May 8, 2023

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

RE: Safeguarding Advisory Client Assets (Release No. IA-6240; File No. S7-04-23)

Dear Ms. Countryman:

Charles Schwab & Co., Inc. ("Schwab")[1] appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission ("Commission" or "SEC") to redesignate current Rule 206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940, as amended ("Advisers Act"), as new Advisers Act Rule 223-1 ("Proposed Rule").[2] As explained in the Proposing Release, the Proposed Rule would generally (i) expand the scope and requirements of the Custody Rule by broadening the types of assets subject to the rule and the activities that would constitute "custody"; (ii) attempt to enhance custodial protections by requiring advisers to enter into agreements with and obtain certain assurances from the qualified custodian ("QC") holding client assets; (iii) modify the existing exception related to privately offered securities; (iv) revise

[1] The Charles Schwab Corporation (NYSE: SCHW) is a leading provider of financial services, with 34.1 million active brokerage accounts, 2.4 million corporate retirement plan participants, 1.7 million banking accounts, and $7.58 trillion in client assets. Through its operating subsidiaries, the company provides a full range of wealth management, securities brokerage, banking, asset management, custody, and financial advisory services to individual investors and independent investment advisers. Its broker-dealer subsidiaries, Charles Schwab & Co., Inc., TD Ameritrade, Inc., and TD Ameritrade Clearing, Inc., (members SIPC, https://www.sipc.org), and their affiliates offer a complete range of investment services and products including an extensive selection of mutual funds; financial planning and investment advice; retirement plan and equity compensation plan services; referrals to independent, fee-based investment advisers; and custodial, operational and trading support for independent investment advisers through Schwab Advisor Services. Its primary banking subsidiary, Charles Schwab Bank, SSB (member FDIC and an Equal Housing Lender), provides banking and lending services and products. More information is available at https://www.aboutschwab.com. TD Ameritrade, Inc. and TD Ameritrade Clearing, Inc. are separate but affiliated companies and subsidiaries of TD Ameritrade Holding Corporation. TD Ameritrade Holding Corporation is a wholly owned subsidiary of The Charles Schwab Corporation. TD Ameritrade is a trademark jointly owned by TD Ameritrade IP Company, Inc. and The Toronto-Dominion Bank.

[2] *See* Safeguarding Advisory Client Assets, Release No IA-6240 (Feb. 15, 2023), 88 Fed. Reg. 14672 (Mar. 9, 2023) ("Proposing Release" or "Proposal").

the audit provision to include other entity types and require written agreements with independent public accountants; and (v) enhance certain recordkeeping and reporting requirements.

At Schwab, we are dedicated to the principles of asset safety and soundness. While we appreciate the Commission's investor protection and public interest mandates, we do not believe that the Proposal advances those goals in a meaningful way, especially with respect to QCs such as Schwab that also are SEC-registered broker-dealers.

As discussed in greater detail below, the Commission already has an extensive regulatory framework that has worked exceptionally well for decades and which adequately safeguards cash and securities of brokerage customers, including those clients who are advised and whose brokerage assets are managed by investment advisers. Unfortunately, the Proposal does little to acknowledge this existing framework, nor does it account for the fact that any additional obligations imposed on broker-dealer QCs would require careful consideration of the existing rules governing broker-dealers under the Securities Exchange Act of 1934, as amended ("Exchange Act"). Our comments below reflect these themes.

SUMMARY OF COMMENTS

As one of the largest broker-dealer QCs in the United States that provides custodial services to retail clients and to clients of independent registered investment advisers, we believe we are particularly qualified to comment on the Proposed Rule. Schwab agrees that safeguarding client funds and securities is a vital element of the investor protection and public interest framework that Congress enacted as part of the federal securities laws.[3] Schwab is mindful of its significant role and experience in providing custodial services with respect to funds and securities, and meticulously ensures that its practices are an exemplar for the investing public, its peer firms, and the U.S. financial system.

