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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: File No. S7-04-23
SEC Proposal on Safeguarding Advisory Client Assets
Release No. IA-6240

Dear Ms. Countryman:

Stradley Ronon appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's (the "Commission" or the "SEC") proposal on Safeguarding Advisory Client Assets to amend and redesignate Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Proposal").[1] Our firm represents many registered investment advisers and the funds that they sponsor and manage. We are writing to provide our views on select aspects of the Proposal.

As a general matter, we respectfully request that the Commission review the responses to its request for comments on the Proposal, gather additional market data about the intended and unintended costs of the Proposal, and then re-consider its Proposal.

I. Statutory Authority

The Proposal would redesignate the current custody rule, Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to the safeguarding rule, Rule 223-1. Given the potential for substantial impact that the proposed rule would have on how registered investment advisers safeguard and protect client assets, and the overall economy, the Commission must establish "clear congressional authorization" as set forth in *West Virginia v. EPA*.[2]

[1] *Safeguarding Advisory Client Assets*, Investment Advisers Act Rel. No. 6240 (Feb. 15, 2023).
[2] *See* 2022 WL 2347278 (Jun. 30, 2022) (slip opinion https://www.supremecourt.gov/opinions/21pdf/20-1530_n758.pdf).

The Commission relies upon Section 411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") to exercise its authority to promulgate rules requiring registered investment advisers to take steps to safeguard client assets over which advisers have custody under Section 223.[3] The Commission states that this authorization under Section 223 covers all assets[4] over which an adviser has custody, not just client funds and securities which are covered in the current custody rule.[5] Investment advisers, as defined by Congress in Section 202(a)(11) of the Advisers Act, however, are persons providing advice about *securities*.[6] Thus, a "client" of an adviser is a person to whom the adviser provides advice about securities and "client assets" are those assets that are part of the advisory arrangement. Any expansion of the term "client assets" beyond those assets that are part of the advisory arrangement is not supported by the statutory provisions of the Advisers Act.[7] There is nothing in the Dodd-Frank Act that expands the scope of assets of an investment adviser to include assets outside of funds and securities. Per *West Virginia v. EPA*, the court notes that, "the words of a statute must be read in their context and with a view to their place in the overall statutory scheme."[8]

The Commission fails to clearly establish the existence of express Congressional authorization to significantly expand the scope of client assets and advisory activities. Therefore, we believe that the Commission does not have the statutory authority required to implement these changes.

II. The Proposal Does Not Establish Substantial Benefits.

In addition to the lack of statutory authority, we believe that the Proposal does not clearly establish sufficient benefits in the economic analysis. Given that the Proposal would significantly affect registered investment advisers, and those required to be registered, as well as current and prospective clients of investment advisers, qualified custodians, and independent public accountants, the Commission must clearly establish, identify, and quantify the economic effects

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[3] *See* Section 411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (adding Section 223 to the Advisers Act which provides "[a]n investment adviser registered under this subchapter shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe." 15 U.S.C. 80b-18b). Congress also required the U.S. Government Accountability Office ("GAO") to study the rule's compliance costs. *See id.* at Section 412.

[4] Assets include crypto assets, commodities, and other real assets; derivative contracts held for investment purposes; and physical assets. *See* Proposal at 133.

[5] *See* Proposal at 12.

[6] 15 U.S.C. § 80b-2(a)(11).

[7] For example, an investment adviser could offer, in addition to advice about securities, a business advising real estate developers with regard to particular real property acquisitions and dispositions. Such an adviser could be authorized by a real estate developer to withdraw funds from a bank to acquire real property for the real estate developer. This arrangement falls outside of any advisory activity, and the Commission lacks authority to regulate such arrangements.

[8] *See* footnote 2. *See also Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (finding Commission interpretation under the Investment Advisers Act "falls outside the bounds of reasonableness"). In addition, this expansion is inconsistent with your prior approach (*see* Investment Advisers Act Release Number 2968 (Dec. 30, 2009) at footnote 2 and accompanying text), as well as your Staff's existing frequently asked questions. *See* SEC Division of Investment Management, "Staff Responses to Questions About the Custody Rule," Question II.3.

that will likely result from the proposed amendments and rules.[9] We identify below some of the ways in which the current Proposal's economic analysis is insufficient.

A. The Proposal's Cost Benefit Analysis is Legally Insufficient.

We question the legal sufficiency of the economic analysis that is articulated in the Proposal. Statutory provisions added by the National Securities Market Improvement Act of 1996 and the Gramm-Leach-Bliley Act of 1999 to the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940—which require the Commission to consider efficiency, competition, and capital formation whenever it is "engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest"[10]—expressly call for consideration of several broad economic issues in addition to the protection of investors.

The D.C. Circuit has viewed these provisions, together with the requirement under the Administrative Procedure Act that Commission rulemaking be conducted "in accordance with law," as imposing on the Commission a "statutory obligation to determine as best it can the economic implications of the rule."[11] Similarly, the court has found certain Commission rules arbitrary and capricious based on its conclusion that the Commission failed adequately to evaluate a rule's economic impact.[12] As the D.C. Circuit has explained, the failure to "view a cost at the margin[] is illogical and, in an economic analysis, unacceptable."[13]

As a consequence of these court cases, the Commission Staff promulgated guidance on economic analyses in Commission rulemakings in 2012.[14] This guidance suggests that every economic analysis should include the following elements: (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis. We identify below some of the ways in which the current Proposal's economic analysis is deficient.

