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VIA ELECTRONIC SUBMISSION

May 8, 2023

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

Re: *Safeguarding Advisory Client Assets (File No. S7-04-23)*

Dear Ms. Countryman:

We appreciate the opportunity to comment on the Securities and Exchange Commission's (the "Commission") above-referenced proposal[1] (the "Proposal") for a new rule under the Investment Advisers Act of 1940 (the "Act") to address how investment advisers safeguard client assets (the "safeguarding rule" or "proposed rule").

The Capital Group Companies is one of the oldest asset managers in the United States. Through our investment management subsidiaries, we actively manage assets in various collective investment vehicles and institutional client separate accounts globally. The majority of these assets consist of the American Funds family of mutual funds, which are U.S. regulated investment companies managed by Capital Research and Management Company, distributed through financial intermediaries and held by individuals and institutions across different types of accounts.

We appreciate the Commission's ongoing efforts to protect investors against the risks of loss, misuse, or appropriation of client assets. However, we generally believe that expanding the scope of current Rule 206(4)-2 under the Act (the "custody rule" or "current

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[1] *Safeguarding Advisory Client Assets*, Release No. IA-6240; File No. S7-04-23 (March 9, 2023), available at https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

rule") as contemplated by the Proposal will not further this stated policy goal in any meaningful way, and that the negative consequences of the Proposal will far outweigh any incremental protection that accrues to investors. The Proposal represents an acute departure from current practices which will cause significant disruption among investors, their custodians and advisers, and other market participants, to the ultimate detriment of investors who will encounter higher costs and substantially diminished choices of custodians, investment advisers, and types of investments and investment strategies. Notwithstanding the Commission's good intentions, the Proposal is flawed and unworkable in many aspects and, to that end, we generally agree with the comments submitted by the Investment Adviser Association (the "IAA Letter"), Investment Company Institute (the "ICI Letter") and SIFMA Asset Management Group (together with the IAA Letter and the ICI Letter, the "Industry Letters"). We write to share our views on the following key issues:

1. The definition of custody should not be expanded to include discretionary trading authority.

In adopting the custody rule, the Commission specifically excluded from the definition of "custody" an adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades.[2] The Commission now proposes to significantly expand the definition of "custody" to include discretionary trading authority, on the basis that such authority presents risks to client assets which must be addressed through the safeguarding rule.

As the Commission noted previously and again in proposing the safeguarding rule,[3] the risk of loss or misappropriation of client assets is limited for transactions that settle on a "delivery versus payment" ("DVP") basis. Although the Commission now asserts that discretionary trading authority in general can place client assets at risk of loss or misappropriation, the Commission does not identify any actual incidents of such loss or

[2] See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003), 68 Fed. Reg. 56692 (Oct. 1, 2003), available at https://www.sec.gov/rules/final/ia-2176.htm.
[3] See, for example, Proposal at 34, 208, 276, 325.

misappropriation that have occurred, and instead only describes theoretical examples of such risks based on non-DVP trading.[4]

However, non-DVP transactions in practice are routinely and reliably settled and have safeguards in place to limit risks to client assets. For example, to reduce settlement risk that the client delivers an asset in a sale but does not receive payment, or that the client makes payment for the purchase of an asset but does not receive delivery of the asset, advisers may negotiate better-than-DVP terms with counterparties, such that receipt of payment (or the asset) is confirmed before the adviser authorizes the delivery of the asset (or the payment). Where better-than-DVP settlement is not possible, advisers may have policies and procedures in place to authorize worse-than-DVP settlement only with certain trusted counterparties and/or only when there is clear recourse for non-performance by the counterparty. Additionally, some assets which settle on a non-DVP basis are custodied with qualified custodians and have the safeguarding protections offered by a qualified custodian, and other non-DVP assets which are not custodied with qualified custodians have impediments and conditions to transferability, such as pre-notification requirements and consent rights, that make them less susceptible to theft or loss.[5]

Furthermore, while we are not aware of concerning incidences of fraud or misappropriation arising from discretionary trading authority, advisers can mitigate such risks through reasonably designed controls and policies and procedures. Advisers may limit authority to provide instructions to custodians to a limited number of authorized personnel, implement appropriate security procedures to ensure only properly authorized persons can transmit such instructions, reconcile records on a regular basis, title or record securities in the name of the client and not the name of the adviser, have separation of responsibilities among personnel, and adopt policies and procedures reasonably designed to prevent violations of such conditions.[6]

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[4] See, for example, Proposal at 13 (describing how discretionary trading practices today do not necessarily involve a one-for-one exchange of assets; i.e., non-DVP trading).
[5] Proposal at 129.
[6] Also see, for example, the controls described in the Appendix to the March 7, 2018 letter from SIFMA Asset Management Group and the Investment Adviser Association regarding IM Guidance Update No. 2017-01, available at https://www.sifma.org/wp-content/uploads/2018/05/February-2017-Guidance-on-Custody.pdf.