While we support the Commission's efforts to modernize and further enhance the custodial protections afforded to clients of investment advisers, we believe that the Commission has not met its burden in support of the Proposed Rule and should consider the following comments, each as further detailed in this letter:

- Unworkable Written Agreement Requirement. The written agreement requirement lacks clarity, contains unworkable components, and would not provide any additional substantive protections beyond those already required by the SEC's financial responsibility rules applicable to broker-dealer QCs. This proposed requirement also inadequately accounts for the significant costs and burdens that advisers and QCs would bear in drafting and negotiating agreements to conform to the requirements of proposed Rule 223-1.

[3] When referring to the federal securities laws, we generally mean the Securities Act of 1933, the Exchange Act, the Sarbanes-Oxley Act of 2002, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Advisers Act, and the Securities Investor Protection Act of 1970.

- Overly Broad Reasonable Assurances Requirement. The written "reasonable assurances" requirement is overly broad in its application, is not sufficiently tailored to avoid duplicative requirements, and would increase the cost of doing business. We believe that the SEC's financial responsibility rules provide more than sufficient safeguards with respect to client funds and securities held by a broker-dealer QC and adequately achieve the Commission's objectives.

- Privately Offered Securities Exception Conditions are Impractical. The Proposed Rule's changes with respect to the privately offered securities exception fails to account for the methods by which beneficial ownership is reflected, and specifically fails to account for how nominee accounts and direct ownership work and the reasons why each type of framework is used. If the Commission proceeds, it may result in a chilling effect on the use of privately offered securities in the advisory context.

- Exceeding Statutory Authority. The Commission seeks to impose obligations on QCs in a manner that is inconsistent with its statutory obligations under Section 553 of the Administrative Procedures Act ("APA"), Section 202(c) of the Advisers Act, and Section 15 of the Exchange Act. Broker-dealers such as Schwab are subject to a panoply of requirements related to the protection and safeguarding of investor funds and securities in the financial responsibility rules under Sections 15 and 17 of the Exchange Act. Yet the Commission, without identifying any specific issues or concerns applicable to broker-dealer QCs, attempts to indirectly modify the longstanding standards established under the Exchange Act through rulemaking under the Advisers Act. Moreover, the Commission has not fully considered e.g– or, at least, it has not clearly articulated – the potential adverse impact that the Proposed Rule will have on QCs, investors, and the financial markets, and it has grossly underestimated the costs in dollars and time that it will take investment advisers and QCs to comply with the requirements of the Proposed Rule if adopted as proposed.

- Recommend a Limited Exemption for Assets custodied by Broker-Dealer QCs. In recognition of the exacting nature of the broker-dealer financial responsibility rules currently in place, we believe the Commission should exempt advisers from the written agreement requirement and assurances requirement to the extent their client assets are custodied with a QC that is a registered broker-dealer.[4]

- Recommend a Uniform Compliance Date. The transition period and compliance date of the Proposed Rule, if adopted, should be uniform across all investment advisers, allowing sufficient time for firms of all sizes to comply. Additionally, as the bulk of the

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[4] SEC and Commodity Futures Trading Commission ("CFTC") officials have stated that the futures industry capital adequacy and customer assets protection requirements (CFTC Rules 1.17, and 1.20-1.30, respectively) generally mirror the requirements in Exchange Act Rules 15c3-1 and 15c3-3.

requirements under the Proposed Rule fall on QCs, it is imperative that the transition period and related compliance date account for the heavy burden that QCs will have.

I. BROKER-DEALER SAFEGUARDING REQUIREMENTS UNDER EXISTING FINANCIAL RESPONSIBILITIY RULES ARE STRONG AND EFFECTIVE.

We believe it is imperative to remind the Commission of the substantial and sophisticated rules related to the safeguarding of customer funds and securities to which registered broker-dealers are subject. These rules are the culmination of decades of Commission and Division of Trading and Markets ("TM") staff guidance and interpretations and reflect a carefully tailored scheme to address the safeguarding of customer funds and securities by broker-dealers under the Exchange Act.

