Electronic Submission

May 8, 2023

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

Re: Safeguarding Advisory Client Assets, SEC Release No. IA-6240; File No. S7-04-23

Dear Ms. Countryman:

This letter is submitted on behalf of the below contributing authors ("**we**")[1] in response to the request for public comments by the Securities and Exchange Commission (the "**SEC**") with respect to the above-referenced release (the "**Proposing Release**") proposing the new rule 223-1 (the "**Safeguarding Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**") to replace the current rule 206(4)-2 (the "**Custody Rule**") as well as certain related amendments to rule 204-2 under the Advisers Act (the "**Recordkeeping Rule**") and Form ADV.

We appreciate the opportunity to comment on this sweeping proposal. Our primary concerns relate to the potential upheaval in the custodial market. We believe the Safeguarding Rule would have significant negative effects on advisory clients, who will bear a significant share of the increased costs associated with compliance with the proposed Safeguarding Rule, and on smaller SEC-registered investment advisers, who will face increased competitive disadvantages both to larger investment advisers and also to unregistered non-U.S. investment advisers. We are particularly concerned about a rule whose compliance is based so heavily on the bargaining power of the investment adviser and its clients. Finally, we believe that the proposed Safeguarding Rule does not adequately consider the consequences of sweeping in a wide range of assets that are not funds or securities, including crypto assets but also including real estate assets, loans, and other assets. Specific comments are included below.

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[1] Please note that the opinions expressed herein are our own and not necessarily the opinions of Goodwin Procter LLP ("Goodwin"). The Goodwin letterhead has been included for identification purposes and does not indicate an endorsement by Goodwin.

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Table of Contents

1. Scope of Assets Required to Be Maintained at a Qualified Custodian ... 3

(a) Exception for Assets Not Required to Be Maintained at a Qualified Custodian ... 4

2. Scope of Definition of Custody ... 12

3. New Requirements for Qualified Custodians ... 14

(a) Reasonable Assurance and Written Agreement Requirements ... 16

(b) Requirements for Foreign Financial Institutions ... 20

(c) Requirements for Banks and Savings Associations ... 24

(d) Futures Commission Merchants ... 24

4. Adviser Segregation Requirements ... 25

5. Annual Audit Exemption ... 27

6. Delivery Requirements for Pooled Investment Vehicle Clients ... 29

7. Recordkeeping ... 31

8. Form ADV ... 32

9. Treatment of Crypto Assets ... 35

10. Real Estate ... 39

11. Loans ... 39

12. Extraterritorial Application ... 40

13. Grandfathering and Transition Period ... 41

14. Comment Period and Re-Proposal ... 44

1. <u>Scope of Assets Required to Be Maintained at a Qualified Custodian</u>

- ***An expansion of the scope of assets to be maintained at a qualified custodian should be matched with an expansion of the types of qualified custodians.***

In the proposed Safeguarding Rule, the SEC has not expanded the types of qualified custodians to match the expansion in the types of assets. We believe that the types of qualified custodians should not remain the same with the vastly expanded universe of assets that will need to be safeguarded.

One example of this inconsistency is the definition of "qualified custodian" still only picks up a futures commission merchant with respect to clients' funds, security futures and certain other securities.[2] It is unclear why there is any such restriction on which client assets the futures commission merchant is holding, so long as it is registered under the Commodity Exchange Act and is holding the client assets in customer accounts.

We further note that the SEC has in the past expanded who can effectively act as qualified custodian by providing the exception permitting the use of a transfer agent of a mutual fund in lieu of a qualified custodian.[3] The adoption of this exception indicated a willingness by the SEC to consider circumstances where an entity other than the traditional qualified custodians can provide the same external safeguard.[4]

Furthermore, banks and broker-dealers (which are the primary categories of qualified custodians under the Safeguarding Rule) are subject to their own legal and regulatory restrictions on the types of assets they can maintain. Absent an expansion of the definition of "qualified custodian" or regulatory exemptions to include market actors that typically hold certain assets, the Safeguarding Rule, as proposed, will likely cause investment advisers to not provide discretionary advice with respect to certain assets due to the lack of qualified custodians willing or able to keep custody of such assets. There does not appear to be a clear justification for why an investment adviser cannot provide discretionary investment advice with respect to assets just because the assets are of a type over which a bank or broker-dealer is not permitted to maintain in a custodial account.

As noted below, the new exception for "privately-offered securities" and "physical assets" is too narrow and has gaps for a range of different assets. We recommend below a number of suggested ways that this exception can be expanded to capture a wider range of assets that present reduced risk of misappropriation even without being held by a qualified custodian. However, even in the absence of expanding that exception, the SEC should consider providing

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[2] Rule 223-1(d)(10)(iii)(including a futures commission merchant within the definition of "qualified custodian" "only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon").

[3] Rule 206(4)-2(b)(1) (proposed to be incorporated into Rule 223-1(b)(1)).

[4] *See* Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2176 (Sept. 25, 2003) at fns. 24 – 25 and the accompanying paragraph (discussing the addition of the exception for shares of a mutual fund maintained with the mutual fund's transfer agent).

more flexibility to hold assets that are not funds or securities with third-party custodians that are not currently within the definition of "qualified custodian" or in another manner that balances the misappropriation risks with the investor benefits (including cost considerations).

