U.S. Chamber of Commerce

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May 8, 2023

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

Re: Proposed Rule, Securities and Exchange Commission; Safeguarding Advisory Client Assets (88 Fed. Reg. 14,672-14,792, March 9, 2023)

Dear Ms. Countryman:

The U.S. Chamber of Commerce's ("Chamber") Center for Capital Markets Competitiveness appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission ("Commission" or the "SEC") that would redesignate and amend the current custody rule[1] covering the investment adviser safeguarding of client funds and securities as new rule 223-1 (the "Safeguarding Rule" or the "Proposal")[2] under the Investment Advisers Act.

Client assets should be safeguarded so that those assets are not lost or misappropriated. The Commission, however, has not demonstrated any pervasive weakness of the existing custody rule that would warrant the disruptive and costly rewrite of the current custody framework. While certain targeted changes to the current rule may be appropriate, this Proposal significantly expands the scope of assets to be safeguarded and the obligations of investment advisers, custodians, and independent public accountants in such a way that is complicated, overly proscriptive, costly, and will disrupt significant markets that are already subject to comprehensive regulation.

Under the Proposal, an investment adviser cannot trade an asset if the qualified custodian is not able to safeguard it. However, many of the provisions are unclear or unworkable when applied to the expanded scope of assets under consideration. Requiring the segregation of assets is inconsistent with current and legitimate business practices wherein banks treat deposits as general deposits of the bank and prime brokerage accounts are allowed

[1] Rule 206(4)-2 of the Investment Advisers Act of 1940. Originally adopted in 1962 and updated in 2003 and 2009. Section 223 of the Advisers Act was added in 2010 by the Dodd-Frank Act requiring an investment adviser to take steps to safeguard client assets over which it has custody and to verify assets by an independent public accountant, as proscribed by the Commission, 17 CFR 275.223.

[2] Securities and Exchange Commission, Release No. IA-6240; File No. S7-04-23 (March 9, 2023), available at https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

to rehypothecate client assets. Furthermore, the Commission's new requirements for foreign custodians will likely prevent registered advisers from investing in important foreign markets. Since the new rules would insert an investment adviser into a relationship that is today one between a client and a custodian, implementing the Proposal would require a monumental undertaking as hundreds of custody and trading agreements would have to be renegotiated at the expense of clients. The costs associated with the Proposal would be massive and the burdens numerous, for little (if any) incremental benefit. Compliance would be especially costly for small investment advisers and their retail investor clients. Ultimately, the Safeguarding Rule will interfere with an underlying client's ability to engage preferred service providers and to invest in preferred asset types and domiciles.

The Commission has rushed the rulemaking and short-changed its due diligence process. The Commission failed to analyze the impact of the Proposal on various markets, or even consider how the rule could be applied to important asset classes. The economic analysis itself is deficient and massively understates the costs to advisers and their clients. The Commission also failed to provide clear justification for the extensive changes recommended in the Proposal. Investment advisers take their legal obligations to their clients seriously. The Proposal does not provide compelling evidence to show that investment advisers are currently failing in their obligation to safeguard securities and funds. Even more troubling is that the SEC is attempting to regulate beyond its jurisdiction by recommending new investment adviser requirements that exceed their authority to compel information or actions from a custodian.

We also remain concerned about the limited amount of time the public has to submit *meaningful* and *thoughtful* comments on such a consequential rulemaking proposal, especially when considering the number of concurrent open rulemaking proposals that divide our attention. As the Chamber has argued in several comment letters to the Commission, the limitation on public feedback on rule proposals undermines the rulemaking process and increases the likelihood that final rules will cause unintended and harmful consequences for the capital markets and the economy.

Like many of the Commission's proposals, this Proposal's cost-benefit analysis is wholly inadequate and does not meet the standard imposed on the Commission by law. The current regulatory agenda has proposed twice as many rules as the Commission under the previous Administration, with most of the rules recommending unreasonably short implementation periods given the multitude of technical and time-consuming changes the affected parties would be required to undertake. As the Commission's unprecedented barrage of rulemaking continues, it is increasingly irresponsible of the Commission to fail to conduct and publish a comprehensive cost-benefit analysis that considers the collective burden of the rulemakings. As part of a holistic review of its policymaking agenda, the Commission should also be fully evaluating how the various proposals interact to minimize confusion and ensure there are no unintended consequences.

For all these reasons, the Chamber recommends that the SEC withdraw the Proposal while it considers a more workable update of the custody rules for investment advisers, custodians, and independent public accountants.