The financial responsibility rules for broker-dealers generally consist of:

1. Net Capital Rule – Exchange Act Rule 15c3-1 ("Net Capital Rule") focuses on the liquidity of broker-dealers and is designed to ensure that broker-dealers maintain at all times sufficient liquid assets to promptly satisfy their liabilities and to provide a cushion of liquid assets in excess of liabilities to cover potential market, credit, and other risks if broker-dealers are required to liquidate assets.
2. Customer Protection Rule – Exchange Act Rule 15c3-3 ("Customer Protection Rule") is designed to give more specific protection to customer cash and securities through two requirements, the cash reserve requirement which protects customer cash in a brokerage account, and the possession or control requirement which provides the framework for the protection of customer securities.
3. Recordkeeping and Reporting Rules – Exchange Act Rules 17a-3, 17a-4, and 17a-5, impose recordkeeping and reporting requirements on broker-dealers, including in relation to aspects of their businesses that support and facilitate the safeguarding of customer assets.
4. Notification Requirements – Exchange Act Rule 17a-11 requires broker-dealers to give notice to the SEC and their designated examining authority ("DEA"), which is most often FINRA, if their net capital declines below certain levels or if there are certain other occurrences related to their net capital or their accounting systems, internal accounting controls, and procedures for safeguarding securities.
5. Reconciliation – Exchange Act Rule 17a-13 requires broker-dealers, on at least a quarterly basis, to count, examine, and verify the securities they hold for customers and themselves.
6. Form Custody – Broker-dealers are required to file Form Custody with their quarterly FOCUS Reports, which is designed to elicit information concerning whether broker-dealers maintain custody of customer and non-customer assets.

In addition, although not specifically financial responsibility rules, Exchange Act Rule 10b-10 requires that broker-dealers send to customers a written confirmation of securities transactions on or before completion of the transaction.

II. COMMENTS ON PROPOSAL

As mentioned above, the overall theme of our comments reflects that broker-dealer QCs such as Schwab are subject to extensive and very prescriptive requirements that address the safety of customer funds and securities, as well as the safety and soundness of the broker-dealer. In light of this framework, Schwab believes that the Proposal is overbroad, unworkable and will subject custodians, advisers and clients to adverse and unintended consequences if adopted as proposed.

A. Written Agreement Requirement

Proposed Rule 223-1 would require an investment adviser that is deemed to have custody of client assets to enter into a written agreement with and receive certain assurances from a QC that maintains the client assets to ensure that the QC provides certain standard custodial protections. A QC must maintain possession or control of client assets pursuant to a written agreement with the investment adviser (or, if the investment adviser is also the QC, with the client) that would, among other things:

- Specify the investment adviser's agreed-upon level of authority to effect transactions in the account, as well as any applicable terms or limitations, and permit the investment adviser and client to reduce that authority ("Proposed Authority Requirement"); and

- Require the QC to send account statements, at least quarterly, to the client (or its independent representative) and the investment adviser identifying the amount of each client asset in the account at the end of the period and setting forth all transactions in the account during that period, including investment advisory fees (such statements would be prohibited from identifying assets not in the possession or control of the QC unless requested by the client and such assets are clearly identified on the statements) ("Proposed Account Statement Requirement").

As proposed, the written agreement requirement contains unworkable components, needs clarity, and, as applicable to broker-dealer QCs, would not provide any additional substantive protections beyond those already provided under the financial responsibility rules.

1. The Proposed Authority Requirement is unworkable and disrupts a well-established client-centric system that affords clients the ability to easily modify or terminate adviser authorities.

