and coordination among FSOC member agencies and other federal and state agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions. While the Safeguarding Proposal is not a rulemaking that is under the jurisdiction of the FFIEC or FSOC, Consortium members nonetheless believe that regulatory coordination with custodians' primary regulators is consistent with Congress' longstanding preference for coordination among financial services regulators.

Because the proposed custodial protection requirements would apply even in instances where an adviser's custody is limited to discretionary authority, could have knock-on effects for the relationships between custodians and their primary regulators and because no evidence has been offered to demonstrate abuses that have taken place as a result of these protections not being in place, we urge the SEC not to adopt this proposal.

II. Expanding the Definition of Custody to Encompass Discretionary Authority Will Significantly Increase Costs With No Significant Investor Protection Benefits.

For the most part, Consortium members serve Client Advisers who are deemed to have custody of client assets largely by virtue of their authority to make withdrawals from client

[2] Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA) (Public Law 95-630) established the Federal Financial Institutions Examination Council ("FFIEC"). The purpose of the legislation was to create a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the constituent agencies, and to make recommendations to promote uniformity in the supervision of financial institutions.

accounts to pay their advisory fees or due to standing letter of authorizations to move money. If the Proposed Rule is adopted, Client Advisers will be deemed to have custody of a larger percentage of client assets because they possess discretionary authority – the authority to decide which assets to purchase and sell for their clients. The Proposed Rule would exempt an investment adviser with discretionary authority from its surprise audit requirements in connection with client assets over which the adviser has discretionary authority, but which settle on a delivery-versus-payment ("DVP") basis. However, the Proposed Rule would still apply its other custody requirements to advisers with discretionary authority.

The SEC justifies this expansion of the definition of custody by arguing that:

> [D]iscretionary authority presents the types of risks the rule is designed to address. 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.[3]

We disagree with the SEC's view of the possible risks that discretionary authority presents. We note that, as Congress considered the legislation that eventually was enacted as Section 411 of the Dodd-Frank Act,[4] it cited the written testimony of Professor John Coffee submitted to the Senate Banking Committee:

> [T]he custodian requirement largely removes the ability of an investment adviser to pay the proceeds invested by new investors to old investors. The custodian will take the instructions to buy or sell securities, but not to remit the proceeds of sales to the adviser or to others (except in return for share redemptions by investors). At a stroke, this requirement eliminates the ability of the manager to recycle' funds from new to old investors.[5]

We agree with Professor Coffee that an independent custodian largely prevents an investment adviser from converting the proceeds of client securities sales to its own use or diverting the proceeds to other parties. We believe that the Proposing Release's examples implicitly endorse Professor Coffee's views, because they involve situations in which a custodian does not safekeep a security.

Moreover, the scenarios set forth in the Proposing Release are unlikely to be remedied by the Proposed Rule, precisely because they involve situations in which assets are not held by an independent custodian. The Proposed Rule would continue to continue to permit shares

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[3] *Proposing Release*, *supra* note 1, 88 FR at 14680.

[4] Section 411 of the Dodd-Frank Act added Section 223 to the Advisers Act. That section gives the SEC authority to adopt rules requiring registered investment advisers to take steps to safeguard all client assets, not just funds and securities, over which an adviser has custody. *Id.*, 88 FR at 14674.

[5] *Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, pp. 8,10 (2009) (Testimony of Professor John Coffee).

of an open-end investment company ("Open-End Fund")[6] to be custodied with the Open-End Fund's transfer agent rather than a qualified custodian. Thus, a Client Adviser with discretionary authority over Open-End Fund shares could continue to issue instructions to the Open-End Fund's transfer agent without the knowledge of the client or a Consortium member. Similarly, as the SEC acknowledges elsewhere in the Proposing Release, loan participation interests may not involve a qualified custodian.[7] To the extent that such interests would continue to qualify for the privately offered securities exception, a Client Adviser with discretionary authority over loan participation interests could continue to issue instructions to the loan syndicate administrator without the knowledge of the client or a Consortium member.