The Chamber provides the following observations regarding the Proposal:

1. **The Proposal inappropriately expands the scope of assets required to be safeguarded by investment advisers and applies unworkable provisions to dissimilar assets.**

2. **The Commission has failed to present clear evidence to justify the breadth of the rulemaking and makes recommendations that are beyond its authority.**

3. **The new safeguarding responsibilities are impractical and may negatively impact smaller advisers and market efficiency.**

4. **The segregation of assets is unworkable for banks and savings institutions who seek to serve as qualified custodians.**

5. **The new requirements for Foreign Financial Institutions seeking to serve as qualified custodians will likely prevent registered advisers from investing in important foreign markets.**

6. **The new obligations for independent public accountants unnecessarily expand their scope of work and are complex and costly.**

7. **The Commission has again provided the public an insufficient amount of time to comment on substantive changes in regulation and has failed to consider the cumulative economic impact of its current regulatory agenda.**

Discussion

1. The Proposal inappropriately expands the scope of assets required to be safeguarded by investment advisers and applies unworkable provisions to dissimilar assets.

The Proposal expands the application of the custody rule from securities and funds under the current rule to all assets. Such widespread expansion is a major departure from the longstanding precedent of the original custody rule of 1962, and as updated during 2003 and 2009, that applied custody regulation to securities and funds only. Under the Proposal, investment advisers who have custody of client assets – to the extent they have possession or control of the assets such that it has the authority to effect change in beneficial ownership of a client's assets – would be required to maintain those assets with a qualified custodian.

In addition to expanding the scope of the assets covered by the safeguarding rule, the Commission seeks to apply a single set of rules to the widespread variety of covered client assets. However, the Commission has not conducted a rigorous analysis that takes into account how custody and compliance would function on an asset-by-asset basis. The lack of granularity makes the Proposal confusing and unworkable. Under the rule, an investment adviser cannot trade an asset if the custodian is not able to safeguard it. However, the expansion of assets covered by the rule combined with the directive to maintain "possession and control" creates a challenge for investment advisers as they consider how to apply broadly developed rules that do not always make sense for such wide-ranging financial instruments. Not only would the Proposal's confusing and complicated requirements result in less efficient markets for some of those assets, but it would effectively prevent investment advisers from investing in significant markets that are already subject to comprehensive regulation. As examples, we highlight below several specific areas of concern.

Commodities: The Proposal is unworkable for commodities, many of which are essential to the U.S. economy. For example, advisers to pooled vehicles trade commodities such as energy as part of their investment strategies. These markets are already subject to comprehensive regulation, including by the Federal Energy Regulatory Commission ("FERC"), and existing regulations set forth complex standards around pipeline storage and title transfer. Requiring auditors to verify each of these transactions is unworkable, and could have significant impact on liquidity and efficiency, which would likely negatively affect the broader U.S. economy.

Derivatives and repurchase agreements: The Commission has not meaningfully attempted to evaluate the impacts of the Proposal on derivatives instruments, such as swaps and commodity futures, and repurchase agreements. There are only six references in the proposal to swaps, four of which have nothing to do with how those instruments would function under the new safeguarding regime. Furthermore, the Proposal makes no reference to repurchase agreements, an important financial instrument that could be impacted significantly by this Proposal.

Under the Proposal, investment advisers would have to maintain swap contracts with a qualified custodian, who, in turn, would need to maintain possession or control over the swap contract. However, application of the safeguarding rule to derivatives products would introduce inefficiencies and complexity to current market practice for both investment advisers and their clients. Among other things, the SEC should assess the impact of the Proposal on how investment advisers hold margin and whether the new rules conflict with Commodity Futures Trading Commission ("CFTC") regulations. The SEC should further evaluate the inefficiencies to derivatives contracts stemming from the likely requirement for clients to post collateral into a segregated account. The application of the safeguarding rule to derivatives could undermine market efficiency for these products. For example, requiring that an intra-day swap for purposes of managing market risk must be routed through a custodian threatens nimbleness in the market.

The Commission must withdraw the inclusion of derivatives and repurchase agreements to the safeguarding proposal until it has fully evaluated how the Proposal would apply to these financial instruments and the costs and burdens to market participants.

Private securities: The application of the Safeguarding Rule to private securities would be complex and unworkable, particularly because recordkeeping for the wide array of private securities is different from public securities. In addition, the notion of possession and control cannot be applied in the same way for private securities as for public securities. For example, a Limited Partnership interest is a security, but it is uncertificated (i.e., there is only a contract) unlike public securities. The previous custody rule provided an exception for such uncertificated securities; however, the Safeguarding Rule reinterprets "uncertificated" – requiring that securities be capable of only being recorded on the non-public books of the issuer – in an effort to enhance the assurance of the existence of the client asset.

While the Commission provides an exception for certain private securities and physical assets that may be difficult or impossible to maintain with a qualified custodian, it also imposes five burdensome compliance requirements to make it harder on investment advisers to take advantage of the exception.[3] The limited assets that qualify for the exception are still subject to new complexities since an adviser would be required to notify an independent public accountant within one business day each time a transaction in one of these assets occurs. The accountant would then be required to provide "prompt" verification of the transaction. While "promptly" is not defined, the Proposal's consideration of one day, two days or one week are all unreasonably short when taking into account existing commitments and the limited pool of accountants.

