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Filed Electronically
Ms. Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549

Re: Safeguarding Advisory Client Assets; File No. S7-04-23

Dear Ms. Countryman:

Pickard Djinis and Pisarri LLP[1] submits these comments in response to the above-referenced proposal to replace the existing custody rule under the Investment Advisers Act of 1940 ("Advisers Act")[2] with a substantially broader and more burdensome rule relating to the safeguarding of advisory client assets.[3] While we believe that the current custody rule should be updated to address issues that have arisen since the rule's last amendment in 2009,[4] we also believe that this proposal misses the mark. Among the most pronounced defects are the treatment of investment discretion as a form of custody—which conflates two very different concepts—and the interposing of investment advisers between investors and their custodians, which would disrupt long-standing business relationships, increase costs and limit customer choice without any offsetting benefits. For these reasons and the others discussed below, we respectfully ask the Commission to substantially revise this proposal before proceeding with this rulemaking.

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[1] Pickard Djinis and Pisarri LLP is a law firm specializing in securities regulation relating to investment advisers, broker-dealers and service providers thereto. Our investment adviser client base ranges from global firms with hundreds of employees and billions of dollars of regulatory assets under management to solo practitioners with relatively modest amount of managed assets. This letter reflects the views of a number of our federally regulated clients, particularly the smaller ones.

[2] Rule 206(4)-2.

[3] *Safeguarding Advisory Client Assets,* IA Rel. No. 6240 (Feb. 15, 2023); 88 Fed. Reg. 14672 (Mar. 9, 2023), *available at*: Proposed rule: Safeguarding Advisory Client Assets (sec.gov) (the "Proposal").

[4] Custody of Funds or Securities of Clients by Investment Advisers, IA Release. No. 2968 (Dec. 30, 2009), 75 Fed. Reg. 1456 (Jan. 11, 2010) ("2009 Custody Release").

Preliminary Statement

The Proposal is part of an avalanche of Commission rulemaking affecting investment advisers over the past two years.[5] These actions collectively threaten to transform the principles-based Advisers Act regulatory regime into a prescriptive, rules-based system that makes investment advisers responsible for policing the conduct of entities that are already regulated by the Commission, as well as those that are beyond the agency's jurisdiction. This approach to investment adviser regulation raises a number of concerns.

First, the pace of the recent rulemaking distorts the public comment process. Even the most well-resourced commenters find it difficult to thoroughly analyze the Commission's successive, voluminous releases and answer the thousands of discrete questions posed therein in the time allotted. For example, half-way through the comment period for the instant proposal—which runs 434 pages and asks 920 questions—the Commission issued another lengthy proposal with an additional 241 questions,[6] diminishing the chances that interested parties will have time to fully address either one. Although comment periods have reopened for some proposals,[7] short, disjointed periods do not give the public the "meaningful opportunity" to participate in the Commission's rulemaking that the Administrative Procedures Act requires.[8]

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[5] *Amendments to Form PF to Require Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers and to Amend Reporting Requirements for Large Private Equity Fund Advisers,* IA Rel. No. 6297 (May 3, 2023); *Regulation S-P; Privacy of Consumer Financial Information and Safeguarding Customer Information*, IA Rel. No. 6262 (Mar. 15, 2023), 88 Fed. Reg. 20616 (Apr. 6, 2023) ("Reg. S-P Proposal"); *Shortening the Securities Transaction Settlement Cycle*, IA Rel. No. 6239 (Feb. 15, 2023), 88 Fed. Reg. 13872 (Mar. 6, 2023) ("Settlement Cycle Proposal"); *Outsourcing by Investment Advisers*, IA Rel. No. 6176 (Oct. 26, 2022), 87 Fed. Reg. 68816 (Nov. 16, 2022) ("Outsourcing Proposal"); *Electronic Submission of Applications for Orders under the Advisers Act and the Investment Company Act, Confidential Treatment Requests for Filings on Form 13F, and Form ADV-NR; Amendments to Form 13F*, IA Rel. No. 6056 (Jun. 23, 2022), 87 Fed. Reg. 38943 (Aug. 29, 2022); *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices,* IA Rel. No. 6034 (May 25, 2022), 87 Fed. Reg. 36654 (Jun. 17, 2022);); *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, IA Rel. No. 5955 (Feb. 9, 2022), 87 Fed. Reg. 16886 (Mar. 24, 2022) ("Compliance Reviews Proposal"); *Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies*, IA Rel. No. 5956 (Feb. 9, 2022), 87 Fed. Reg. 13524 (Mar. 9, 2022) ("Cybersecurity Proposal").