The Proposed Authority Requirement is simply unworkable. For one, it is not clear how QCs would be able to effectively manage the thousands of new written agreements they would be required to establish with investment advisers. This is particularly the case when viewed against the expansive breadth of investment advisory clients that grant differing levels of authority over their brokerage accounts to their respective advisers, whether on a client-by-client basis, or account-by-account basis. The common contractual arrangements for custody of advisory assets

by a broker-dealer QC involve the client opening one or more brokerage account(s) with that broker-dealer QC. It is quite common for advisory clients to maintain multiple brokerage accounts with a broker-dealer QC. Those accounts are governed by the terms and conditions of the respective account agreement that each client enters into with a QC. These agreements provide a host of services that may not be limited to custody, but that also include trading and execution services. These agreements are between the broker-dealer QC and the client who are in direct privity of contract.

In contrast, the investment advisory agreement between the adviser and client specifies the scope of the advisory relationship as well as the specific investment responsibilities delegated by the client. The advisory agreement typically outlines whether the adviser is permitted to *exercise* investment discretion. In some cases, a client does not delegate investment discretion to the adviser but does authorize the adviser to place trades in their brokerage accounts (i.e., this trading authorization is memorialized in the brokerage account agreement). This arrangement typically means the adviser must obtain client consent prior to submitting the trade order on the client's behalf.

Thus, the authorities granted by clients to advisers are refined and limited by the advisory agreements between the clients and advisers, as well as other instructions provided by clients to the QCs and advisers after the date of contracting. Since the QC is not privy to the advisory agreement, the Commission surely cannot expect that broker-dealer QCs somehow act as the validators-in-chief of the specific type of investment authority (e.g., whether discretionary or not) granted to an adviser.

Moreover, the investment adviser may have some advisory accounts for which the adviser has the broadest authority to transact for the account (e.g., trading, money transfers, disbursements, etc.), and other accounts for which the adviser's authorities are more limited. Importantly, these authorities can change over time. At Schwab, customers can expand, reduce, or revoke an adviser's authorities at any time by contacting Schwab directly via phone, email or other type of communication. Indeed, customers sometimes bypass an adviser and go directly to Schwab for these purposes.

Since an advisory relationship is naturally expected to change over time or between accounts, requiring that a specific level of authority be reflected in a written agreement on an account-by-account basis is an unworkable requirement that would result in significant operational risk. This requirement could further expose a broker-dealer QC to potential liability if the QC were to specify an adviser's agreed-upon level of authority in a written agreement with an investment adviser at the adviser firm level prior to somehow validating that authority directly with the end-client pursuant to the custodial agreement or some other client authorization.

In addition, the Proposal is contradictory in how it describes the Commission's expectations regarding how QCs and investment advisers may satisfy the agreed-upon level of authority requirement. In particular, the Proposed Rule would apply this requirement on an "account" basis,

such that a reasonable reading of the rule would demand a written agreement that explicitly covers and identifies each account over which the adviser is deemed to have custody. Naturally, as advisers onboard new clients any existing written agreement would need to be amended. However, in its Paperwork Reduction Act ("PRA") analysis, the Commission asserts that it believes investment advisers would only need to enter into a single written agreement with each QC that covers all of the adviser's clients with accounts held by the QC.[5]

It is striking that the Proposed Authority Requirement requires the specification of account-by-account authorizations, yet the Commission somehow asserts that a single agreement can address the various levels of authorizations across different clients and account types. Given the language of the Proposed Rule and the practical realities of how investment advisers, their clients, and QCs interact contractually and otherwise, it is difficult, if not impossible, to fully understand what the Commission expects in terms of compliance with this requirement. Simply put, it does not protect investors or advance the public interest for the Commission to cavalierly assert a simplistic solution in the PRA analysis that is wholly at odds with a plain reading of the Proposed Rule.