Given the complexity of the rules, most advisers would be unable to contract with custodians to keep private securities on their books. The Commission should reassess and better tailor the provisions around private securities to ensure they are workable when applied to such assets and for investment advisers, qualified custodians, and their clients.

Digital assets: Unlike the deficient consideration of traditional markets, the Proposal includes over 200 references to crypto assets, a clear indication that these financial instruments are the impetus for the expansion of the custody rules. The Chamber is not opposed to the idea of developing custody rules on digital assets if designed in a way to bring more regulatory clarity to this novel asset class. In a 2021 Chamber report on digital assets,[4] we recommended that the SEC prioritize developing and implementing a suitable and durable approach to broker-dealer custody of digital asset securities, well before the end of 2025. We further stated that a workable approach to custody under federal securities laws will foster secondary trading and promote investor safeguards.

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[3] Proposal, p. 23-24.

[4] Center for Capital Markets Competitiveness*, Digital Assets: A Framework for Regulation to Maintain the United States' Status as an Innovation Leader* (January 2011), available at https://www.centerforcapitalmarkets.com/wp-content/uploads/2021/01/CCMC_DigitalAssets2021_v3.pdf.

The Safeguarding Rule, however, is not a workable or reasonable approach to custody for digital assets.[5] We are highly concerned about the "'no win' scenario for crypto assets" that Commissioner Uyeda highlights. [6] As explained by the Commissioner, although an adviser may custody crypto assets at a bank, banks have been cautioned by regulators against custodying crypto assets. Further, because crypto assets trade on platforms that are not qualified custodians, an adviser that trades crypto assets on such a platform could potentially violate the proposed rule.

The proposed language surrounding exclusive control creates confusion and potential unintended repercussions. In the Proposal, the SEC states:

> "[I]t may be difficult actually to *demonstrate* exclusive possession or control of crypto assets due to their specific characteristics…"[7]

Elsewhere in the Proposal, the SEC goes on to state:

> "While demonstrating that a qualified custodian has exclusive possession or control of an asset would be one way to demonstrate that the qualified custodian is required to participate in a change of beneficial ownership, it is not the only way. For example, under the proposed rule, a qualified custodian would have possession or control of a crypto asset if it generates and maintains private keys for the wallets holding advisory client crypto assets in a manner such that an adviser is unable to change beneficial ownership of the crypto asset without the custodian's involvement."[8]

The SEC should explicitly clarify in the final adopting release that demonstrating exclusive possession or control is not the only mechanism, nor a necessary requirement, for a qualified custodian to comply with the proposed rule's "possession or control" requirement despite the references to "exclusive control" in the Proposal.

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[5] This is not the first time the SEC has taken a haphazard approach to crypto asset policymaking resulting in significant regulatory uncertainty that could otherwise be avoided. On March 31, 2022, the SEC published Staff Accounting Bulletin No. 121 ("SAB 121") expressing the views of the staff regarding the accounting obligations to safeguard crypto assets an entity holds for platform users. SAB 121 adds interpretive guidance for entities to consider when they have obligations to safeguard crypto assets held for their platform users and would require companies to adjust their accounting so digital assets are treated as part of the balance sheet. This change is consequential for companies that provide custody services for digital assets and is uniquely problematic for banks given their regulatory capital requirements are linked to assets held on their balance sheet. Custody assets have not traditionally been treated as part of the balance sheet. Treating custody assets as part of the balance sheet would require banks to hold increased regulatory capital that does not correlate with real economic risk.

[6] Commissioner Mark T. Uyeda Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets (February 15, 2023), available at https://www.sec.gov/news/statement/uyeda-statement-custody-021523.

[7] Proposal, p. 66.

[8] Proposal, p. 67.

Given the difficulty in proving exclusive possession or control of crypto assets by a qualified custodian, if interpreted to be the only way a qualified custodian would be able to demonstrate compliance with the "possession or control" requirement, an investment adviser would not be able to advise their clients on custodied crypto assets. Recognizing they would be in a no-win situation, investment advisers and custodians would get out of the business of crypto rather than run afoul of the Safeguarding Proposal. We agree with Commissioner Peirce that by "shrinking the ranks of qualified crypto custodians" and "insisting on an asset neutral approach to custody we could leave investors in crypto assets more vulnerable to theft or fraud, not less."[9]

Furthermore, we agree with Commissioner Uyeda's concern that the Commission's "approach to custody appears to mask a policy decision to block access to crypto as an asset class." Such a policy would deviate from the Commission's long-standing position on neutrality of the merits of investments, a position that Chair Gensler recently reaffirmed during his testimony before the House Financial Services Committee on April 18, 2023.[10] We are deeply concerned that any regulator would consider setting rulemaking requirements for which they know no one can comply. Moreover, if the requirements make it impossible for crypto assets to be custodied, we are concerned that a consequence of this Proposal will be to constrain innovation in crypto assets and any future financial asset technologies.