[6] *See* Reg. S-P Proposal, *supra.*

[7] *See Reopening of Comment Period for Modernization of Beneficial Ownership Reporting, SEC Rel. No. 33-1110* (Apr. 28, 2023), 88 Fed. Reg. 28440 (May 4, 2023); *Reopening of Comment Period for "Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies,"* IA Rel. No. 6263 (Mar. 15, 2023), 88 Fed. Reg. 16921 (Mar. 21, 2023); Reopening of Comment Periods for "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews" and "Amendments Regarding the Definition of 'Exchange' and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities," IA Rel. No. 6018 (May 9, 2022), 87 Fed. Reg. 29059 (May 12, 2022).

[8] 5 USCS § 553(c); *Craker v. United States DEA*, 44 F.4th 48, 55 (1st Cir. 2022) ("[T]he APA generally requires the agency to first publish a notice of proposed rulemaking and provide interested parties with a meaningful opportunity to comment on the proposal."). *See also* Executive Order 12866, Regulatory Planning and Review (Sept. 30, 1993), 58 Fed. Reg. 51735 (Oct. 4, 1993) ("[E]ach agency should afford

The rapid issuance of successive, complex proposals also robs the Commission of the opportunity to use the public comments from one rulemaking to inform the design of the next. For example, the written agreement and reasonable assurance provisions of the Proposal are premised on a flawed assumption that investment advisers have bargaining power equal to that of the largest financial institutions that hold their clients' assets. Commenters have already disputed similar assumptions about advisers' bargaining power in the Outsourcing and Cybersecurity Proposals;[9] yet their views are not reflected in the instant release.

Furthermore, the pace and scope of the recent rulemaking sets investment advisers up to fail. Before they can complete the many operational and compliance tasks necessary to address one set of regulatory changes, another set is upon them. In the past fifteen months alone, the Commission has proposed *five* separate amendments of the Advisers Act recordkeeping rule, without acknowledging the effect such perpetual change would have on the day-to-day functioning of an adviser's compliance program.[10] This is especially troubling in light of the fact that federally registered investment advisers are, for the most part, small businesses with few employees.[11]

We respectfully submit that a fire-hose approach to rulemaking harms advisers and does nothing to protect investors. We urge the Commission to adopt a more measured and wholistic approach, affording the public a meaningful opportunity to comment on each *concise* proposal and recognizing the cumulative impact of all new rules and rule amendments on an fully-developed regulatory regime.

Definition of Custody

In ordinary parlance, "custody" means physical possession.[12] That generally-accepted definition was deemed to apply to the custody rule until 2003, when the Commission expanded the concept of custody to also include the authority to obtain possession of a client's funds and

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the public a meaningful opportunity to comment on any proposed regulation, which in most cases should include a comment period of not less than 60 days").

[9] *See e.g.,* Comment Letter of Investment Adviser Association on the Outsourcing Proposal (April 20, 2023); Comment Letter of Pickard Djinis and Pisarri LLP on the Outsourcing Proposal (Dec. 27, 2022); Comment Letter of American Investment Council on the Outsourcing Proposal (December 22, 2022); Comment Letter of Pickard Djinis and Pisarri LLP on the Cybersecurity Proposal (May 3, 2022); Comment Letter of Investment Adviser Association on the Cybersecurity Proposal (April 11, 2022).

[10] In addition to the Proposal, amendments to Rule 204-2 have been proposed in the Settlement Cycle Proposal, the Outsourcing Proposal, the Compliance Reviews Proposal and, most recently, the Reg. S-P Proposal.