In addition, the Commission further asserts that there is a blind spot in existing market practices in this area, claiming that "advisers are rarely parties to the custodial agreement, … resulting in an adviser having limited visibility into the custodial arrangements of its clients."[6] This assertion is out of touch with current custodial practices of broker-dealer QCs that serve investment advisers and their clients. As a matter of course, the visibility that advisers have into their client's custodial arrangements varies among industry participants and is driven by the client. While we agree that advisory clients generally enter into custodial agreements directly with a broker-dealer QC, and such clients are often able to modify an adviser's authorities at any time by contacting the broker-dealer QC, advisers do often have access to the terms and authorities contained in their clients' custodial agreements with broker-dealer QCs such as Schwab. This would include information in relation to such things as trading, money transfers, and disbursement authority.

Further, the suggestion that advisers have little insight into their authorities is inconsistent with the fact that advisers of retail clients often (i) assist their clients with completing custodial account forms, or (ii) review such forms with their clients, advising them on the optional account features contained in the account applications, such as those relating specifically to the adviser's trading and disbursements authorities, among other account features. Indeed, this practice is often part of an adviser's process in seeking to ensure that it can effectively carry out any responsibilities delegated by a client in an advisory agreement. Similarly, to the extent an investment adviser recommends a particular custodian, the adviser would, at a minimum, be familiar with the relevant agreements.

[5] Proposing Release, 88 Fed. Reg. at 14762-63.

[6] Proposing Release, 88 Fed. Reg. at 14690.

2. The Proposed Account Statement Requirement including the additional recordkeeping requirements for advisers would not enhance asset safety.

The Proposed Account Statement Requirement is an unnecessary expansion of the obligation already imposed on advisers, and the related obligations under Rule 15c3-3 and FINRA Rule 2231 already imposed on broker-dealer QCs. In a change from the current Custody Rule, the Proposed Rule would require QCs to send account statements, at least quarterly, to the investment adviser. The Proposing Release states that this new requirement "would allow the adviser to more easily perform account reconciliations" and "because of custody rule 206(4)-2(a)(3), the account statement contract provision is consistent with longstanding custodial practices and would easily be incorporated by qualified custodians into the written agreement."[7]

Schwab agrees with the Commission that "the integrity of custodial account statements [is] critical to the safeguarding of client assets."[8] However, the Commission appears to overstate any additional protection that would result from the Proposed Account Statement Requirement, and does not consider alternatives. For example, the Commission cites no empirical evidence to demonstrate that clients are not already today receiving accurate statements from QCs or that advisers are not adequately complying with their "due inquiry" requirement under the Custody Rule.

Moreover, a physical delivery requirement would be ill-suited for reconciliation since statements are generally sent at quarterly intervals. Accordingly, advisers often seek and regularly obtain raw transaction and position data from their clients' QCs regarding their clients' activities that can be securely uploaded directly into the advisers' own client management systems. This provides a more comprehensive data set that can provide the adviser with real-time reconciliation and better monitoring capabilities.

The Commission also fails to acknowledge that it has previously blessed structures in which broker-dealer customers can waive receipt of transaction-by-transaction confirmations and instead receive periodic reports on at least a quarterly basis containing the same information provided the customer's investment adviser has discretion and receives the immediate confirmations.[9] The requirement that the adviser receive immediate information is, in part, meant to give the adviser more timely information regarding the transactions in the account. When coupled with the fact

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[7] Proposing Release, 88 Fed. Reg. at 14697.

[8] *Id.* at 14675.

[9] *See* Confirmation of Transactions Release No. 34-34962 (Nov. 10, 1994), 59 Fed. Reg. 59612 (Nov. 17, 1994). Under 1994 amendments to Exchange Act Rule 10b-10, the Commission provides that a customer may waive the receipt of an immediate confirmation where a fiduciary has discretion over the customer's account. In order to effect the waiver, the broker-dealer must: (i) obtain from the customer a written agreement that the fiduciary will receive the immediate confirmation; and (ii) send to the customer a periodic report, not less frequently than quarterly, containing the same information that would have been contained in an immediate confirmation. The customer may not waive the periodic report.

that this information can be delivered electronically[10] and that advisers may use confirmation/affirmation service providers to, among other things, allocate clients positions in real time and receive electronic feeds of information,[11] stale account statements hardly advance the purported goals of the Proposed Account Statement Requirement.