We believe the custody rule was intended to address specific risks associated with holding or transferring assets, and not to broadly address every risk that could be associated with each trade and settlement under an investment adviser's discretionary trading authority. As risks to client assets from discretionary trading authority are low or can be addressed with appropriate safeguards, expanding the definition of custody to include discretionary trading authority would not significantly benefit investors, but would come at significant cost. Such an expansion would subject many advisers who have not historically been deemed to have custody of client assets to the requirements of the proposed safeguarding rule, imposing significant compliance costs and burdens on such advisers, who would spend meaningful time and effort to implement and maintain custody-related procedures and controls just to mitigate the low risk to client assets arising from discretionary trading authority. Furthermore, as described in further detail below, the safeguarding rule could limit clients' choices of custodians and the availability of investment and advisory options, and expanding the definition of custody to include discretionary trading authority would significantly increase the number of adviser-client relationships that would be subject to such limitations and complications.

For these reasons, the proposed rule should continue to exclude discretionary trading authority from the definition of custody. If, however, the Commission has heightened concerns about the risk of loss or misappropriation with respect to assets that settle on a non-DVP basis, the Commission could require advisers to implement controls, policies, and procedures designed to mitigate the risk of loss or misappropriation of such assets, like those described above. In this scenario, we believe advisers should be able to design such controls, policies, and procedures based on their specific circumstances, such as the specific types of non-DVP assets under the adviser's custody and the clients which would hold these non-DVP assets. The Commission could also require advisers to disclose to clients the risks of non-DVP trading, so that clients can make informed decisions about authorizing an adviser to trade in such manner. To the extent the Commission decides to make any distinctions based on whether a transaction settles on a DVP or non-DVP basis, we would urge the Commission to clearly define what constitutes DVP settlement for purposes of such distinctions and adopt a reasonable materiality threshold or safe harbor; as currently proposed, a single, non-DVP settlement in an account without a change in the authority of the adviser (e.g., a corporate action) would automatically subject the entire account to the Proposal's requirements for non-DVP trading.

2. The Commission should not seek to indirectly regulate custodians by imposing the written agreement and reasonable assurances requirements on advisers.

In proposing the written agreement and reasonable assurances requirements, the Commission seeks to strengthen investors' ability to negotiate a certain level of custodial protections with custodians by requiring advisers to separately obtain these protections. Although we understand the Commission's goal of creating a minimum floor of custodial protection for investors, the Commission's attempt to enforce this objective through a unilateral requirement on advisers is a misdirected solution that could lead to clients facing costly changes in custodial or advisory services.

The Commission notes that contractual limitations on custodial liability vary widely in the marketplace,[7] with some custodial agreements providing for indemnification on a gross negligence standard and others using an ordinary negligence standard.[8] The Commission predicts that the Proposal's requirement to obtain reasonable assurances that a custodian will indemnify the client based on an ordinary negligence standard would likely result in a substantial expansion in the protections provided by qualified custodians to clients, since custodians would no longer be able to disclaim liability for misconduct that does not rise to the level of gross negligence.[9]

Recognizing that the negotiating power of the client appears to play an outsized role in determining the scope of the indemnity a custodian will provide, the Commission seeks to interject advisers into the client-custodian relationship, as it seems to believe that advisers will be able to negotiate greater protections for clients than the clients themselves. In doing so, the Proposal underappreciates the off-market nature of a negligence standard for indemnification in custodial agreements as well as the degree to which these provisions are negotiated. At the same time, the Commission overestimates advisers' negotiating power relative to that of their clients with respect to their clients' custodial arrangements.

[7] Proposal at 87.
[8] Proposal at 83.
[9] Proposal at 287.

