May 8, 2023

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

**Re: Proposed Rule – Safeguarding Advisory Client Assets; File Number S7-04-23**

Dear Ms. Countryman:

We respectfully submit the following comments to the above referenced proposal. In general, we believe that the proposal will increase cost while reducing competition and choice in custodial services. Many custodians will be unable, or unwilling within their current business models, for example, to bear the likely increase in insurance costs for providing indemnities, or needlessly park capital to meet financial strength requirements. This will exacerbate an already strong trend of asset concentration in large banks that will ultimately pass the cost of compliance to investors. The proposal also seems the latest in a series of proposals[1] attempting to apply to private funds and private advisory relationships onerous reporting and compliance responsibilities traditionally associated with registered investment companies. The cost of compliance with that level of regulation will further drive out smaller advisers in favor of the largest. The proposal is particularly ill suited to the private fund industry, as further discussed below.

**Indemnification of Client Losses**

*"The proposed rule would require that the adviser obtain reasonable assurances in writing from the qualified custodian that the qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct*."[2]

While recognizing the varied contractual models and levels of indemnity in the custodial market, the proposal seems to ignore how or why such market practice developed in favor of a one-size-fits-all standard. In the private fund advisor context, there are sophisticated parties on all sides of the custodial relationship from the advisor to the fund to the underlying investors. These sophisticated parties are best placed and have the market power to allocate risk among themselves. For example, the nature of the assets being custodied may not justify a private fund advisor paying for shifting risk to the custodian via broad indemnity. The custodian could be holding private securities that would be exempt from the need for a custodian but for the inability to produce an audit within the regulatory time frame. In those circumstances, there is no genuine risk of loss, but the proposal would create a fee premium to the fund/adviser as if there were. And that premium is unlikely to be immaterial, as the indemnity portion of the proposal is structured to encourage the most litigation possible.

Every commercial contract in one form or another creates the possibility of liability (and therefore litigation) between the parties to that contract. An indemnity, however, creates exposure for the custodian to claims brought by any third party that claims injury in the transaction, however specious and however remote from the intentions of the actual parties to the contract. Moreover, by requiring the custodian to indemnify the adviser/fund in the event of mere negligence (as opposed to other standards like willful misconduct), an incentive is created to search

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[1] *See*, "Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies" - File No: S7-04-22; "Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers" - File No: S7-01-22; "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews" - File No: S7-03-22.

[2] *See*, "Safeguarding Advisory Client Assets" - File No. S7-04-23 at pg. 86.

for any slight negligence on the part of the custodian to cover the adviser/funds' losses from third-party claims, or for that third party to reach into an additional deep pocket. Likely, the only class of custodian capable of facing this possibility and covering the cost of insuring against it are large institutions with bundled services. We, therefore, respectfully request the Commission to consider permitting, at least in the private fund context, a variety of contractual protective measures already used in the market that are aligned with the actual risk in the subject custodial arrangement.

**FFIs and Requisite Financial Strength**[3]

The proposal also attempts to limit the ability of foreign financial intuitions ("FFI") to serve as qualified custodians. Of the seven limiting factors proposed, the one that is seemingly designed to concentrate assets at large banks is the requirement that the FFI have "the requisite financial strength to provide due care for client assets". While suggesting no such measure or indicator, the proposal states that "financial strength could be based on objective measures and other indicators of financial health that are reasonably comparable to those that apply to U.S. banks and other regulated financial institutions."[4] If the Commission requires qualified custodians to be reasonably comparable to U.S. banks, then U.S. banks will be the only reasonable option. And as Silicon Valley Bank, Signature Bank, and First Republic Bank demonstrate, that is not a risk free option.

We respectfully request the Commission to reconsider this portion of the proposal. As noted in reference to the indemnity requirement, financial strength measures comparable to a U.S. bank are insensitive to the actual risk of the custodial relationship or the asset type being custodied, especially in the private fund context. However, if the Commission were inclined to retain it, we respectfully suggest that such financial strength be satisfied via maintenance of insurance or, in the case of a regulated FFI, the regulatory standard of financial strength required by the FFI's regulator.

**The Commission's Authority**

Perhaps most troubling about the proposal is the apparent sui sponte expansion of Commission authority to ostensibly regulate custodians. Traditionally, the Commission has used its authority over registered investment advisors to establish prudential rules related to the selection and oversight of service providers. Via this proposal, the Commission goes much further by prescribing the very terms of the custodian relationship, and to mandate custodian submission to Commission authority and enforcement. By this logic, the Commission could make itself, without legislation, the de facto regulator of virtually any business tangentially touching its authority, from cybersecurity providers to fund administrators to fund formation law firms. Moreover, this proposal demonstrates a willingness of the Commission to impose requirements on those businesses that even exceed those imposed on the actual subject of regulation—not even registered investment advisers are required to indemnify their clients or have "requisite financial strength".

[3] Id at 48.

[4] Id. at 51.