[11] As of the end of 2021, more than one-third of federally registered investment advisers had five or fewer employees; more than half had ten or fewer employees; and roughly 88 percent had fifty or fewer employees. The typical adviser who manages money primarily for individuals has, on average, only eight employees. Investment Adviser Association, NRS, "Investment Adviser Industry Snapshot 2022," *available at* https://investmentadviser.org/wp-content/uploads/2022/06/Snapshot2022.pdf at 7, 16, 39, 41 and 43.

[12] *See e.g.,* Custodian: What It Means in Banking and Finance (investopedia.com) ("Custodian" defined as a "financial institution that holds customers' securities for safekeeping to prevent them from being stolen or lost.").

securities. This was a wise decision, since the authority to take a client's property poses the same risk of loss, misuse, theft, misappropriation or exposure to the adviser's financial problems that actually holding the property does. However, the use of a single term to cover both physical and constructive possession created much confusion. An adviser with "custody" (the power to obtain possession) of a client's funds or securities is forbidden to have "custody" (actual possession) of those funds and securities unless the adviser is qualified to act as a "custodian." We addressed this confusion in our comments to the 2009 custody rule amendments and urged the Commission to modify its terminology to more clearly distinguish between the different forms of custody.[13] The Commission did not adopt this approach, but instead expanded the term further to include "indirect" custody through a related person's physical or constructive possession of client funds or securities.[14]

As the Proposal acknowledges, confusion over the meaning of the term "custody" continues to this day.[15] However, rather than address this problem, the Commission proposes to make matters worse by expanding the definition of custody to include ordinary investment discretion, or what might be called "imaginary" custody. We respectfully urge the Commission to drop this aspect of the Proposal and to clarify the existing definition instead.

The Commission has not adequately explained the reasons for the change in its long-standing position that discretion and custody are two separate concepts.

When the Commission expanded the definition of custody in 2003, the agency was careful to explain that the authority to obtain possession of client funds and securities is different from the authority to issue instructions to a broker-dealer or other custodian in connection with the execution or settlement of authorized trades.[16] For at least the past twenty years, therefore, trading discretion has not been deemed to be a form of custody, and advisers have relied on this interpretation in designing their investment advisory services and their compliance programs.

When an agency changes a previously-held position, as the Commission is doing here, it must "show that there are good reasons for the new policy. . . [and] provide a more detailed justification than what would suffice for a new policy created on a blank slate" when the "new policy rests upon factual findings that contradict those which underlay its prior policy; or when its prior policy has engendered serious reliance interests that must be taken into account."[17] The

[13] Comment Letter of Pickard and Djinis LLP (Jul. 28, 2009), *available at:* [Microsoft Word - comments on custody rule - july 09.docx (sec.gov)].

[14] Rule 206(4)-2(d)(2). The SEC Staff has subsequently introduced the concept of "inadvertent" custody, which is custody that the adviser does not intend to have, and often does not know it has. Proposal at 74, 88 Fed. Reg. at 14690-91; IM Guidance Update No. 2017-01 (Feb. 2017). We do not perceive inadvertent custody to pose a risk to clients that cannot be addressed by an adviser's internal controls. This concept should not be covered by the safeguarding rule.

[15] Proposal at 228, 88 Fed. Reg. at 14730.

[16] *Id.* at n. 37, *citing Custody of Funds or Securities of Clients by Investment Advisers*, IA Rel. No.2176 (Sep. 25, 2003), 68 Fed. Reg. 56692 (Oct. 1, 2003) ("2003 Custody Release").

[17] *FCC v. Fox Television Stations, Inc*., 556 U.S. 502, 515 (2009) (*quoting Smiley v. Citibank (South Dakota), N. A.*, 517 U.S. 735, 742 (1996).

failure to do so creates an "[u]nexplained inconsistency in agency policy [which] is a reason for holding an interpretation to be an arbitrary and capricious change from agency practice."[18] Moreover, "[w]hen an agency rescinds a prior policy its reasoned analysis must consider the alternatives that are within the ambit of the existing policy."[19]

We respectfully submit that the Commission has not adequately explained its decision to reverse the long-standing position that discretionary authority—especially, but not only, with regard to trades settling on a DVP basis—is not custody under the Advisers Act.[20] Justification certainly cannot be found in the plain meaning of the subject terms, because having the authority to issue settlement instructions for authorized trades does not give the adviser the power to remove assets from a client's account at a qualified custodian for the adviser's own benefit.