- ***The Safeguarding Rule will lead to inefficient advisory structures, particularly with respect to assets that are difficult or costly to maintain with a qualified custodian.***

By creating an onerous rule that would raise significant costs (among other issues) both for the investment adviser and the advisory client, it is likely that both advisers and clients will gravitate toward structures that avoid some or all of the Safeguarding Rule. For example, a client who primarily seeks to invest in assets that are not securities (*e.g.*, real estate) may artificially restrict its investment strategy to exclude all "securities" (*e.g.*, minority interests in real estate companies), so as to avoid becoming a "client" under the Advisers Act and coming under the "protection" of the Safeguarding Rule. This avoidance would be particularly with respect to non-security assets given the absence of tailoring the rule to permit efficient safeguarding of such assets. This type of avoidance is inefficient for the client (*e.g.*, since it restricts diversification) but also harms capital formation since it makes it less likely that a client would invest in securities.

Similarly, clients may seek more non-discretionary relationships with investment advisers to avoid the application of the Safeguarding Rule. Non-discretionary relationships are less efficient in certain circumstances where the client (or its representative) is less able to act as quickly or efficiently as the investment adviser after the adviser has made its recommendation. This is particularly true with respect to smaller clients who are less able to efficiently execute on investment advice as compared to larger clients. This inequity may further be exaggerated since investment and/or trade allocations may be more difficult to efficiently manage in non-discretionary relationships as compared to discretionary relationships.

The SEC itself appears to acknowledge this possibility when it notes in the Proposing Release that absent "a robust market for custodial services," "advisers would be faced with the inability to comply with a Commission requirement or a need to transition to providing nondiscretionary advice or take certain other actions in order to avoid a violation of Commission rules, which could be disruptive or result in client harm".[5] We are concerned, however, that the SEC does not sufficiently grapple with the consequences of this result, particularly with respect to assets that do not meet the proposed exception for physical assets and privately offered securities.

(a) Exception for Assets Not Required to Be Maintained at a Qualified Custodian

- ***The exception creates a trap for assets where a qualified custodian can maintain ownership or control but cannot (or will not) comply with the other requirements of the Safeguarding Rule.***

The exception for privately offered securities and physical assets is not available if a qualified custodian exists who can maintain ownership or control. However, this creates a trap in certain

[5] Proposing Release at 132

circumstances because maintaining ownership or control is just one of many requirements for a qualified custodian to comply with the Safeguarding Rule. The exception is not available if the qualified custodian can maintain ownership or control but, for example, cannot (or will not) comply with the requirements relating to written reasonable assurances[6] and/or written agreement.[7] This means that the investment adviser could be faced with an unenviable choice of not complying with the Safeguarding Rule because, for example, the qualified custodian that could maintain possession or control over the asset does not provide the required reasonable assurances or enter into a written agreement compliant with the Safeguarding Rule (*e.g.*, because it does not receive the required internal control report, provide the required level of indemnification, submit to SEC jurisdiction (for a foreign financial institution), or satisfy the account segregation requirements). The SEC should allow reliance on the exemption if the investment adviser reasonably determines that it is unable to negotiate a relationship with a qualified custodian that is compliant with the Safeguarding Rule.

- ***There should not be a requirement that the books of the issuer be non-public in the privately-offered securities exception.***

There is no reason to limit the privately-offered securities exemption to where the books on which the issuer records the ownership are non-public. This is a new addition that is not included in the current exception, however, the SEC does not provide any explanation as to why it was added, other than to support why a security recorded on a public blockchain should be excluded.

There is no evidence that the use of public books would increase the risk of misappropriation. On the contrary, it seems that the use of public books would make it easier for investors (and their representatives), accountants and other third parties to monitor the ownership of the issuer and detect potential misappropriation by the investment adviser. In fact, this justification is why many real estate transactions are required by law to be recorded in public records.[8] For these reasons, we believe that the SEC should remove the requirement that the books be non-public in the privately-offered securities exception.

- ***There is no evidence of uncertificated, privately-offered securities of a client being at risk from the insolvency of the adviser, and there should not be any requirement to maintain such securities with a qualified custodian even if one is theoretically available.***

The SEC states that the characteristics of privately offered securities "do little, if anything, to protect a client against misuse, misappropriation, or losses that may result from the adviser's insolvency or bankruptcy". It provides no source for this statement or evidence that an adviser's insolvency or bankruptcy has resulted in the misappropriation of the privately offered securities of the adviser's clients. One of the conditions of the existing exception for privately offered

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6 Rule 223-1(a)(1)(ii).

7 Rule 223-1(a)(1)(i).

8 *See*, *e.g.*, Powell on Real Property, at Chapter 14, § 82.01 (2023)(discussing the history and purpose of real property recording acts and how "[r]ecording acts, by definition, require the public preservation of written documents of title to land, or of other written evidences of certain proprietary interests").

securities is that the ownership of the security is in the name of the client. It would already be a violation of the existing exception if the ownership of the security was in the name of the adviser. It is unclear why assets in the name of the client (which are also subject to the other transfer restrictions of the privately offered securities, including that the ownership of the asset is recorded on the books of the issuer) are at any risk of being treated as an asset of the adviser during any bankruptcy or insolvency proceeding.