In our experience, most qualified custodians do not assume liability on a simple negligence standard. In addition, as the Commission acknowledges in the Proposal, advisers are rarely parties to custodial agreements today[10] and have had little success in modifying or eliminating unwanted authority under existing agreements between clients and their custodians, because custodians are reluctant to entertain advisers' requests or because clients lack bargaining power with their custodians.[11] The Commission explains that the proposed reasonable assurances and written agreement requirements are designed to mitigate these concerns and empower advisers to modify custodial agreements,[12] but then fails to provide advisers with greater authority or bargaining power to modify custodial arrangements, leaving advisers with a set of requirements that are largely beyond their control.

The reasonable assurances and written agreement requirements may thus have undesirable consequences for both advisers and their clients. Take, for example, cases where the client selects its custodian. An adviser that does not direct a client's selection and retention of custodial services has no privity of contract, negotiation leverage, or legal authority to enter into an agreement with the client's custodian. What must the adviser do if the custodian refuses to agree to the terms required by the Proposal? Would it be obligated to require the client to choose a different custodian who is willing to agree to these terms, regardless of the client's preference for their original custodian or the respective breadth and quality of services provided by these custodians? And if an existing or prospective client declines to change their custodian, would the adviser need to terminate its existing advisory relationship with the client or decline the prospective advisory relationship? Clients could thus be deprived of their choice of preferred custodian and/or investment adviser and spend time and incur costs in transitioning from one custodian or investment adviser to another. Alternatively, clients could decide to avoid such costs altogether by resorting to non-discretionary or self-managed investing and trading.[13]

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[10] Proposal at 74.
[11] Proposal at 106.
[12] Id.
[13] An adviser may face similar difficulties in other advisory relationships, such as when it acts as a sub-adviser or when it provides advisory services in separately managed account programs sponsored by broker-dealers or other financial institutions. In these instances, the primary adviser or the program

We do not believe imposing the written agreement and reasonable assurances requirements on advisers is an appropriate means to achieve the Commission's goal of strengthening investors' ability to receive heightened protections in their custodial arrangements. The Commission should instead seek to achieve this goal directly through coordination with custodians' regulators, rather than attempting to indirectly regulate custodians through advisers.

If, however, the Commission still determines to impose written agreement and reasonable assurances requirements on advisers, the Commission should limit these requirements solely to circumstances where an adviser recommends, requests, or requires a particular custodian for a client, given the concerns described above.[14] This exclusion would be particularly reasonable with respect to custodial arrangements of separate account clients who meet the accredited investor definition under the Securities Act of 1933, as amended, and therefore have the expertise and resources to evaluate their risks of loss through custodial misconduct or misappropriation, as well as custodial arrangements selected by primary advisers in sub-advisory relationships or by SMA program sponsors. Such persons are sophisticated and capable of negotiating their own custodial agreements, would not expect their choice of advisers to determine or influence their custodial relationships, and would be better placed to negotiate appropriate terms with their selected custodian than an adviser who has no relationship with the custodian.

3. The proposed changes to the privately offered securities exemption are not practical, and investors may lose access to this asset class.

The Commission expresses concern that the privately offered securities exception under the current rule may no longer adequately protect clients from the risk of

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sponsor selects and oversees the custodian and the secondary adviser has minimal involvement in the custodial relationship.

[14] The Commission has previously recognized the difference in circumstances in cases where an adviser recommends, requests, or requires a client's custodian and those where the adviser does not. See Question II.11 in the responses of the staff of the Division of Investment Management to questions about the custody rule ("We note, however, that this relief is not available where the adviser recommended, requested, or required a client's custodian."), available at https://www.sec.gov/divisions/investment/custody_faq_030510.

misappropriation, due to changes and expansion in the market for privately offered securities since its adoption.[15] While we recognize this concern, many of the proposed changes to the exception would be overly costly and impractical, and could result in dissuading advisers from providing advisory services with respect to privately offered securities.

The requirement to have an independent public accountant verify each purchase, sale, or other transfer of beneficial ownership of a privately offered security would be particularly problematic and costly. Although advisers are subject to the annual audit requirements under the current rule, advisers do not seek transaction verifications for every single trade of a privately offered security. Accordingly, this new requirement would be a wholesale change in how advisers are required to engage independent public accountants. As there is not currently a developed market for independent public accountants to provide this type of service to advisers, it is unclear how quickly such a market would develop and whether there would be a sufficient supply of independent public accountants to fulfill the transaction verification requirements of all advisers who would have custody of privately offered securities. It is clear, however, that seeking, operationalizing, and paying for such transaction verification services would impose significant costs on advisers and clients.