Nor has the Commission demonstrated an investor-protection justification for expanding the definition of "custody."

Today, roughly 92 percent of federally registered investment advisers exercise discretion over client accounts.[21] Such discretion typically involves deciding what securities to buy and sell, placing orders for the purchase and sale of those securities and issuing settlement instructions for the resulting trades. We are not aware of, and the Commission has not cited, *any* evidence that such routine activities have subjected client assets to loss, misuse, theft or misappropriation, or that they have exposed client assets to the adviser's insolvency or financial reversals. In the absence of any data to support this aspect of the Proposal, the Commission falls back on vague predictions that subjecting almost all advisers to the extensive requirements of Rule 223-1 might/may/just possibly could make assets safer than they are today. Hazy, theoretical benefits of this type do not justify the imposition of substantial regulatory burdens, especially when the affected parties have long relied on the regulator's opposite interpretation of the activity in question.

For these reasons, we respectfully ask the Commission to eliminate the words "or discretionary authority" from proposed Rule 223-1.

<u>The existing definition of "custody" should be clarified.</u>

As a threshold matter, we agree that *custody* should continue to be defined as "holding, directly or indirectly, client assets, or having any authority to obtain possession of them."[22] We also agree that the revised rule[23] should incorporate the existing examples of what "holding" and

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[18] *Encino Motorcars, LLC v. Navarro,* 136 S. Ct. 2117, 2026 (2016) (internal quotations omitted).

[19] *Dep't of Homeland Sec. v. Regents of the Univ. of California*, 140 S. Ct. 1891, 1913 (2020).

[20] Note that although the proposing release says that custody includes "discretionary authority to trade" [Proposal at 20, 88 Fed. Reg. at 14677], the proposed rule defines "discretionary authority" to mean "the authority to decide which assets to purchase or sell for the client." Rule 223-1(d)(4).

[21] Proposal at 351, 88 Fed Reg. at 14762.

[22] Our views on the proposed definition of the term "assets" are discussed below.

[23] We take no position on whether the Commission should simply update Rule 206(4)-2, or move the regulation of custody to a new Rule 223-1.

"authority" look like. However, to eliminate confusion and facilitate compliance, we suggest that the various types of custody be clearly labeled. For example, possession of client assets (proposed Rule 223-1(d)(2)(i)) should be identified as *physical custody;* while the authority to obtain possession of those assets, as described in 223-1(d)(2)(ii) and (iii), should be identified as *constructive custody.* Custody arising where the adviser's related person has either physical or constructive custody of client assets should be identified as *indirect custody.*

We also agree that the rule should identify the types of situations that do *not* constitute custody. For example, the rule should confirm that physical custody does not include possession of checks drawn by clients and made payable to third parties; the inadvertent receipt of assets that are promptly returned to the sender; or the inadvertent receipt of assets that are promptly forwarded to the client under the limited circumstances discussed in prior SEC Staff guidance.[24]

Likewise, the rule should confirm that constructive custody does not include closed-loop distributions between client accounts held at one or more qualified custodians;[25] or the authority to issue settlement instructions in connection with authorized trades. Nor should custody include situations in which the adviser or its affiliate serves as a co-trustee of a trust or co-executor of an estate if no single co-trustee or co-executor is able to withdraw the trust's or estate's assets without the prior written consent of a co-trustee or co-executor that is not a related person.

The Adviser's Role in Custodial Arrangements

As the Commission acknowledges, the typical custodial arrangement runs between the investor and the bank, broker-dealer or other financial institution that holds the investor's funds and securities.[26] Large, institutional investors often work with multiple investment advisers trading through multiple broker-dealers and other execution facilities on a DVP basis, using standing settlement instructions, all coördinated through a single custodian. Retail investors, on the other hand, often have long-standing relationships with broker-dealers who provide them with a range of services, including custody. These clients may direct advisers to trade through the designated broker-dealers who continue to hold the managed assets. Even where advisers recommend custodians to their clients, they do not enter into custodial agreements on their clients' behalf. The current practice thus ensures privity of contract between the investor and the party that possesses and controls the investor's assets.