Since this is presented as the sole justification for requiring that uncertificated, privately-offered securities be maintained with a qualified custodian (if there is one that can maintain possession or control over such securities), we believe that the exception for uncertificated, privately-offered securities should not have any such condition. Requiring uncertificated, privately-offered securities to be maintained with a qualified custodian will not provide any meaningful additional protection to clients and will result in substantial costs that will be significantly (if not completely) borne by such clients.

- ***The SEC does not consider that there are assets other than privately offered securities or physical assets that cannot be maintained with a qualified custodian.***

The exemption requires that the asset either be a "privately offered security" or a "physical asset". However, certain assets may not be "privately offered securities" or "physical assets" but may not be able to be maintained with a qualified custodian (*e.g.*, certain evidence of real estate ownership, evidence of ownership of artwork, commodities that are not physical assets, loans, and general partnership or other ownership interests that are not "securities"). We believe that in order to create an evergreen rule, the SEC should drop the limitation on the exception to privately offered securities and physical assets and open it to any assets that cannot be maintained with a qualified custodian in a manner that complies with the Safeguarding Rule (or at least any assets that are not securities and any uncertificated, privately offered securities).

An investment adviser should not be prohibited from providing investment advice concerning assets with respect to which clients have sought its expertise solely because there are no qualified custodians who are able to maintain such assets in compliance with the Safeguarding Rule. Such a result would unnecessarily harm investors by depriving them of the investment adviser's expertise, while providing no additional investor protection (since the investor could be left to safeguard the assets on its own).

- ***As alternative, the SEC should consider dropping the limitation of the privately offered securities exception to include other assets that share similar protections against misappropriation***

The privately offered securities exception is conditioned on the asset being a "security" under the Advisers Act. While this made sense while the Custody Rule was limited to funds and securities, it does not make sense where the Safeguarding Rule would apply to all client assets. There are a range of other assets that exhibit similar characteristics that protect them from misappropriation without being maintained with a qualified custodian.

First, there are assets (for example, general partnership or joint venture interests) that would meet the specific requirements of the privately offered securities exception with the simple change of broadening the exception to be available to any asset and not just securities (*i.e.*, acquired in a transaction not involving in a public offering, uncertificated, ownership recorded only on the books of the issuer in the name of the client, and transferable only with prior consent of the issuer or holders of the outstanding interests). We believe that there is no reason to treat similarly situated assets differently just because, for example, the *Howey* analysis results in different treatment of the interest in the entity under the federal securities laws (*e.g.*, a general partner or managing member LLC interest is not at a greater risk of misappropriation as compared to an ordinary limited partner or LLC member interest). It seems like a perverse result to treat an interest that is otherwise deemed as not needing the protections of the federal securities laws as needing greater protection under the Safeguarding Rule.

Second, the SEC should consider other types of assets that are not securities but have similar protections that reduce the likelihood of misappropriation. The SEC states that evidence of ownership of physical assets (such as warehouse receipt for commodities or a real estate deed) are not able to rely on the exception; however, the SEC also does not provide any support for why these certificates or other evidence of ownership are at same risk of misappropriation as cash or bearer instruments. In fact, as discussed further below, there are wide range of assets that are subject to legal and regulatory regimes apart from the banking or securities laws that have included differing types of protections against misappropriation. The SEC does not provide any analysis concerning whether these other existing legal or regulatory protections are sufficient to protect against misappropriation. In addition, the SEC does not consider where there would be a conflict of laws between a requirement to maintain such assets with a "qualified custodian" when the existing governmental or regulatory authority requires that they be maintained in a different fashion (including with the governmental or regulatory authority).

One could walk through some of the different types of assets and create an exception for each one, including, among many other possibilities, real estate (*e.g.*, real estate deeds, leases and other similar evidence of ownership of real estate), oil, gas and mineral rights, intellectual property (*e.g.*, patents, licenses, rights to royalties), loans, artwork, collectibles, commodities, and receivables. However, we believe that any such exercise would likely be impossible for the purpose of creating an evergreen rule due to the wide range of possible assets that could be owned by an advisory client (including potential innovations both within the securities markets and outside of the securities markets) as well as the patchwork of legal and regulatory regimes that exist across all of the U.S. and non-U.S. jurisdictions in which the advisory clients make investments. For this reason, we believe the prudent approach would be to take an approach based on principles rather than specific requirements or, where the SEC believe specific requirements are required, narrow such specific requirements to particular types of assets or provide a safe harbor for assets being maintained in accordance with such specific requirements.

When considering widening the application of the privately-offered securities exception to other types of assets, we would suggest the following modifications to the requirements:

No public offering requirement. The concept of a "public offering" is tied solely to Section 4(a)(2) of the Securities Act, including, typically, a prohibition on a "general solicitation."

However, there are other assets that may be similarly limited in their distribution but which may include public advertising. For example, if a real estate fund purchases an ownership interest in a single-family home advertised in a newspaper or a website, we do not believe that this public advertising significantly affects the potential for the misappropriation risk of the real estate deed owned directly or indirectly by the fund. We would recommend dropping this requirement with respect to assets that are not "securities" and rely on the conditions discussed below to ensure that they are not a material risk for misappropriation.