The rules under consideration for the safeguarding of digital assets are complex and require greater clarification by the Commission. The fourteen questions asked by the Commission of commenters would have been more appropriate for a concept release rather than a formal proposal under notice and comment. As such, the Chamber recommends the Commission should engage in concerted outreach to digital assets stakeholders who can help inform a more workable and less complex approach to custody for digital assets.

2. The Commission has failed to present clear evidence to justify the breadth of the rulemaking and makes recommendations that are beyond its authority.

The SEC has failed to provide clear justification for the extensive changes recommended in the Proposal. The Commission cites the Bernie Madoff scandal of 2008 as justification for the rule; however, the SEC already strengthened custody rules in response to this scandal in 2009. The Proposal does not provide compelling evidence, for instance from examinations, to show that investment advisers are currently failing in their obligation to safeguard securities and funds. The Commission further cites "the evolution in products and services;" however, it would have been more instructive to the Commission's efforts to have first issued a Request for Information to solicit input from the impacted parties to custody issues.

[9] Commissioner Hester M. Peirce Statement of Safeguarding Advisory Client Assets Proposal (February 15, 2023), available at https://www.sec.gov/news/statement/peirce-statement-custody-021523 ("Commissioner Peirce Statement").

[10] House Financial Services Committee, Hearing on Oversight of the Securities and Exchange Commission (April 19, 2023), see discussion at 5:09:25, available at https://www.youtube.com/watch?v=DmipafFCli0&t=2s.

The SEC states that it is relying on authority given to it under the Dodd-Frank Act to require an adviser to meet safeguarding regulations for all assets (not just securities).[11] However, it is reasonable to consider that Congress' use of the term "client assets" should be read to only refer to those assets under the scope of the SEC's regulatory authority, specifically, securities and cash related to buying and selling securities. Even if Congress has granted the Commission the right to expand its oversight of custodial obligations beyond securities and funds, it is not a foregone conclusion that it makes sense that every possible instrument could be considered an asset. Here, the Commission naively applies a single set of rules to the full and diverse range of covered client assets.

The Proposal's economic analysis fails the legal standard required of the Commission. The Safeguarding Rule would impose significant new costs and burdens, not only on advisers and custodians, but also independent public accountants. Our members believe that the Commission has well-underestimated the costs of implementing the various new due diligence requirements, recordkeeping, disclosure, expanded internal controls reports, and other accounting obligations. Investment advisers would incur significant costs to enter into written agreements with custodians that establish the responsibilities promulgated under the Safeguarding Rule.

Many investment advisers are not currently involved in the client's choice of custodian and are not a party to the existing custodial agreement. If finalized, investment advisers would be forced to attempt to negotiate new written agreements and written assurances with custodians to satisfy the requirements of the Safeguarding Rule. This is a serious and costly legal burden for our members who would be forced to enter into new custodial agreements and repaper every trading and custodial arrangement they currently maintain to ensure compliance with the Proposal.

There are other important burdens the Proposal's cost-benefit analysis fails to evaluate. Although the Commission considers the costs of entering into new contracts between an adviser and a qualified custodian, a glaring oversight is the missing analysis of the significant costs of renegotiating existing client agreements – the agreements between the client and their custodians. The Commission should also consider the costs that clients may incur from having to potentially engage multiple custodians and / or multiple advisers to effectuate the investment of their assets. The Commission's analysis also does not assess the costs associated with advisers being forced to exit certain markets, the impact on market efficiency, or the potential for client choice to be limited as a result of the Proposal.

Even more troubling is that the SEC is again attempting to regulate beyond its statutory authority. For example, in considering commodities, we have serious concerns that the Commission is overstepping the authority of both the CFTC and FERC. Furthermore, the SEC is attempting to regulate custodians; however, the Investment Advisers Act does not cover the

[11] Proposal, p. 11.

actions of custodians. Alluding to the SEC's approach to its proposal on Outsourcing by Investment Advisers,[12] Commissioner Peirce expressed concern over jurisdiction of custodians in her dissent to the Proposal. She also raised concern over the misuse of PCAOB registered accountants for a purpose Congress did not assign to it and questioned who would bear responsibility for any failure of a custodian in meeting the various requirements set out to protect client assets.