The Commission proposes to upend this long-standing custom and practice by requiring every adviser with investment discretion to interpose itself in the relationship between the client and the client's custodian. In this regard, Rule 223-1 would require the adviser to enter into a written agreement with each qualified custodian specifying the adviser's agreed-upon level of authority to effect transactions in the account, as well as the applicable terms and limitations

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[24] Investment Adviser Association, SEC Staff No-Action Letter (Sep. 20, 2007), *available at*: Division of Investment Management No-Action Letter: Investment Adviser Association (sec.gov). For ease of administration, we suggest the same time frame—five days—be used for both inadvertent receipt exceptions.

[25] Such distributions were addressed in SEC Staff Responses to Questions About the Custody Rule, Q.II.4 (modified Feb. 21, 2017), *available at*: SEC.gov | Staff Responses to Questions About the Custody Rule.

[26] Proposal at 74, 77, 88 Fed. Reg. at 14690.

established by the adviser and the client. The required contract must also obligate each qualified custodian to furnish the adviser with annual internal control reports and must impose recordkeeping and client account statement obligations on the custodian as well.[27] In addition, the adviser would be required to obtain reasonable assurances in writing relating to the custodian's standard of care, indemnification responsibilities, liability for sub-custodial services, segregation of client assets and limitations on the attachment of liens to client assets.[28] Because such written assurances would most likely be included in the agreement between the adviser and the custodian, we refer to both the written agreement and the written assurance requirements as "Contractual Obligations."

We respectfully submit that this aspect of the Proposal is flawed for the following reasons:

The Contractual Obligations presume that advisers have bargaining power that does not exist.

The Commission recognizes that market for qualified custodians is highly concentrated, due, among other things, to low margins and economies of scale.[29] The Commission also acknowledges that changes in the custodial marketplace have led some qualified custodians to limit their liability to clients and outsource their operational departments in order to remain profitable.[30] At the same time, the Commission admits that advisers have had little success eliminating their risk of inadvertent custody because

> qualified custodians have been reluctant to modify or customize the level of authority investment advisers have with respect to customer accounts. It increases their need to monitor customer accounts, and to accept liability, for unauthorized transactions by an adviser and its personnel.[31]

All this being the case, the presumption that advisers can make qualified custodians substantially enhance customer protections[32] and agree to customized levels of adviser authority is incomprehensible.[33] The economic realities of the marketplace and custodians' superior bargaining power will not evaporate simply because a new rule has been adopted under the Advisers Act.

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[27] Rule 223-1(a)(1)(i).

[28] Rule 223-1(a)(1)(ii).

[29] Proposal at 256, 88 Fed. Reg. at 14737.

[30] *Id.* at 76, 88 Fed. Reg. at 14691.

[31] *Id.* at 106, 88 Fed. Reg. at 14699.

[32] For example, the Commission views the proposed indemnification requirement as a substantial expansion of the current protections afforded by qualified custodians, since the Proposal would impose a simple negligence standard instead of the gross negligence standard that typically applies today. *Id.* at 89, 88 Fed. Reg. at 14694-5.

[33] *See* n. 9, *supra.*

<u>The Contractual Obligations have little, if anything to do with safeguarding client assets from loss, theft or misappropriation by the adviser.</u>

The Advisers Act regulates the conduct of investment advisers, including conduct relating to advisers' actual or constructive possession of managed assets. However, the Contractual Obligations do not address the risks emanating from an *adviser's* activities, but instead are focused on risks associated with the *qualified custodian's* activities. Indemnification, internal control reports, liability for sub-custodians' conduct, *etc.* might well enhance the safety of clients' assets, but these measures are more appropriately directed to the party to whom the assets have been entrusted. Using investment advisers as a means of controlling the conduct of qualified custodians is not appropriate.