B. The Commission Does Not Identify a Clear Justification for the Proposal.

The Commission does not justify the need for regulatory action and how the Proposal would meet that need. While we agree that safeguarding client funds and securities is an important regulatory goal, the Commission fails to clarify how the dramatic expansion of the scope of assets covered under the Proposal and the unduly burdensome requirements of the Proposal, including, for example, that an investment adviser obtain written reasonable assurances from a qualified custodian that it will indemnify the adviser's client for simple negligence, justify that goal. These extraordinary measures require much clearer justification given that the

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[9] *See* Proposal at 254.
[10] 15 U.S.C. § 77b.
[11] *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005) ("Chamber I").
[12] *See, e.g.*, *Business Roundtable v. SEC*, 647 F.3d 1144, 1148-49 (D. C. Cir. 2011) ("[T]he Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.").
[13] *Id.* at 1151.
[14] Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012) ("EA Guidance"), *available at* www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

Commission Staff has recognized that a person intent on committing fraud will not be deterred by provisions of a custody-related rule.[15]

C. The Commission's Estimate of Costs is Wholly Insufficient.

The Commission fails meaningfully to quantify any of the costs associated with the Proposal. The Commission recognizes on multiple occasions that aspects of the Proposal are not reflected in current industry practice and would require fundamental changes. For example:

- With regard to requiring a written agreement between an adviser and the custodian, the Proposal acknowledges "that an agreement between the custodian and the adviser would be a substantial departure from current industry practice;"[16]
- The Proposal acknowledges that the "reasonable assurances" an adviser must receive from a qualified custodian with regard to due care are outside of an adviser's area of expertise: "We also recognize that while the understanding of appropriate safeguarding measures is generally expected to be within the expertise of the qualified custodian, advisers also generally should seek to become sufficiently familiar with safeguarding practices to identify concerns or red flags in order to, among other things, form an opinion as to whether the assurance that they receive from the qualified custodian that the qualified custodian is acting with due care is reasonable;"[17]
- The Proposal also acknowledges that the "reasonable assurances" that an adviser must receive from a qualified custodian under the written agreement, particularly the requirement that a custodian's liability be based on simple negligence, "may create practical difficulties (*e.g.*, higher costs of compliance, or market contraction for custodial services);"[18]
- With respect to crypto assets, the Proposal acknowledges that satisfying the possession or control standard may be difficult to prove;[19] and
- The release acknowledges the lack of custodial market for certain privately offered securities but would impose substantial prescriptive requirements that render the privately offered securities exception difficult for advisers to take advantage.[20]

The EA Guidance notes that the Commission Staff may not always be able to quantify costs. In those instances, the EA Guidance suggests that the economic analysis should not only identify and discuss uncertainties underlying the cost estimates and explain why costs cannot be quantified, but also include at least a qualitative assessment of the likely economic consequences of the proposed rule.[21] The Commission makes only passing reference qualitatively to costs

[15] *See* Investment Advisers: Requirements and Costs Associated with the Custody Rule, GAO report (July 2013) ("According to SEC staff, an adviser with custody and intent on defrauding its clients also may not register with SEC or, if it does, may not report that it has custody of client assets or hire an accountant to conduct a surprise examination.").
[16] Proposal at 77.
[17] *Id.* at 84.
[18] *Id.* at 80.
[19] *Id.* at 66.
[20] *Id.* at 128.
[21] *See* EA Guidance.

imposed by these fundamental changes to the custody ecosystem. This is particularly noteworthy as the Commission does quantitatively estimate costs for purposes of the Paperwork Reduction Act.[22]

D. Certain Costs are Completely Unexplored by the Commission.

The economic analysis fails to address certain costs. For example, the economic analysis does not address the increased litigation risk for both advisers and qualified custodians. The potential for increased liability and litigation risk likely would result in increased insurance costs to cover the costs of potential litigation. Moreover, the Proposal will increase the potential for litigation aimed at auditors because of the increased scope of what auditors are being asked to do. This also likely would result in increased insurance costs for auditors.

Moreover, the Commission does not attempt to explore the significant impact of the Proposal on smaller advisers. For example, smaller advisers may not be able to find qualified custodians that are willing to custody certain privately offered securities, or the costs for such services may be prohibitive. This is particularly troubling given the overall impact of the multitude of proposed rulemakings impacting advisers, including ESG, cybersecurity, oversight of service providers, and amendments to Form PF, all of which would have a disproportionate impact on smaller advisers.

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In conclusion, we believe that the Commission should not move forward with the combination of changes described in the Proposal.[23]

Thank you for considering our comments. If you have any questions, please contact our Investment Management Group at (202) 822-9611.

Very truly yours,

/s/ Stradley Ronon Stevens & Young, LLP

Stradley Ronon Stevens & Young, LLP

[22] For purposes of the Paperwork Reduction Act, for example, the Proposal estimates that: (1) qualified custodians and advisers will incur aggregate initial costs of $27,469,680 associated with advisers obtaining reasonable assurances from qualified custodians and aggregate ongoing annual costs of $5,493,936; (2) investment advisers and qualified custodians would incur aggregate initial costs of $41,218,464 to prepare written agreements and that aggregate annual costs associated with modifying these agreements would be $3,503,599; and (3) advisers would incur aggregate ongoing annual costs of $21,000,000 associated with the verification of transactions by independent public accountants. While we believe that these estimates substantially underestimate actual costs, the fact that the Commission can provide estimates for purposes of the Paperwork Reduction Act highlights the extent of its failure to provide quantitative estimates for purposes of the cost benefit analysis.

[23] In addition to the concerns outlined above, we believe that the Commission should address the significant issues outlined by Commissioner Peirce in her statement on the Proposal, including with respect to the written agreement and reasonable assurances requirements, authority to regulated custodians directly, and overriding private agreements. *See* Hester M. Peirce, Commissioner, SEC, *Statement on Safeguarding Advisory Client Assets Proposal* (Feb. 15, 2023), *available at* https://www.sec.gov/news/statement/peirce-statement-custody-021523.

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