Outside of these scenarios, we believe that instances in which an adviser could use its discretionary authority to sell its client's interest and to direct the cash proceeds of the sale to an account that the adviser owns and controls would be limited to scenarios in which the adviser has custody of client assets by virtue of possessing client assets. If an adviser does not actually possess client assets, it would not be able to utilize its discretionary authority to cause the cash proceeds of a sale of client assets to be diverted to its own control or the control of another party. Because the Proposed Rule would not prevent the practices identified by the SEC as concerns, and is unnecessary to prevent assets (other than Open-End Funds or privately offered securities) for which an adviser has discretionary authority from being sold and having the proceeds unlawfully converted, we urge the SEC not to adopt this proposal.

III. The Economic Analysis Conducted by the SEC is Flawed.

The SEC's economic analysis and related Paperwork Reduction Act estimates materially understate both the amount of time and the related costs of the proposed amendments. The understatements begin with the SEC's estimate of the number of qualified custodians that would be required to enter into agreements with advisers. The Proposing Release states that "[b]ased on the information currently reported by advisers about qualified custodians on in Item 9.F of Form ADV, we estimate that each adviser would enter into approximately 4 written agreements."[8] The SEC justifies the estimate by stating that:

> This estimate is based on responses to Form ADV, Part 1A, Item 9.F, which requires advisers to report the number of persons acting as qualified custodian. For all advisers responding to this question, the average number of persons acting as qualified custodians amounted to 4. We believe that it is possible that the proposed rule could result in advisers entering into agreements with a greater number of qualified custodians for custody services related to assets that advisers may not currently maintain with a custodian. At the same time, we believe that it is possible that current custodians will expand their services in order to provide custody services for asset types that they do not currently maintain for advisers. As a result, for the purposes of this analysis, we will rely on the average obtained from Form ADV Part 1A, Item 9.F. data.[9]

[6] While the rule defines such companies as mutual funds, an open-end company is not so limited, and would include shares of exchange-traded funds registered as open-end companies.

[7] *Proposing Release*, *supra* note 1, 88 FR at 14677.

[8] *Proposing Release*, *supra* note 1, 88 FR at 14763.

[9] *Id.*, 88 FR at 14763 n. 590.

Yet, this estimate fails to take into account the likelihood that the expansion of the definition of custody to encompass discretionary authority will markedly increase the number of custodians per investment adviser.

Similarly, the SEC's estimate of the total number of initial agreements between advisers and custodians that would be required under the Proposed Rule is flawed. The SEC estimates that "initially, advisers would enter into a total of 55,776 written agreements."[10] The SEC arrives at this estimate by multiplying the number of investment advisers who report on Form ADV, Part 1A that they or a related person have discretionary authority to determine the securities to be bought or sold for a client's account – 13,944 – by the number of primary custodians per adviser currently reported on Form ADV, Part 1A – a population that would exclude advisers that would be subject to the Proposed Rule solely because they have discretionary authority.[11] Nowhere does the SEC explain – or even attempt to explain – why advisers with discretionary authority should be presumed to have the same average number of primary custodians as advisers who are deemed to have custody under the current Custody Rule.

Moreover, the estimate is flawed because it fails to take into account the number of advisers that have custody under the current Custody Rule but that do not currently have agreements with their clients' primary custodians. This population would also be required to enter into initial agreements with their primary custodians. Nor does the estimate take into account the number of advisers who currently have custody under the current Custody Rule and who have agreements with primary custodians, but would have to amend their agreements to bring those agreements into conformity with the Proposed Rule.

The estimates with respect to the Proposed Rule's requirements that an adviser obtain reasonable assurances in writing from each qualified custodian regarding certain client protections and that an adviser notify its client in writing promptly upon opening an account with a qualified custodian on its behalf, which notification includes the custodial account number, are similarly flawed. Each of those estimates, like the agreement estimate, takes into account only the advisers who would be deemed to have custody under the Proposed Rule by virtue of their discretionary authority.[12] The account opening estimate is further flawed because it assumes that all advisers that would be subject to its provisions are already subject to the account opening notice requirements under the current Custody Rule.[13] But that cannot be the case given the number of advisers who are not subject to the requirements of the current Custody Rule who would become subject to the Proposed Rule solely by virtue of their discretionary authority.