Uncertificated. We support the SEC's interpretation that "uncertificated" should include both the meaning set forth in article 8 of the Uniform Commercial Code and "where the certificate cannot be used to redeem, transfer, purchase, or otherwise effect a change in beneficial ownership of the security for which the certificate is issued." However, we believe that this requirement should be interpreted consistent with the guidance previously provided by the SEC staff that it is still uncertificated where the "certificate can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security" after satisfying the transfer consent requirements (discussed below).[9]

Recording of Ownership. While we believe that a requirement that the ownership of a security be recorded on the books of the issuer or its transfer agent makes sense for a security, we believe that there should be alternative allowed for other types of assets.

In particular, we believe that a similar type of protection can be provided where the ownership of the asset is recorded with a governmental or other regulatory authority, such as where a real estate deed is recorded with a local government authority. In many cases, these governmental or regulatory requirements are coupled with extensive and longstanding legal or regulatory requirements with respect to transfers for the purpose of minimizing misappropriation. We believe that this is particularly the case for real estate where there are laws and regulations long pre-dating the securities laws aimed at protecting against misappropriation (among other risks).[10] In addition, these governmental or regulatory authority often maintain publicly available databases that will facilitate the ability of investors (and their representatives), accountants and other third parties to confirm the ownership of the asset (and also trace the transactional history of the asset).

Furthermore, "issuer" and "transfer agent" are by their terms limited to assets that are "securities." We believe that similar protections can be provided by other third parties who perform substantially similar roles with respect to assets that are not "securities." For example, an administrative agent of a loan syndicate may be responsible for recording the ownership of participations in particular loans and, therefore, simply transferring evidence of ownership of the participation interest would not result in a transfer in proceeds associated with such participation interest. We believe the key point is that there is a third party who maintains the official record

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[9] SEC Division of Investment Management, Privately Offered Securities under the Investment Advisers Act Custody Rule, IM Guidance Update No. 2013-04 (Aug. 2013), available at https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

[10] *See* discussion on real estate assets in Section 10.

of the ownership and that the holder of the certificate or other evidence of ownership is not able to transfer ownership simply by transferring such certificate or other evidence.

Transfer Restrictions. Similar to the recording of ownership issue, we believe there should be more flexibility as to whose consent or participation is needed with respect to assets that are not securities. First, we recommend clarification that "issuer" not be limited to an issuer of "securities" but include similar persons or entities that play substantially the same role with respect to other assets. For example, we believe that it should also include where a governmental or regulatory authority is required to consent to or otherwise participate in the transfer of the asset. For example, real estate deeds and other assets typically require the participation of governmental authorities who will typically confirm that all of the legal requirements for the transfer are satisfied. As discussed above, the participation of governmental or regulatory authorities in such transfers typically reflects a desire to reduce the likelihood of misappropriation. Also as discussed above, we also believe that other third parties (such as an administrative agent of a loan syndicate) can play a similar role in other contexts as well.

- ***The SEC should provide an exception for an asset that cannot be maintained with a qualified custodian in accordance with the Safeguarding Rule because it would violate or conflict with other laws or regulations***

As noted above, the SEC has not considered whether there are types of assets that require that the assets or other evidences of ownership be maintained in a fashion that is not compliant with the Safeguarding Rule. The SEC already provides such consideration for registered investment companies who are subject to their own requirements under the Investment Company Act.[11] By broadening up the range of assets captured under the Safeguarding Rule, the SEC is correspondingly broadening the potential for conflicts with other legal or regulatory regimes. However, as discussed above, it would be impossible to provide exceptions for each such situation because of the indeterminate range of assets that are captured and the numerable number of potential jurisdictions in which advisory clients invest. We therefore recommend that the SEC adopt a broad exception for any situation in which the investment adviser determines that there is a significant risk that maintaining the asset in compliance with the Safeguarding Rule would violate or otherwise conflict with other applicable laws or regulations.

We believe that it would place investment advisers in an impossible position of deciding whether to violate the Safeguarding Rule or the other applicable law or regulation. This position is further aggravated because of the conflict of interest inherent in such a choice—a violation of the Safeguarding Rule creates liability for the investment adviser under Advisers Act (but not for the client); however, a violation of the other applicable law may create liability for the client either directly (as owner of the asset) or indirectly (through applicable exculpation or indemnification provisions). In this way, the SEC may be causing the investment adviser to create liability for its clients in order to comply with the Safeguarding Rule.

[11] Rule 223-1(b)(5).

- ***The SEC should allow an investment adviser to consider whether maintaining a privately-offered security or physical asset with a qualified custodian is in the best interests of the client in accordance with the fiduciary duty of the investment adviser to client, taking into consideration, among other things, the cost and quality of such custodial services***

The proposed rule would require an investment adviser to maintain a privately-offered security or a physical asset with a qualified custodian as soon as one was available that could maintain possession or control over such security or asset. The rule, however, does not allow for cost or other considerations in determining whether maintaining such security or asset with such a qualified custodian is in the best interest of the client. For example, if a qualified custodian commences offering a new service that allows for possession or control over a type of physical asset but charges an exorbitant fee for such service or has a bad reputation, the exception does not allow the investment adviser to consider whether the usage of such custodian is actually in the best interests of its clients.

The SEC itself acknowledges that a prerequisite of an efficient outcome is the existence of a "robust market for custodial services" for physical assets and privately offered securities.[12] Absent such a robust market, the SEC acknowledged that the Safeguarding Rule "could be disruptive or result in client harm."[13] However, the proposed Safeguarding Rule would not permit an investment adviser to wait for the development of such a "robust market" but instead would require it to maintain client assets with qualified custodians competing in a thin market (or even where they are the only participant).