The Proposal also fails to fully consider the complexities and challenges of verifying transactions in privately offered securities, which will depend on the cooperation of issuers, transfer agents, or other third parties beyond the adviser's control. These third parties will have no legal or contractual obligation to respond to inquiries and requests for information from independent public accountants engaged by advisers, leading to delayed or no responses at all and therefore potential violations of the prompt verification requirement under the Proposal. If an adviser finds that it is not able to obtain such transaction verification services or that the costs of such services are prohibitively expensive, it may be forced to cease providing advisory services with respect to privately offered securities, which may result in clients losing access to this asset class altogether.

Privately offered securities can be valuable and important investments in a client's portfolio. They also often are more complex and have different operational challenges compared to investments in public securities. If advisers cannot educate and advise clients on

[15] Proposal at 131-132.

investment in privately offered securities, clients will be forced to manage such complex investments on their own or forego investments in privately offered securities. We do not believe the custody rule was intended to prevent investors from investing in, or receiving advisory services with respect to, certain types of assets; accordingly, the Commission should not indirectly block access to privately offered securities through the safeguarding rule.

Instead of requiring verification of every transaction, the Commission could require advisers to adopt and implement policies and procedures designed to ensure adequate controls around maintenance and transfers of privately offered securities, like those described above in Section 1 of this letter. Such policies and procedures would provide more protections to client investments in privately offered securities than a post-transaction verification, as these policies and procedures would be designed to prevent a bad actor from misappropriating client assets, but a post-transaction verification would only identify such a misappropriation after it has already occurred. The existing annual surprise examination or audit requirement would serve as a similar post-transaction check, while not imposing the costs that might lead to clients being effectively barred from investing in privately offered securities. The Commission could also require advisers to deliver quarterly summaries of client transactions of privately offered securities to the independent public accountant to supplement their annual surprise examination or audit.

In addition, we urge the Commission to provide additional guidance regarding the proposed requirement that an adviser must make a reasonable determination that a privately offered security cannot be maintained with a qualified custodian for the privately offered securities exemption to be available. The Commission notes that this reasonable determination would generally involve an analysis of the asset and the available custodial market.[16] As the Commission recognizes, some custodians are willing to custody privately offered securities[17] but others will not,[18] and the point at which an adviser can reasonably determine that a particular security cannot be maintained with a custodian is unclear. The Proposal notes that the proposed rule does not prescribe exactly how advisers should comply with this requirement and that advisers would have some flexibility in making these

[16] Proposal at 137.
[17] Proposal at 15.
[18] Proposal at 130.

reasonable determinations.[19] However, absent clearer guidance and/or a reasonable safe harbor regarding this requirement, uncertainties about whether the Commission might second-guess an adviser's determination could cause advisers to decline to advise clients with respect to privately offered securities.

4. The Commission should ensure that any enhanced requirements regarding foreign financial institutions ("FFIs") and sub-custodial liability do not cause investors to lose access to certain investments, markets, and/or investment strategies.

We agree with comments in the Industry Letters that the modified requirements for foreign financial institutions to serve as qualified custodians could make investing in certain foreign markets unfeasible, decreasing the availability of certain investments and investment strategies for clients.

For example, for an FFI to be a qualified custodian under the proposed rule, it must be "required by law" to (i) comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act and (ii) implement practices, procedures, and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets. As the Commission recognizes, however, a foreign country may not have laws and regulations which would fulfill such requirements,[20] in which case the safeguarding rule would not only prevent a client from selecting a financial institution in that country as its custodian, but would broadly prohibit investment in securities which would need to be held with local custodians in that country. To the extent the Commission determines to impose stricter requirements on FFIs, we urge the Commission to carefully consider how any such new requirements might effectively foreclose investment in certain markets before finalizing any such requirements.

We also urge the Commission to permit advisers to rely on a primary custodian's determination of whether a sub-custodian FFI qualifies as a qualified custodian, similar to how the eligible foreign custodian assessment under Rule 17f-5 under the Investment Company Act of 1940 may be delegated to a qualifying bank as foreign custody manager. Typically, a client does not independently select each foreign custodian that custodies its

[19] Proposal at 308.
[20] Proposal at 283 n. 488.

assets in foreign markets, as the client's primary custodian will arrange for such foreign custodial relationships through its sub-custody network. As the Commission acknowledges, advisers and clients are unlikely to have direct contractual relationships with sub-custodians or to have decision-making authority over which sub-custodians are used by a primary custodian.[21] Accordingly, where an FFI is part of a sub-custodian relationship, advisers should be able to rely on the primary custodian's FFI assessment.