B. The "Reasonable Assurances" Mandate is Overly Broad.

The Proposed Rule would require an investment adviser to obtain certain "reasonable assurances" in writing from the client's QC to ensure the client will receive certain minimum custodial protections. Additionally, the investment adviser would have to evidence an ongoing reasonable belief that the QC is complying with the requirements. These "reasonable assurances" would need to address among other things:

- *Due care* – The QC will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss;
- *Indemnification* – The QC will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the QC in the event of the QC's own negligence, recklessness, or willful misconduct;
- *Sub-Custodian or Other Similar Arrangements* – The existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the QC's obligations to the client;
- *Segregation of Client Assets* – The QC will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the QC's proprietary assets and liabilities; and
- *No Liens Unless Authorized in Writing* – The QC will not subject client assets to any right, charge, security interest, lien, or claim in favor of the QC or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.

The Commission rightly observes that certain financial institutions already provide various investor protections. Schwab notes, however, that the indemnification provision is particularly troublesome, as proposed. As stated by the Commission, the goal of this proposed requirement "would be for the client to be compensated in the event of a loss for which the qualified custodian is responsible."[12] This requirement results in regulatory overreach by the Commission into the

[10] *See*, e.g., Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information Release No. 34-37182 (May 9, 1996), 61 Fed. Reg. 24644 (May 15, 1996) (use of electronic media by broker-dealers for delivery of information to customers).

[11] *See*, e.g., The Depository Trust Company, SEC Staff No-Action Letter (Oct. 29, 1974); The Depository Trust Company, SEC Staff No-Action Letter (Jan. 31, 1983); Omgeo LLC, SEC Staff No-Action Letter (Dec. 14, 2006); Omgeo LLC, SEC Staff No-Action Letter (Mar. 12, 2008).

[12] Proposing Release, 88 Fed. Reg. at 14694.

private negotiations and contractual arrangements between and among QCs, investment advisers, and clients. This is concerning because the indemnification standard triggers on simple negligence (rather than gross negligence), and "loss" is an undefined term with no apparent limiting principles. When coupled with the proposed due care provision, a broker-dealer QC could potentially be exposed to unlimited liability that it may have to reflect on its balance sheet in a manner that could have a material impact on the broker-dealer's net capital computation. This is especially the case if the Commission's Office of the Chief Accountant ("OCA") subsequently takes the position that broker-dealer QCs must reflect this unlimited indemnity as a liability on their financials. The Commission does not appear to have adequately considered the impact that these mandatory indemnity provisions may have on a QC's reserve and/or net capital calculations.

With respect to the other assurances, the Proposed Rule seems to ignore that broker-dealer QCs often offer sweep programs in accordance with Exchange Act Rule 15c3-3(j), under which customer free credit balances (i.e., cash that is payable upon demand to the customer) are automatically transferred to depository institutions with the goal of permitting customers the opportunity to earn interest while their cash awaits investment. These bank deposit programs can be structured to provide customers with significant free credit balances the benefit of allocating cash among different depository institutions to maximize the amount of FDIC insurance that a customer can receive. Once free credit balances are in a depository account, they generally are no longer liabilities on the books and records of the broker-dealer (e.g., since the liability is now the bank's) even though the broker-dealer may "control" the movement of cash from the deposit accounts to the brokerage accounts.[13] It is unclear if the Commission considered whether the Proposed Rule would stifle the use of these programs.