Again, this type of situation shows how the Safeguarding Rule would be creating a new conflict of interest between the investment adviser and the client where the investment adviser would stuck deciding whether to maintain the asset with the custodian in order to comply with the Safeguarding Rule (even if it is at great cost or otherwise not in the best interests of the client) or violating the Safeguarding Rule (with the potential liability to the investment adviser) but maintaining the assets in a different manner that is in the best interests of the client.

The absence of such a condition would appear to run contrary to what the SEC has expressed with respect to outsourcing by investment advisers.[14] Similar to that proposal, we believe that an investment adviser should be allowed to consider, among other considerations, (i) the risks resulting from the custodian performing its functions, (ii) the custodian's competence, capacity and resources necessary to perform its functions, (iii) the costs associated with the custodian providing its services, and (iv) the custodian's compliance with applicable laws.

- ***Investment advisers should not be required to maintain almost all of their assets in the name of a bank (or other similar custodian) as nominee of their clients***

One interpretation of the proposed Safeguarding Rule and the release is that where there is not otherwise a qualified custodian willing to hold the asset directly and maintain possession or

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12 Proposing Release at p. 132.
13 Proposing Release at p. 132.
14 Outsourcing by Investment Advisers, SEC Release No. IA-6176 (Oct. 26, 2022)

control, the adviser would be required to engage a bank (or other similar custodian) to hold the asset in the bank's name as nominee for the client. If interpreted in this fashion, it could mean that there is effectively no exception for privately offered securities and physical assets, because the adviser will be required to re-organize all such arrangements so that a bank (or other qualified custodian) is holding such privately offered securities and physical assets as nominee for the relevant advisory clients. The SEC does not discuss this possibility or engage with the potential costs of re-papering all existing arrangements and all future arrangements so that all such assets are held by banks (or other qualified custodians) as nominee for the advisory clients.

It also remains unclear whether the custodian acting in a nominee arrangement adds significant protection from misappropriation where the custodian is not providing quarterly account statements (*i.e.*, where the client is undergoing an annual audit). In those cases, the custodian will not know whether the transaction is authorized under the advisory agreement or other governing agreements and will not know whether any distribution of the proceeds is permitted under such agreements. Ultimately, in such cases, such oversight will be performed by the accountant performing the annual audit and the investors reviewing the audited financial statements.

- ***The transaction verification requirement will not significantly affect the misappropriation of client assets and will be more costly than the SEC expects***

The Safeguarding Rule would require an investment adviser to notify an independent public accountant concerning any transaction involving an asset relying on the exception for privately offered securities and physical assets so that such accountant could verify such transaction. It is unclear why such process will reduce the likelihood of misappropriation. An investment adviser or other person who is attempting to misappropriate an asset is highly unlikely to notify the accountant of such transaction. In addition, the accountant would not otherwise be notified of such a transaction. Therefore, it remains likely that any such misappropriation would only be uncovered during a surprise examination or an annual audit. The accountant, therefore, would only be called into verify a transaction for which there almost certainly was no misappropriation.

Given that it would not appear to serve any real purpose in uncovering transactions involving misappropriation, this requirement seems to serve no purpose other than to increase the costs and logistics associated with transactions in assets relying on the exception for privately offered securities and physical assets. However, the economic estimates associated with the verification requirement also appear to have significant drawbacks. For example, first, it estimates that advisers will take only one minute to deliver the notice to an accountant, which seems unrealistic for any communication with a third party concerning a transaction. Second, the estimate is based on estimates of private equity transactions. However, regardless of whether they are accurate estimates of private equity transactions, there would remain a wide range of other assets that could satisfy the exception for privately offered securities and physical assets. Therefore, the number of transactions should be estimated to be significantly higher than just the estimate for private equity transactions. Finally, the SEC estimates that each such verification will cost on average $2,625. However, this is a wholly new service for which we have no knowledge as to the potential cost. Also, certain transaction may involve significant travel and other expenses that the SEC does not consider.

- ***If independent verification remains required, then more third parties other than independent public accountants should be permitted to perform these services.***

If the independent verification requirement is included in the final Safeguarding Rule, we believe that the potential verifying third parties should be expanded beyond independent public accountants, so as to reduce the costs borne by advisory clients. Given the likely limited benefit from such verification, as discussed above, we believe that investment advisers (with the consent of the applicable advisory clients) should have the option to use other persons to perform the verification. Options for other persons include: (i) the client itself (or a representative appointed by the client), (ii) another third-party adviser to the client (*e.g.*, a primary adviser could verify the transactions of a sub-adviser to a fund or an account as part of its oversight activities of the sub-adviser), (iii) a licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law (*e.g.*, the lawyer or law firm that is responsible for the negotiation and execution of the transaction), or (iv) a registered broker-dealer or equivalent foreign financial institution (*e.g.*, the broker-dealer involved in the execution of the transaction).[15] Since in many circumstances, these third parties could provide the verification services along with other services it is providing with respect to the transaction, these parties could potentially provide these verification services in a more cost efficient manner than an accountant wholly uninvolved in the transaction.