<u>The Contractual Obligations would force advisers to police the conduct of parties that either are already regulated by the Commission or are beyond the reach of the Commission's jurisdiction.</u>

The Commission already regulates domestic broker-dealers and can impose due care, indemnification, internal control report, sub-custodian liability, asset segregation, recordkeeping, account statement, and lien requirements on them if that is deemed necessary. Policing broker-dealers is not, and should not be, the advisers' responsibility.

The proposal to force advisers to assess and direct the conduct of banks, trust companies, futures commission merchants and foreign financial institutions is even more indefensible, because the Commission has no jurisdiction over these entities. If the Commission is concerned about the conduct of these custodians, it should address its concerns with the appropriate domestic or foreign regulatory authority.

<u>The Commission has vastly understated the costs associated with the Contractual Obligations.</u>

It is far from clear how the Contractual Obligations are to work in practice. Are the written agreements between the adviser and the custodian meant to supplant the custodians' existing agreements with clients? Are the new contracts and the old meant to work in tandem? If so, which contract controls in the event their terms are inconsistent? Must clients be third-party beneficiaries of the adviser-custodian agreements? If they are not, how can they enforce their new-found protections? Would investment advisers be responsible for negotiating their clients' custody fees as part of the written agreement obligation? If not, might these agreements fail for lack of consideration?

Assuming, contrary to the evidence, that advisers can coax custodians to agree to the new requirements, the cost of implementing the Contractual Obligations would be staggering. In addition to negotiating master agreements with each qualified custodian and customizing those agreements to address various levels of authority as necessary, advisers also would have to assemble and review each existing agreement between clients and their custodians and would have to review and repaper their investment management agreements which reflect clients' current custodial arrangements. The Commission's estimate that advisers would have to deal with only four written agreements and that they would spend only one hour on each is risible.[34] Given advisers'

[34] *Id.* at 353-54, 88 Fed. Reg. at 14763. The Commission offers no estimate for the review and modification of the other contracts.

experience in unsuccessfully trying to negotiate away inadvertent custody, we believe 100 hours for all the preliminary contracting work could be closer to the mark.

The Commission's cost analysis relating to the Contractual Obligations—like its cost analysis of the entire Proposal—also ignores the very substantial compliance costs involved in implementing this radical change to existing practice. Every discretionary investment adviser would have to revise its written compliance policies and procedures and related operational procedures, conduct training of affected staff, and add oversight of qualified custodians to its already long list of topics for its annual review. Moreover, as discussed above, we believe that the cumulative burden of all the Commission's recent rulemaking should be factored into the analysis of each discrete proposal.

The Contractual Obligations would harm investors by raising costs, reducing the availability of custodial services, and eliminating choice.

We appreciate the Commission's efforts to protect investors, particular retail investors who are often second-class citizens in the financial services marketplace. Unfortunately, we believe that the practical effect of the Contractual Obligations will be the opposite of what the Commission desires.

Substantially increasing costs in a highly concentrated market with tight margins will invariably cause some service providers to exit the market. It is impossible to predict how many qualified custodians will cease offering custody services if the Contractual Obligations are adopted, but it is not impossible to predict that the ones who remain will be very expensive. The custodians who are willing to fulfill the Contractual Obligations are likely to focus on the most well-heeled institutions who can afford the enhanced protections, and leave small retail investors behind.

The Contractual Obligations are also likely to cause some advisers to cease providing discretionary management services, either because of cost or their inability to negotiate a compliant written agreement with custodians. Again, the brunt of this diminution in services is likely to be borne by the retail investors.[35] Advisers who continue to offer discretionary services may choose to contract with only a single custodian, thereby depriving clients of the ability to decide where their assets are held. This could impose substantial burdens on institutional and retail investors alike.

All in all, we believe that the Contractual Obligations aspect of the Proposal is impractical (if not impossible), expensive, disruptive and more likely than not to harm retail investors.