5. As the Proposal would broadly expand the custody rule and require advisers to create new relationships with custodians, advisers should have at least three years to implement the proposed changes.

We concur with the Industry Letters that the proposed transition periods would not provide advisers with sufficient time to implement the changes required under the Proposal. Because the proposed expansion of the definition of custody to include discretionary trading authority would be a significant change, many advisers and client assets would become newly subject to the safeguarding rule. The Commission's own analysis estimates a 60% increase in advisers deemed to have custody of assets,[22] but even this substantial figure underestimates the entire impact of the Proposal, as advisers who currently report custody of client assets may have custody of client assets in one part of their advisory services but not in others. An adviser may currently have custody with respect to its pooled investment vehicle clients but not with respect to its separate account clients, and its experience with complying with the custody rule for its pooled investment vehicle clients would not translate seamlessly to compliance for its separate account clients due to differences in client and custodian relationships and operational practices.

Similarly, the revised definition of in-scope client assets would expand an adviser's custody obligations to new types of asset classes that advisers, custodians, and other market participants have not previously had to consider. As one example, the Proposal notes that financial contracts held for investment purposes would be in scope for the safeguarding rule. As described in further detail in the Industry Letters, today most custodians do not offer custodial services for such instruments, and extending the custody rule to such instruments

[21] Proposal at 90.
[22] Proposal at 352 (describing an estimated increase of 8,724 advisers to 13,944 advisers being deemed to have custody).

would require significant changes in market practices. Accordingly, advisers, custodians, and other market participants would have to implement a considerable number of new processes, controls, policies, and procedures to comply with the safeguarding rule as proposed.

Furthermore, advisers would not be able to implement these changes alone. Advisers would need the cooperation of third parties like clients, custodians, accountants, and counterparties to implement the proposed changes to the custody rule, and the Commission underestimates the time and effort needed for these changes. For example, the Commission estimates that it would take an adviser approximately 15 minutes to obtain the proposed reasonable assurances requirements from a custodian[23] and one hour to enter into the required agreement with each custodian.[24] These agreements and reasonable assurances would take significantly longer to obtain. These would be entirely new agreements and requests of custodians, and many of the requirements for these agreements and reasonable assurances involve terms that are likely to be heavily negotiated and that will require custodians and advisers to develop new internal policies and procedures. The Commission seeks to bring advisers into the client-custodian relationship because clients may have difficulty negotiating terms like indemnities and liability standards; however, advisers will also find themselves in difficult and time-consuming negotiations over such terms, as advisers will not have any particularly privileged relationship with, or negotiation leverage over, most custodians.

We also believe the Commission underestimates the number of agreements an adviser will need to negotiate. The Commission estimates that each adviser will enter into approximately four written agreements, assuming that an adviser would enter into a single agreement with each custodian, regardless of how many clients the custodian provides services for.[25] We believe this number will be significantly higher, particularly for advisers which manage separate accounts for institutional clients; institutional clients typically have existing or preferred custodial relationships, and an adviser which manages separate accounts for 10 different institutional clients may find that each client has a different

[23] Proposal at 359.
[24] Proposal at 354.
[25] Proposal at 353.

custodian. We also do not agree with the Commission's assumption that an adviser would only have to enter into a single agreement with each custodian – clients, particularly sophisticated institutional clients, may prefer that their advisers follow the same form of agreement with their custodian or may have specific requirements of their advisers, so advisers may need to negotiate client-specific agreements with custodians.

For these reasons, we agree with comments in the Industry Letters that a longer transition period of at least three years for all advisers would be appropriate.

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We appreciate the opportunity to comment on the Proposal and are grateful for your consideration of our recommendations. If you have any questions regarding our comments, please feel free to contact Tim Moon at (213) 615-0050.

Sincerely,

Nelson N. Lee
Senior Vice President and Senior Counsel
Capital Research and Management Company

Tim Moon
Counsel
Capital Research and Management Company

cc. The Hon. Gary Gensler, Chairman
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The Hon. Caroline A. Crenshaw, Commissioner
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