2. <u>Scope of Definition of Custody</u>

- ***The SEC should continue to exclude discretionary authority from the definition of "custody" under Safeguarding Rule at least for DVP assets***

The SEC should not include discretionary authority in the definition of "custody" under the Safeguarding Rule at least with respect to assets that are settled delivery-versus-payment ("DVP"). It has been the SEC's long position that the risks of discretionary authority with respect to DVP assets is sufficiently low because of the fact that the custodian is receiving the securities in return for the cash (or vice versa).[16] The SEC claims there are other risks but then gives only an example of a non-DVP asset where there is the potential for the adviser to change the account to which the cash is delivered.[17] This risk does not exist with respect to discretionary advice provided with respect to DVP assets.

Furthermore, advisory relationships where the investment adviser's authority is limited to discretionary investment advice are often the types of relationships where the investment adviser is least likely to have the bargaining power necessary to comply with the Safeguarding Rule. We discuss the bargaining power in detail below. In addition, as also discussed below, seeking to impose the Safeguarding Rule on these limited relationships will place SEC-registered

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[15] Compare to the persons who can verify "accredited investor" status under Rule 506(c) under Regulation D of the Securities Act. Securities Act Rule 506(c)(2)(ii)(C).

[16] *See* Custody of Funds or Securities of Clients by Investment Adviser, SEC Release No. IA-2176 (Sep. 25, 2003) (excluding authorized trading from the definition of "custody").

[17] *See* Proposing Release at p. 33 (discussing re-direction of cash from loan syndicate).

investment advisers at a severe competitive disadvantage versus investment advisers that are not subject to the Safeguarding Rule.

Therefore, since the SEC has not articulated any reason for believing there are significant misappropriation risks associated with discretionary authority with respect to DVP assets, we believe it should continue to be excluded from the definition of "custody."

- ***The SEC should not also exclude limited discretionary authority with respect to non-DVP assets from the definition of "custody" where there are other safeguards in place***

There has been more historical uncertainty about the exception for discretionary investment authority with respect to non-DVP assets.[18] In addition, the specific risk raised in the Proposing Release with respect to discretionary authority would appear only to relate to non-DVP assets where the money may be sent to a different account then is at the custodian. However, we believe there are other factors can effectively limit the risks associated with such circumstances, including (i) client participation or specific authorization for the signing of the transaction documents, (ii) client participation or specific authorization for the movement of any cash either at the purchase date or afterwards to fund a capital commitment (*e.g.*, with respect to an investment in a private closed-end fund), and/or (iii) limitation on the legal authority (including any power-of-attorney) to change the bank or other account information with respect to the receipt of proceeds. We also note that in most circumstances, the clients investing in the non-DVP assets are sophisticated investors (*e.g.*, "qualified clients" under the Advisers Act) who receive detailed reports on their transactions and account holdings and are able to effectively monitor for potential misappropriation. These sophisticated investors often actively seek arrangements with respect to separately managed accounts for non-DVP assets that avoid the application of the Custody Rule because they do not want to incur the costs associated with the Custody Rule.

- ***The SEC should limit the term "discretionary authority" to mean only where such authority does not include the consultation or other participation of the client (or representative or agent of the client)***

The proposed definition of "discretionary authority" under the Safeguarding Rule includes "authority to decide which assets to purchase and sell for the client"; however, it does not include situations where the client (or a representative or agent of the client) may be required to be consulted or participate in such decision or the execution of such decision. (As discussed below, we note that this is different than the definition in Form ADV, which includes a requirement that it be done without consulting the client.) We believe that any misappropriation or other risks are substantially reduced when the client (or a representative or agent of the client) is participating in the investment decision making process or the execution of such investment decisions. We therefore recommend that the definition of "discretionary authority" be limited to situations where the investment adviser has the decision to purchase or sell assets for a client

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[18] Paul G. Cellupica, SEC Division of Investment Management, Letter to Karen Barr, Investment Adviser Association, Engaging on Non-DVP Custodial Practices and Digital Assets (Mar. 12, 2019), available at https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.

without consultation with, or participation by, the client (or a representative or agent of the client) in such decision or the execution of such decision.

3. New Requirements for Qualified Custodians

- ***The proposed Safeguarding Rule does not appreciate the absence of bargaining power for most small and mid-size investment advisers***

We have severe concerns about how many of the new requirements of the Safeguarding Rule will require investment advisers to negotiate new provisions and protections from qualified custodians that do not reflect the current market. The SEC appears to have an unrealistic expectation of the bargaining power of investment advisers with respect to qualified custodians. First, we note that investment advisers are typically smaller than custodians by orders of magnitude. Second, the custodial business of such investment advisers also is an immaterial amount of business of such large custodians. This factor would be aggravated with respect to foreign financial institutions where a U.S. investment adviser may have only limited business. It will not make economic sense for many potential custodians to undertake the litany of requirements with all of their related burdens and costs where the investment adviser's business is insubstantial. Our expectation is that many investment advisers will hear a lot of "no" from potential qualified custodians.

This expectation of bargaining power also runs counter to the experience of investment advisers' negotiations with respect to the "inadvertent custody" issue.[19] As the SEC itself observes in the release, "advisers have had little success in modifying or eliminating their unwanted authority either because a custodian is reluctant to accept the adviser's request to modify its agreement with its client, or the client may lack the bargaining power to negotiate more limited terms on the adviser's authority over the client's assets because the custodian may refuse to modify its standard forms" and "[o]ur staff has observed that 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."[20] The SEC presents no reason why an investment adviser or a client will have greater success in such negotiations when the requirements are even more extensive and the burdens and costs on the custodians are even greater.