Furthermore, we believe that the estimate that each investment adviser and each qualified custodian that enters into an agreement would incur an internal burden of only one hour each to prepare the written agreement is a gross underestimate of the time that it would take to negotiate these agreements. By contrast, we note that when the SEC adopted Rule 22c-2 under the Investment Company Act of 1940, it estimated that all mutual funds would be required to modify their agreements or contracts with intermediaries in order to comply with that Rule's requirement that funds and intermediaries enter into written agreements under

[10] *Id.*, 88 FR at 14763.
[11] *See id*.
[12] *See id.,* 88 FR at 14764 nn. 619, 624.
[13] *Id.,* 88 FR at 14764.

which the intermediary agrees to provide certain shareholder identity and transaction information upon request by the fund.[14] The SEC later modified the requirement, and noted that "industry representatives are working together to develop a uniform set of model terms, and anticipate that such model terms may significantly reduce the costs related to developing individualized agreement terms for each fund and intermediary."[15] Even with the uniform set of model terms, the SEC estimated that it would take an average fund complex five hours to prepare the model agreement, or provisions modifying a preexisting agreement, between the fund and the intermediaries. [16] By contrast, there is no evidence that industry representatives are collaborating to develop a uniform set of model terms for these agreements. Yet the SEC estimates that negotiating bespoke agreements between an adviser and a primary custodian will take less time than negotiating uniform agreement with model terms. We would assert that it will take far longer for advisers and custodians to negotiate bespoke agreements than it took fund complexes and intermediaries to negotiate uniform agreements with model terms.

IV. If Adopted, the SEC Should Allow a 24 Month Transition Period.

The Proposing Release would require advisers to comply with the Safeguarding Proposal starting one year following the rules' effective dates, which would be sixty days after the date of publication of the final rules in the *Federal Register* for advisers with more than $1 billion in RAUM. For advisers with up to $1 billion in RAUM, the SEC proposed that the compliance date of any adoption of the Safeguarding Proposal occur 18 months following the rules' effective dates. The SEC requested comment in the Proposing Release on this transition period is appropriate.

Given the substantial impact that the Safeguarding Proposal would have on advisers' relationships with their clients' custodians, the Consortium strongly believes that the SEC should consider a more reasonable, and practicable, 24-month compliance period. This would allow custodians and advisers to, among other things, include the resulting costs in their annual budgets, develop necessary compliance programs, hire necessary personnel, and train their staff. In addition to providing ample time for custodians and advisers to include the costs of compliance in their annual budgets, there are practical considerations for the Consortium's request that the SEC consider a longer compliance period. Consortium members are unlikely to use a bifurcated implementation approach to support small and large advisors. Consortium members will need to ensure that all agreements, systems, and processes are sufficiently upgraded to support the shortest implementation period impacting advisers (i.e., 12 months). Staggered implementation simply is not feasible or practical and would, furthermore, create uncertainty for advisers that are on the cusp or just under the $1 billion threshold or contemplating a merger or acquisition that may close during the transition period.

Should the SEC advance this proposal, the Consortium recommends a 24-month transition period for all advisers.

V. Conclusion

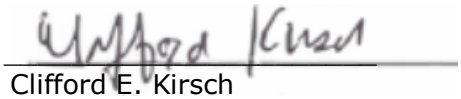
The Consortium is committed to constructive engagement in the regulatory process and welcomes the opportunity to work with the SEC on this and other regulatory efforts. Thank

[14] *Mutual Fund Redemption Fees*, Investment Company Act Rel. No. 26782 (Mar. 11, 2005), 70 FR 13328, 13339.
[15] *Mutual Fund Redemption Fees,* Investment Company Act Rel. No. 27504 (Sept. 27, 2006), 71 FR 58257, 58265.
[16] *Id.*, 71 FR at 58268.

you for considering the Consortium's comments. Should you have any questions, please contact Clifford Kirsch at [redacted] or Ethan Corey at [redacted].

Respectfully submitted,

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