> "In what is becoming something of a habit, the Commission is once more proposing to dictate contract provisions involving entities the Commission does not regulate. As the release acknowledges, 'under existing market practices, advisers are rarely parties to the custodial agreement, which is generally between an advisory client and a qualified custodian.' The proposed rule would require that an adviser enter into a written agreement with a qualified custodian and obtain certain assurances, also in writing. The agreement would oblige the qualified custodian to, among other things, send account statements to the client at least quarterly and provide the client with a written internal control report that includes an opinion of an independent public accountant who is registered with the Public Company Accounting Oversight Board, a continuation of our inappropriate attempt to use the PCAOB for a purpose Congress did not assign to it. In addition, the qualified custodian must provide the adviser with reasonable assurance that it will, among other things 'exercise due care in accordance with reasonable commercial standards,' will indemnify the client against loss of assets in the event of the custodian's negligence, and will segregate 'client assets from the qualified custodian's proprietary assets and liabilities.' A qualified custodian would have to provide records related to client assets promptly to the Commission upon request. The Commission does not have authority to regulate custodians directly, but we propose to regulate them indirectly. Given our lack of regulatory authority, who would be on the hook if a qualified custodian failed to satisfy these requirements?"[13]

The Commission's attempt at backdoor regulation of custodians in this Proposal is neither appropriate nor lawful. Previous attempts by regulators to regulate beyond their jurisdiction have been overturned by courts. One such example was the Department of Labor's attempt in its 2016 Fiduciary Duty Rule to regulate IRAs through a Best Interest Contract exemption. The Commission must not only conduct a more thorough economic analysis; it must also reassess the appropriateness of its regulation of custodians through the investment adviser relationship in excess of its authority.

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[12] Securities and Exchange Commission, Release No. IA-6176; File No. S7-25-22 (October 26, 2022), available at https://www.sec.gov/rules/proposed/2022/ia-6176.pdf.

[13] Commissioner Peirce Statement, *supra* note 7.

3. The new safeguarding responsibilities are impractical and may negatively impact smaller advisers and market efficiency.

Beyond whether the Commission even has the authority to compel custodians to comply with requests from investment advisers, many of the requirements set forth in the Proposal are thoroughly impractical and unworkable for all parties involved. Moreover, the breadth and cost of the new obligations will make it harder for small advisers to maintain clients and serve as custodians. Analysis of these issues is wholly absent from the Commission's cost-benefit analysis.

The Safeguarding Rule inserts an investment adviser into a relationship that is today one between a client and a custodian. Subject to a written agreement between an investment adviser and a qualified custodian, the Proposal requires the custodian to maintain possession or control of client assets and to participate in any change of beneficial ownership of a client's assets. The SEC acknowledges that requiring written agreements between advisers and custodians "would be a substantial departure from current industry practice,"[14] wherein advisory clients typically enter into agreements with custodians directly.

Although the investment adviser has no contractual relationship with the custodian, the adviser would have to compel custodians to adopt standards of care and indemnification provisions in a contract and ensure that the custodian meets the various requirements. The SEC seems to understand there are challenges in requiring a third-party not subject to the Investment Advisers Act to comply with the requirements of the Proposal.

> "We understand that many of the obligations under the contractual provisions and reasonable assurances obtained by the adviser rest on the qualified custodian, and that implementation for each requirement may vary widely depending on the facts and circumstances of the parties in interest and assets in interest."[15]

Nevertheless, the Commission states that an adviser should rely on a "reasonable belief that the qualified custodian is capable of, and intends to, comply with the contractual provisions."[16] However, since custodians are not subject to the Investment Advisers Act, it may prove challenging to compel these third parties to take on the additional burdens and costs required by the Commission. Compelling a custodian to provide the adviser reasonable assurances that it will exercise due care, to provide indemnification of the client against losses, to segregate client assets, to obtain internal controls reports, and to provide records to the Commission upon request are all costly and burdensome requirements. They may cause firms to rethink whether they want to be custodians. Investment advisers and their clients will be worse off if there are not enough custodians to manage the full scope of assets covered by the Proposal. The Commission should be concerned about the possibility of concentration in the

[14] Proposal, p. 77.
[15] Proposal, p. 81.
[16] Id.

market for custodians, which could lead to higher fees and less quality of service. Even without consolidation, the costs of these new requirements for custodians will be passed along in higher fees to their customers.

The breadth of the Proposal extends beyond both the increased scope of assets subject to safeguarding and the long checklist of custodial obligations. Because the Proposal expands safeguarding to every single asset class and defines discretionary authority of any type as a form of custody, any normal asset management relationship will now become a custodial relationship. As an example, an asset manager who has a relationship with a pension plan would be forced to enter into an agreement with that client's custodian, who is chosen and paid for by the pension plan. Since an investment adviser cannot take a client account if the custodian does not accept the terms set forth by the adviser, the failure to reach an agreement would have reverberating ramifications for investment advisers and their clients.