C. Privately Offered Securities

The Proposed Rule would modify the "privately offered securities" exception from the QC requirement to require that an adviser seeking to rely on the exception meet the following conditions:

- Reasonably determine and document in writing that ownership cannot be recorded and maintained (book-entry, digitals means, or other method) in a manner in which a QC can maintain possession or control transfers of the beneficial ownership of such assets;
- The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency;
- An independent public accountant under agreement with the adviser:
    - Verifies any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets; and

[13] While we recognize that the Commission has drawn the proposed segregation requirements from rule 15c3-3 of the Exchange Act, the text of the Proposed Rule fails to explicitly acknowledge that broker-dealers acting in compliance with rule 15c3-3 would meet the requirements under Proposed Rule 223-1(a)(1)(ii).

    - o Notifies the Commission's Division of Examinations within one business day upon finding any material discrepancies during the course of performing its procedures;
- The adviser notifies the independent public accountant engaged to perform the verification of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day; and
- The existence and ownership of each of the client's privately offered securities or physical assets that are not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit.[14]

The modification to the privately offered securities exception has the potential of creating a chilling effect on the ability of advisory clients to purchase shares of privately offered securities. As an initial matter, advisers will have a significant hurdle in showing that a QC cannot record and maintain possession or control of privately offered securities. In this regard, the Commission fails to distinguish between a QC's ability to have possession or control of privately offered securities, with a QC's willingness to do so.

As mentioned above, the financial responsibility rules have a very sophisticated and time-tested methodology by which broker-dealer QCs can establish control of uncertificated securities, including privately offered securities. This process can often include submitting so-called good control location applications to the Commission in order to effectively approve a sub-custodial location. As such, there is no question that a broker-dealer can record control of privately offered securities under Rule 15c3-3 as nominee. However, the proposed requirements associated with the indemnity provisions and no-lien requirements of Proposed Rule 223-1 may sap any willingness on the part of broker-dealer QCs to provide these accommodations if doing so has the potential to adversely impact a broker-dealer's balance sheet. Advisers would be faced with a conundrum in that broker-dealer QCs are able to custody positions as nominee and establish the necessary control but simply avoid doing so since (1) clients can always be directly on the books and records of the issuer of a privately offered security in a manner that avoids having a broker-dealer act as nominee and (2) the potential liability is not worth providing this service.

D. Statutory Authority

The Commission's proposal would impose substantial obligations on registered broker-dealers acting as QCs in a manner exceeding the Commission's statutory authority under the Advisers Act. As reflected above, broker-dealers are already subject to extensive requirements related to the operation of their businesses and have substantial financial, operational, and safekeeping obligations. These requirements derive from and are enacted under Sections 15 and 17 of the Exchange Act. The Exchange Act, which Congress enacted six years before the Advisers Act, is the exclusive mechanism by which Congress intended broker-dealers to be regulated by the Commission.

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[14] Proposing Release, 88 Fed. Reg., at 14706.

The Proposed Rule would impose requirements on broker-dealer QCs that directly impact their obligations under the financial responsibility rules, the books and records rules, and the notification and reporting rules, all in contravention of the statutory framework that Congress enacted. Indeed, the Commission is proposing to impose these obligations on broker-dealers with little to no analysis of the operational and financial impact that these requirements would have on broker-dealers as is required when engaging in rulemaking that could directly and fundamentally impact how broker-dealers operate and comply with the Exchange Act.

As the Commission notes, the proposal is being made pursuant to Sections 223 of the Advisers Act through an expansive and, in our view, unsupportable reading of the language that allows the Commission to implement rules requiring investment advisers to "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..." The Commission's reading of this language is insupportably broad and indirectly regulates QCs such as broker-dealers that are subject to entirely different and comprehensive regulatory requirements, which in our view, is in violation of a host of statutory provisions.

First, we note that under Section 202(c) of the Advisers Act:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

We believe that the Commission has not, and cannot, satisfy this mandate. In this regard, given the vast regulatory framework applicable to broker-dealers, the Proposed Rule is not sufficiently tailored to meet the Commissions goals, and thus the Commission cannot maintain that it is appropriate in the public interest. Doing so would necessarily mean that the financial and operational frameworks applicable to broker-dealers are insufficient.