Effect of the Proposal on Small Advisers

As has been the case with all the recent rulemakings affecting investment advisers, the Commission has produced a meaningless Regulatory Flexibility Act analysis of the impact of the Proposal on small entities, because the standard the Commission employs to identify small advisers is so flawed. The obsolete assets-under-management test incorporated into Advisers Act

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[35] Losing access to professional investment advice is no small hardship. As the Commission notes, academic studies have documented a range of benefits such advice confers on retail investors. *Id.* at 259, 88 Fed. Reg. at 14738.

Rule 0-7(a) ensures that the Commission's assessment of the effect of its rules on small advisers will eliminate virtually the entire population of federal registrants from consideration. Ironically, many of the advisers that do meet the outdated standard are large, global financial services firms whose right to register under the Advisers Act derives not from asset management activities, but from their other advisory services that have an effect on the national markets.

Because an adviser's ability to shoulder regulatory compliance burdens depends on its human and financial resources, we believe that Rule 0-7 should be amended to identify small entities by looking at their staff and revenues, not their R-AUM. We respectfully ask the Commission to classify an investment adviser as a small entity if the business has fewer than 50 employees.[36]

Additional Comments

In addition to the foregoing, we offer the following thoughts on some of the specific questions the Commission has raised about this Proposal:

1. We do not believe that Congress authorized the Commission to regulate the custody of "all positions" in an investment advisory account. Congress added Section 223 to the Advisers Act as part of the Private Securities Act of 2010, which, in turn was part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[37] Although this legislation did follow the discovery of a string of Ponzi schemes, these scandals involved the misappropriation of client funds and securities, not commodities, real estate, jewelry or art, and certainly not crypto. Moreover, we believe that the Commission reads too much into Congress' use of the term "assets" instead of "funds and securities" in Section 223. The Senate Report related to this legislation[38] referred to the SEC's 2009 Custody Release, which used the phrase "client assets" "solely for ease of reference," and not to "modify the scope of client funds or securities subject to [the Custody Rule]."[39]

9.-10. For the reasons explained above, we do not believe Rule 223-1 should be triggered by an adviser's having discretionary authority over client assets. Advisers currently have safeguards that effectively limit the risks to clients of loss, misuse, theft, or misappropriation. These include limiting the number, and tracking the identity, of the individuals authorized to trade or issue

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[36] On April 26, 2023, the House Financial Services Committee unanimously approved the Small Entity Update Act, which directs the Commission to carry out a study and rulemaking on the definition of a "small entity" under the Regulatory Flexibility Act and ensure that regulations placed on such small entities are not overly burdensome. H.R.2792, 118th Cong. (2023). The Act would further direct the Commission to reassess the definition of a "small entity" every five years to "ensure that a meaningful number of entities would [continue to] fall under that definition" in the event of growth in the markets since the last assessment of the definition. *Id*. Sponsoring representative Ann Wagner stated that the bill is intended to "result in a better understanding of regulatory costs on small entities and ensure that the SEC modernizes its criteria for defining them, leading to a more targeted regulatory framework for these entities." House.gov, *Wagner Capital Formation Bills Pass Financial Services Committee* (April 26, 2023) *available at:* https://wagner.house.gov/media-center/press-releases/wagner-capital-formation-bills-pass-financial-services-committee. The bill has advanced to the House floor and is awaiting a vote by the full chamber.

[37] Pub. L. No. 111-203, § 411, 124 State. 1376, 1577 (2010).

[38] S. Rep. 111-176 (Apr. 30, 2010).

[39] 2009 Custody Release, *supra* n. 4 at n. 2.

settlement instructions on behalf of managed accounts; periodic review of standing settlement instructions; periodic reconciliation of internal account records against custodian statements; functional separation of personnel so that the same individuals do not communicate settlement instructions and review custodian account statements; and compliance reviews of email and other electronic communications.

12. The definition of custody should exclude situations in which the adviser has authority to instruct the client's custodian to remit assets from the custodial account to the client at his or her mailing address of record, so long as the adviser lacks the authority to open an account on the client's behalf and so long as the adviser has a reasonable belief that the custodian will notify the client—at the client's old address of record—of any mailing address change request by the adviser.