We are further concerned that the Proposal does not deeply assess the impact on smaller advisers. The new rules, which require advisers to engage in heightened oversight of custodians and their recordkeeping that well exceeds their responsibility, would create a barrier to entry for smaller advisers. Due to the expense and time burden of compliance, market concentration is likely to occur with more work going to larger, full-service advisers. Some small advisers may determine they can only afford to take on clients and a custodial obligation for public securities.

Requiring an investment adviser to establish written agreements with a custodian would create a substantial compliance burden on investment advisers, who would have to enter into new custodial agreements and repaper every trading arrangement and every custodian agreement they currently maintain. The SEC believes that a new written agreement should only require one hour to complete. Had the Commission first issued a concept release on this topic, it would have been able to ask investment advisers and custodians for a more realistic time considerations for writing or rewriting the agreements, which our members anticipate being much higher on average than one hour. The scope of such negotiations, which would require advisers to secure off-market terms, would be unprecedented. A single firm would see hundreds of agreements impacted at a cost in the millions of dollars to complete. In addition, the SEC should be careful not to assume one-size-fits-all. Renegotiating a retail client agreement – where there is probably just one qualified custodian – will be a lot easier than renegotiating with an institutional client who likely works with multiple advisers and multiple qualified custodians. As the Commission further evaluates the time needed to renegotiate such written agreements and receive the necessary assurances from a qualified custodian, it should also include in its calculation the time clients must spend renegotiating existing custody agreements to cover assets that are not currently under scope.

We are also concerned that the rule will impact market efficiency. As an example, an investment adviser and a custodian will need to include in the contract the level of authority each party will have to effect transactions. A custodian will need to consider and involve the adviser before transactions can be settled. This additional layer of oversight has implications for the timing of transactions that runs counter to the Commission's preference for a more efficient market by shortening the settlement cycle from T+2 to T+1.

4. The segregation of assets is unworkable for banks and savings institutions who seek to serve as qualified custodians.

The Proposal changes the conditions under which institutions may serve as a qualified custodian for client assets. A key component of the new Safeguarding Rule is that qualified custodians must maintain client assets they are holding in accounts that are clearly identified and segregated from the custodian's proprietary assets. The Commission's objective is to ensure that clients assets would be protected from creditors of an institution in the event of insolvency or failure.

Bank deposits are today treated as general deposits of the bank and are not kept in segregated accounts, as would be required under this Proposal. The provision to require segregation of client assets is entirely unworkable and will lead to inefficiencies across the market. If the SEC moves forward with this provision, it will put at risk the economics of bank businesses. To compensate for the change, banks and savings institutions may be forced to either raise fees on their clients or find other onerous ways to comply. For example, while a bank could explore the creation of a special deposit protected from creditors, it would be near impossible to implement given the need to renegotiate all their deposit agreements with bank clients. Compounding this challenge, such special deposits are determined by state law and have generally not been favored by the courts.[17]

The burden of compliance for banks and savings institutions would be significant, time-consuming, and costly. The segregation of assets by the bank or savings institution custodian would create new challenges for investment advisers who would not be able to provide services and make recommendations to their clients unless or until either the bank custodian complies with the Safeguarding Rule or the client changes custodians. Limiting the banks and savings institutions who are able to comply with segregation is not to the benefit of the client who will likely pay increased costs.

Furthermore, the segregation requirement would also disrupt and adversely affect standard prime brokerage and banking services by prohibiting qualified custodians from rehypothecating client assets, which is currently permitted subject to limits imposed under applicable SEC regulations and banking law. Prohibiting rehypothecation would have severe consequences and negative implications for prime brokerage arrangements by either significantly increasing the fees and rates charged by broker-dealers to clients (negatively impacting returns) or making margin financing unavailable to certain clients.

[17] Mayer Brown, available at https://www.mayerbrown.com/en/perspectives-events/publications/2023/04/indepth-us-sec-proposes-new-safeguarding-rule-for-investment-advisers.

5. **The new requirements for Foreign Financial Institutions seeking to serve as qualified custodians will likely prevent registered advisers from investing in important foreign markets.**

Foreign Financial Institutions ("FFIs") would also be subject to new obligations. FFIs would be required to satisfy seven new conditions in order to serve as a qualified custodian for client assets under the proposed rule.[18] Like U.S. banks and savings institutions, the Proposal would require FFIs to keep advisory client assets in segregated accounts from an FFI's proprietary assets.[19] However, FFIs would face challenges in complying with the requirement to hold financial assets in an account designed to protect assets from creditors of the FFI. First, even if an FFI is able to segregate assets, depending on the jurisdiction the customer may share in any pro-rata losses with respect to the FFI's other customers and it is unclear whether the client would be protected from claims of other creditors. Second, as part of their prime brokerage model, FFIs may need to maintain the right to rehypothecate securities in order to provide financing to its customers.