Furthermore, there will be great inequity between different size advisers where compliance with the Safeguarding Rule will depend so greatly on the bargaining power of the advisers. The Safeguarding Rule would heavily favor larger advisers, advisers with substantial international presence, and advisers affiliated with custodians (and, in particular, banks). Each of these types of advisers will be materially more likely to be able to negotiate the required requirements of the Safeguarding Rule with qualified custodians (particularly if it is affiliated) whereas smaller, standalone investment advisers will be left to pursue costlier, less efficient solutions if not stop

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[19] SEC Division of Investment Management, Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, IM Guidance Update No. 2017-01 (Feb. 2017), available at https://www.sec.gov/investment/im-guidance-2017-01.pdf.

[20] Proposing Release at p. 105.

providing discretionary advice with respect to certain asset types entirely. We do not believe that harming the competition among investment advisers in this fashion is beneficial to investors.

- ***The Safeguarding Rule does not appreciate circumstances where a client and custodian have a pre-existing relationship***

Similarly, the proposed rule pre-supposes that the investment adviser is the dominant negotiating party among the client, the custodian and the adviser when there are many circumstances where a client and custodian have a pre-existing longstanding relationship and the investment advisory relationship with the client (and, indirectly, the custodian) is secondary to that relationship. In these circumstances, many custodians will not be willing to provide the required reasonable assurances or enter into a written agreement with the investment adviser and the client will value its relationship with the custodian more than its potential relationship with the investment adviser. The client, therefore, may need to seek our investment advisers who are not subject to the Safeguarding Rule or would lose the valuable expertise of investment advisers in making their investment decisions. We believe that this loss of expertise will be particularly costly with respect to non-traditional investments, which are exactly the type of the investments for which complying with the Safeguarding Rule will be the most difficult.

We believe this will particularly be true for non-U.S. relationships where, as discussed more fully below, non-U.S. financial institutions will be less willing to subject themselves to the U.S. laws. In addition, there will be greater competition from non-U.S. investment advisers who are not registered with the SEC or are not required to comply with the Safeguarding Rule with respect to their non-U.S. clients.

- ***The Safeguarding Rule would increase costs associated with accounts for clients and also the time associated with opening new accounts for clients***

The litany of new requirements for qualified custodians will inarguably increase the costs associated with the accounts for clients as the custodians seek to pass on some (if not all) of the increase increased costs. The ability of the custodian to pass along the costs will similarly be affected by the bargaining power of the investment adviser and the client, which further exacerbates the inequities of the Safeguarding Rule. It is not at all clear that clients will value any additional asset protection provided by the Safeguarding Rule at the same level as the indirect costs they will be expected to bear. Few clients have sought to negotiate the full list of requirements from a custodian that matches the Safeguarding Rule requirements. The fact that the market differs so dramatically from the Safeguarding Rule is more consistent with a thesis that clients do not value the increased protection at that cost level. It is unclear why the SEC is inserting itself into the relationship between a client and custodian without clear evidence that clients value the protections it is seeking to provide.

There will also be a significant lengthening in the time it will take to open new accounts, including when considering the considerable amount of search costs to find a custodian willing to undertake the Safeguarding Rule obligations and to negotiate the written assurances and written agreement required by the Safeguarding Rule. As an initial matter, this lengthening in time will delay entering into investment advisory relationships and increase legal and other costs

that may also be indirectly borne by clients. In addition, it makes it harder to deal with situations where an existing custodian is dealing with financial distress since it will be harder for the adviser to act nimbly in finding alternative custodians in a timely fashion. This situation will create another situation where the adviser's fiduciary duty to act in the best interests of the client will conflict with its obligation to comply with the Safeguarding Rule, since it may be in the best interest of the client to transfer their assets into an account of a custodian where the relationship does not satisfy all of the requirements of the Safeguarding Rule.

(a) Reasonable Assurance and Written Agreement Requirements

- ***The SEC should not seek to set due care and indemnification standards that are inconsistent with the market and not required by the custodian's primary regulator***

The SEC states that it believes that it is addressing a situation where "the standard of care is not universal in the custodial market"[21] and "the contractual limitations on custodial liability vary widely in the marketplace" due to the importance of the "negotiating power of the investor."[22] However, as discussed more fully above, the Safeguarding Rule does little to solve the imbalance in negotiating power. It may be that larger investment advisers will be able to negotiate greater protections on behalf of their smaller advisory clients. However, smaller investment advisers are unlikely to have any such success. The Safeguarding Rule will do little to increase the willingness of large custodians to negotiate with smaller investment advisers.

This inequitable position would result in larger investment advisers being more likely to be able to comply with the Safeguarding Rule while smaller investment advisers will be less likely. By trying to meddle indirectly in the negotiations between custodians and clients, the SEC will be perversely negatively affecting the negotiations between smaller investment advisers and clients.

We would recommend leaving due care and indemnification standards to be set by the custodians' primary regulators who will have an actual ability to cause a change in the market. Absent such activity, we believe that the SEC should be permissive of due care and indemnification standards that are standard in the industry so that smaller investment advisers without negotiating power are not locked out of the market.