13. As a matter of public policy, the Commission should make it clear that an adviser will not be subject to the custody rule solely because a related person acts as the trustee of a participant-directed defined contribution plan established for the benefit of the adviser's employees. This should be the case *whether or not* the adviser provides investment advisory services to the plan, plan participant or investment option available under the plan. The current rule deprives advisory employees of professional investment advice because employers are loathe to assume the burdens of the custody rule.

85. For the reasons set forth above, we believe that the written agreement and reasonable assurances requirements (Contractual Obligations) should be eliminated from the Proposal. However, if the Commission decides to retain these provisions, we believe that an exception should be made for instances in which an advisory client has a custodial relationship that predates the client's engagement of the adviser. This would minimize the harm that could arise where the adviser cannot or will not satisfy the Contractual Obligations with respect to the client's existing custodian. There should be no required time period connected to the term "predates."

87. If the Commission decides to retain the Contractual Obligations, there should be no specific time period in which a qualified custodian would need to provide records.

89. The current custody rule's requirement regarding qualified custodians' delivery of account statements has worked well for many years. The proposed requirement regarding account statements is neither helpful nor necessary.

98. If the Commission determines to retain the Contractual Obligations, it should not also prescribe who or how internal control reports should be evaluated. As discussed above, a substantial percentage of federally registered advisers have very few employees.

109 - 110. Inadvertent custody is a theoretical problem that does not call for regulatory intervention. There is absolutely no evidence that clients are being harmed by authority advisers do not want and often know nothing about. The scope of an adviser's authority is more appropriately addressed in the investment management agreement. Furthermore, as discussed above, custodians' historic refusal to recognize custom limits on authority is unlikely to change simply because advisers are subject to yet another regulation.

123. We do not believe that the mutual fund shares exception entails investor-protection risks. The exception should be maintained.

124. An investor should not be deprived of access to discretionary management services

simply because an asset cannot be maintained with a qualified custodian. (As indicated above, we believe that the Proposal's definition of "assets" may exceed the Commission's jurisdiction.)

168.-169. The Commission already solicited public comment on these financial responsibility measures in connection with the fiduciary standard interpretive release.[40] It is discouraging, five years later, to find the same ideas buried deep within a proposal to update the custody rule. We believed in 2018 that there was no need to impose fidelity bond or net capital requirements on advisers, and we hold the same view today. *See* our prior comments at: s70918-4185788-172671.pdf (sec.gov).

235. and 238. For the reasons set out above, we submit that discretion is not custody and should not be regulated as such. However, if the Commission decides to define discretion as a form of custody, then we believe that there should be an unqualified exception to the surprise exam requirement for advisers whose "custody" is derived from the ordinary exercise of investment discretion.

239. As explained above, we do not agree with the Commission's assessment of the risks to client assets held by a qualified custodian as a result of an adviser's discretionary authority over those assets. Such risks are, at best, theoretical.

240. We do not believe that "closed loop" transfers (transfers between like-titled accounts at the same or different qualified custodians) should be treated as custody.

241. The exceptions to the surprise exam requirement should not be mutually exclusive.

242. and 245. We agree that an adviser should be exempt from the surprise exam requirement if the adviser's custody arises in connection with a SLOA and if the client's instructions include the name and either the address or the account number of the recipient to whom a transfer of investments should be directed.

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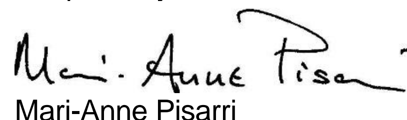
We appreciate the opportunity to submit these comments. We would be happy to supply any additional information you may desire about the matters discussed above. Kindly contact the undersigned at 202.223.4418 if we can be of further assistance.

Respectfully submitted,



Mari-Anne Pisarri

[40] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, IA Rel. No. 5248 (Jun. 5, 2019), 84 Fed. Reg. 33669 (Jul.12, 2019).

cc: The Honorable Gary Gensler, Chairman
The Honorable Hester M. Peirce
The Honorable Allison H. Lee
The Honorable Caroline A. Crenshaw
The Honorable Mark Uyeda
William A. Birdthistle, Director, Division of Investment Management