Further, under the Proposal, an adviser and the SEC must be able to enforce judgments, including civil monetary penalties, against an FFI, as well as comply with the anti-money laundering ("AML") requirements and related provisions similar to those of the Bank Secrecy Act ("BSA").[20] Assessing whether foreign counterparties can meet the obligations of the Proposal is an enormous undertaking and creates significant challenges for FFIs. For example, some bank solvency regimes may not allow a counterparty to be a custodian under the conditions established by the Proposal. Even where FFIs in the sub-custodial network of a qualified custodian are subject to equivalent AML and BSA regimes and to the enforcement of civil monetary judgments for the benefit of the SEC and the investment adviser, if the main qualified custodian is unwilling to provide reasonable assurances in the written agreement to FFI sub-custodians, the Proposal could be interpreted in such a way as to restrict the ability of investment advisers to invest in those jurisdictions. Such restrictions will minimize the pool of FFIs who are able to serve as custodians.

The new requirements for foreign custodians will likely prevent registered advisers from investing in important foreign markets, particularly in emerging growth markets. Accessing certain foreign markets requires advisers to work with local banks. For example, in order to repatriate the proceeds of an investment denominated in local currency from a particular jurisdiction, an investment adviser would need to conduct an onshore deliverable currency trade using local custodians. If an investment adviser cannot contract with FFI custodians, investors such as pension funds, insurers, sovereign wealth management, governments, and economic development institutions will be adversely affected.

[18] Proposal, p. 46.
[19] Id. at 48
[20] Id. at 47-48.

6. The new obligations for independent public accountants unnecessarily expand their scope of work and are complex and costly.

Under the current rule, investment advisers that maintain custody of client assets are required to engage an independent public accountant to conduct an annual surprise examination to verify that a sampling of client funds and securities exist, or have the audited financial statements of a pooled investment vehicle prepared in accordance with the generally accepted accounting principles and distributed to investors in the pool. They are also required to obtain a report from an independent public accountant to evaluate internal controls related to custody where the investment adviser or its related person serves as the qualified custodian.

The scope of work for independent public accountants is vastly expanded in the Safeguarding Rule since all assets would now be in scope (not just funds and securities); and the scope of internal control reports would be expanded to safeguarding and include all qualified custodians (not just advisers or related persons that act as a qualified custodian). Further, the Proposal creates significant new requirements for independent public accountants, notably for: (1) the prompt verification of changes in beneficial ownership of privately offered securities and physical assets; (2) the verification of the existence and ownership of all privately offered securities and physical assets during the annual surprise examination; and (3) the expansion of the provision for annual financial statement audits for limited partnerships and pooled investment vehicles to any other entity.

The Chamber recognizes the value of the work performed by independent public accounting firms as "third-party gatekeepers to provide 'another set of eyes' on client assets."[21] Nonetheless, there are several matters of concern with the Proposal, notably whether many of these new provisions are necessary, workable, and cost-effective. Further, these new obligations will ultimately limit the firms that can provide the services proposed by the SEC.

Among the most significant new obligations are the requirements for prompt verification (after notification from investment advisers) of changes in beneficial ownership of privately offered securities and physical assets and for 100% verification of ownership and existence of the assets during the annual surprise examination. Aside from preferring to have another set of eyes on client assets, the SEC has not justified the proposed increases in obligations, the cost of which investment advisers would pay, and which could ultimately be borne by clients in the form of increased fees.

The requirement to promptly verify changes in beneficial ownership of any asset (for privately offered securities or physical assets) after notification from an investment adviser is not realistic. For example, while "promptly" is not defined, apparently the Commission has in mind very short parameters such as one day, two days, or one week. [22] In addition, the costs of

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[21] Proposal, p. 24.

[22] Proposal, p. 155.

verifying the existence and ownership of every single investment in privately offered securities and physical assets during annual surprise examinations will be much more extensive and expensive than the SEC estimates.

An independent public accounting firm is also required to notify the SEC within one business day upon finding any material discrepancies during the course of performing the verification of change in beneficial ownership. Not only is “finding” a vague and problematic term, but it is impractical to require notification to the Commission within just one day. Further, we are concerned that such new obligations would transfer risk to auditors by turning them into a guarantor. This would unnecessarily expand legal liability for independent public accounting firms.

Expanding the scope of internal control reporting to all qualified custodians (from the current rule’s application to an adviser or its related person that acts as a qualified custodian) represents a significant expansion in the work to be conducted by independent public accountants and increases the demand for their services when they are already overwhelmed. Qualified custodians currently obtain internal controls reports voluntarily or pursuant to requirements of a functional regulator. However, these reports may be inadequate given the proposed expansion of internal controls to include safeguarding assets. Further, if their current accountant is not independent of the qualified custodian per the Proposal, then custodians may need to engage a new accountant.