In addition, the Proposing Release does not adequately articulate whether the Proposed Rule will promote efficiency, competition, and capital formation. Quite to the contrary, with respect to QCs, the Proposed Rule is likely to yield the opposite effect and reduce the number of broker-dealers willing to act as QCs, thereby reducing competition in this space over the long term.

We also note that Section 553 of the APA requires that an agency "provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully." As it relates to broker-dealers that act as QCs, the Commission has failed to meet its obligations under Section 553. The Commission already has a substantial ruleset applicable to broker-dealer QCs to ensure the safety of customer assets. In the Proposing Release, the Commission has not provided factual detail or a rationale as to why it is necessary to indirectly impose additional requirements on broker-dealer QCs.

E. Advisers Should Be Exempt from the Written Agreement and Reasonable Assurances Requirements with Respect to Assets Maintained by Broker-Dealer QCs that are subject to the Customer Protection Rule.

As mentioned above, the Customer Protection Rule provides regulatory safeguards regarding the custody and use of customer securities and free credit balances held by broker-dealers.[15] The rule, with limited exceptions, requires compliance by all registered broker-dealers and serves to protect customer funds and securities through the possession or control requirements, and the customer reserve requirement. This is in addition to the numerous other requirements under the financial responsibility rules outlined above. Based on the extent to which broker-dealer QCs are already subject to such stringent asset protection requirements, the Commission should reconsider whether its written agreement and reasonable assurances requirements are materially net additive to the protections advisory assets already receive from broker-dealer QCs, particularly given the significant costs, risks, and uncertainty that the proposal could inject into the broker-dealer regulatory framework.

F. The Commission Should Adopt a Uniform Compliance Date Across All Investment Advisers

The proposal, if adopted, would require compliance within 12 months following the rule's effective date for investment advisers with more than $1 billion in regulatory assets under management ("RAUM"), and within 18 months for investment advisers with $1 billion or less in RAUM. This timeframe is extremely aggressive considering the extent to which custodians and advisers would need to overhaul many of their agreements, systems, operational processes, etc. Importantly, broker-dealer QCs are unlikely to use a bifurcated approach to support small and large advisers, so they would 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 practical for QCs and could, in some instances, create uncertainty for advisers that are just under the $1 billion threshold or contemplating a merger or acquisition that may close during the transition period.

If it moves forward with some form of the Proposed Rule, the SEC should adopt a transition period that is reasonable and workable for both small and large firms, which creates more certainty and consistency across the industry. We recommend at least a 24-month period for all advisers.

[15] The SEC Customer Protection Rule 15c3-3 functions as a safeguard regarding the custody and use of customers' funds and securities in the conduct of the broker-dealer business. The Net Capital Rule and Customer Protection Rule form the foundation of the securities industry's financial responsibility framework.

Conclusion

We encourage the Commission to work with the industry to develop less intrusive, risk-based reforms that strengthen investor protections and complement existing regulatory regimes that have proven to be effective.

Thank you very much for the opportunity to offer our perspective on these issues. We would be happy to answer questions or provide any additional information as the Commission continues to explore this topic.

Sincerely,

Bernie Clark
Managing Director, Head of Advisor Services, Charles Schwab & Co., Inc.

Cc: Gary Gensler, Chair, Securities and Exchange Commission
Hester M. Peirce, Commissioner, Securities and Exchange Commission
Caroline A. Crenshaw, Commissioner, Securities and Exchange Commission
Mark T. Uyeda, Commissioner, Securities and Exchange Commission
Jaime Lizárraga, Commissioner, Securities and Exchange Commission

William A. Birdthistle, Director, Division of Investment Management, Securities and Exchange Commission
Haoxiang Zhu, Director, Division of Trading and Markets, Securities and Exchange Commission
Michael Macchiaroli, Associate Director, Division of Trading and Markets, Securities and Exchange Commission
Thomas McGowan, Associate Director, Division of Trading and Markets, Securities and Exchange Commission