As the Commission should be aware, many investors likely do not realize that engagements the SEC is requiring to be performed by Public Company Accounting Oversight Board (PCAOB)-registered and inspected accounting firms are not subject to PCAOB inspection. The SEC is relying on the notion of a firm’s quality control system being subject to inspection because the firm audits issuers and/or broker-dealers. However, given the PCAOB’s broker-dealer inspection program is an interim one, some firms that audit only broker-dealers may not have been inspected by the PCAOB; and, the PCAOB does not publish audit firm inspection reports that identify the firms with broker-dealer engagements it does inspect.

Much like the new audit provisions required in the Commission’s private fund adviser proposal last year,[23] the SEC fails to appreciate the staffing challenges independent public accountants already face when requiring them to take on new and more time-intensive obligations. The Chamber urges the Commission to analyze whether an adequate supply of audit firms would be available to provide the necessary services before adopting the proposed requirements.

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[23] Securities and Exchange Commission, Release No. IA-5955; File No. S7-03-22 (February 9, 2022), available at https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

7. The Commission has again provided the public an insufficient amount of time to comment on substantive changes in regulation and has failed to consider the cumulative economic impact of its current regulatory agenda.

The Chamber and many other organizations have consistently communicated our concerns over the insufficient comment periods the Commission has allowed to respond to a wide array of new and complex proposals. Most of these proposals are hundreds of pages in length and collectively ask thousands of questions on highly technical and complex matters.

While the Commission has provided a 60-day comment period for this Proposal and posted the draft rule on its website in advance of it being published in the Federal Register, there are reasons why the amount of time provided by the Commission is actually unreasonably short. First, this rulemaking was released in the Federal Register on March 9, 2023, during the time that industry stakeholders were inundated with and responding to other proposals, specifically the four lengthy and highly technical equity market structure proposals all of which were due on March 31, 2022. Second, even if an interested party is not in the midst of simultaneously evaluating multiple, complex open proposals, stakeholders know that certain aspects of a proposal can change between the time an advanced copy is released and the formal version is published in the Federal Register.

The Commission provided insufficient time for the public to comment in a meaningful way and to identify every potential unintended consequences that could result from this Proposal, and it increases the likelihood that the costs of any final rule will vastly outweigh the benefits. A letter from the SEC Inspector General in October 2022 raises serious concerns about the capacity of the SEC to review, assess and analyze comments in light of the unprecedented volume of proposed rulemakings from the SEC since 2021.[24] Senior SEC officials reported a troubling increase in attrition and expressed concern that the SEC "may have not received as much feedback during the rulemaking process, either as a result of shortened timelines during the drafting process or because of shortened public comment periods."[25]

Like many of the Commission's proposals, this Proposal relies on an inadequate cost-benefit analysis and lacks compelling evidence to warrant changes to the current rules. The current regulatory agenda has proposed twice as many rules as the Commission under the previous Administration, with most of the rules recommending unreasonably short implementation periods given the multitude of costly, technical and time-consuming changes the affected parties would be required to undertake. Investment advisers are already evaluating potential ramifications of pending rules involving new mandates for private funds, environmental, social, and governance disclosures, climate change disclosures, and other matters. As the Commission's unprecedented barrage of rulemaking continues, it is becoming increasingly irresponsible of the Commission to fail to conduct and publish a cumulative cost-

[24] The Inspector General's Statement on the SEC's Management and Performance Challenges (October 13, 2022), available at https://www.sec.gov/files/inspector-generals-statement-sec-mgmt-and-perf-challenges-october-2022.pdf.
[25] Id.

benefit analysis that considers the collective impact and burden of the rulemakings on investment advisers and the overall economy.

In addition to the cumulative cost-benefit impact of the various rulemakings under consideration by the Commission, we are increasingly concerned about how the provisions of these rulemakings will interact with one another. It is impractical to view each proposal from the Commission in isolation. Since many provisions are interconnected, we encourage the Commission to conduct, and publish, a holistic review of its policymaking agenda to evaluate how the various proposals interact to minimize confusion and ensure there are no unintended consequences.

As the Chamber has argued in several recent comment letters to the Commission, the limitation of meaningful and detailed public feedback on rule proposals undermines the rulemaking process and increases the likelihood that final rules will cause unintended and harmful consequences for the capital markets and broader economy.

Conclusion

Safeguarding client assets is an important element of investor protection and we believe the SEC should develop suitable rules for custody of digital asset securities. However, the Proposal under consideration is unworkable, complex, and costly to the wide range of assets that would now be included under the Safeguarding Rule. For the reasons outlined in this letter, we urge the SEC to withdraw this Proposal while it develops a more practical update of custody rules. The Chamber will continue to serve as a resource for SEC commissioners and staff on this and other important policy matters.

Sincerely,

Kristen Malinconico
Director
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U.S. Chamber of Commerce