- ***The internal control report should not be required from unaffiliated custodians or at least should provide more exceptions for when such an internal control report is not required***

As discussed extensively above, we believe there will be significant issues with the ability of many investment advisers to bargain for internal control reports where the unaffiliated custodian does not already receive one. For this reason, we believe that the SEC should drop the requirement.

[21] Proposing Release at p. 86.
[22] Proposing Release at p. 87.

However, if the requirement is maintained, then we believe the SEC should provide exceptions to the requirement, where bargaining for it is particularly difficult or where there are substantially similar protections.

To this point, we believe that any internal control report should be more permissive of existing regulatory requirements for a custodian. For example, we believe it should be permitted to receive a report even if the report is done by an accountant meeting an independence standard different from Regulation S-X but that is done in compliance with the requirements of the custodian's primary regulator.

More generally, we believe there should be an exception if the adviser is able to demonstrate that the custodian's existing regulatory requirements provide substantially similar protections as the internal control report specified by the Safeguarding Rule.

In addition, we believe the SEC should remove the requirement with respect to foreign financial institutions who are both less likely to agree to such requirements and also are less likely to want to comply with strict requirements (including the unfamiliar independence standards) of the SEC.

- ***The SEC should clarify that the provision of record provision may be restricted by applicable privacy or similar laws***

The SEC acknowledges that there are two separate reasons why custodians (particularly foreign financial institutions) may refuse to provide records to an adviser or an accountant performing a surprise examination. First, there may be an absence of contractual privity between the adviser and the custodian. Second, there may be privacy concerns to provide the information without consent from the client. The SEC acknowledges that requiring such a provision would only address the first and not the second issue. However, it does not consider that a custodian may refuse to provide the provision (or place restrictions in the provision) if the custodian is concerned that compliance with the provision would violate applicable privacy or other laws. For this reason, we recommend that the SEC provide the ability of the adviser to include consideration for compliance with privacy and other laws and regulations in the provision requiring custodian to provide client records to avoid a conflict of laws.

- ***The economic analysis with respect to the written agreement and reasonable assurances requirements for qualified custodians is severely flawed in many respects***

The Safeguarding Rule would represent a massive sea change in the relationships between investment advisers and custodians in many different dimensions. However, the economic analysis presented in the Proposing Release appears to treat the Safeguarding Rule as a minor update date on an existing rule. We highlight a few examples with respect to the economic estimates with respect to the written agreement and reasonable assurances requirements below.

We are also concerned that the Proposing Release does not provide adequate analysis of the likely economic incidence of the costs associated with the Safeguarding Rule. It appears likely that advisory clients will, directly or indirectly, bear a substantial percentage of the increased costs associated with the Safeguarding Rule. We believe a thorough economic analysis of the

Safeguarding Rule should consider whether the decreased risks of misappropriation under the Safeguarding Rule (and any associated savings to investors from a decrease in that misappropriation risk) is sufficient to justify the increased costs borne by advisory clients as result of the new requirements under the Safeguarding Rule. Based on our experience with the Custody Rule (which has comparatively fewer requirements), many clients are likely to not value the increased protections of the Safeguarding Rule when considering the minimal effect on the misappropriation risk in many situations.

- Written agreements.
  - *Number of Qualified Custodians*. The SEC estimates that each adviser would enter into approximately 4 written agreements based on the fact that that is the current average number reported on Form ADV.[23] Relying on the current number would clearly lead to an undercount, since the following changes are likely to increase the number of qualified custodians being utilized by investment advisers: (i) the expansion in the types of assets required to be maintained with a qualified custodian beyond funds and securities, (ii) the expansion of the definition of "custody" to include discretionary authority, and (iii) the conditioning of the exception for privately offered securities and physical assets on there being no available qualified custodians. In addition, current market factors (including, in particular, the crisis with respect to Silicon Valley Bank) has led to many investment advisers considering whether additional diversification is necessary with respect to their custodial relationships.
  - *Number of Written Agreements*. Beyond the issues with estimate on the number of qualified custodians, the SEC is estimating that there will be a single master agreement between each investment adviser and each qualified custodian.[24] This is unlikely to be the case for all relationships. There are a wide range of reasons why the costs and other terms would vary in a manner that could necessitate separate agreements, including (i) different types of assets maintained with the custodian, (ii) different types of clients for which the custodian is maintaining accounts, and (iii) changes in practice over time.
  - *Drafting and Negotiation Time*. The SEC is estimating that it will take a single hour to prepare each written agreement.[25] It appears to focus only on the specification of the investment adviser's agreed-upon level of authority. This estimate does not in any way reflect the radical changes that the SEC is proposing to the relationships between custodians and investment advisers. First, custodians will need to be educated (either independently or by investment advisers) as to why they need to enter into any of these agreements. Second, investment advisers and custodians will need to evaluate what they are permitted to agree to as a corporate matter. Any such agreements (particularly a master form like the SEC appears to be envisioning) will likely involve multiple persons, including

23 Proposing Release at fn. 590 and the accompanying text.
24 Proposing Release at fn. 591 and the accompanying text.
25 Proposing Release at fn. 592 and the accompanying text.

approval up the chain, as well as consultation with outside counsel. Third, custodians will need to evaluate as a business matter whether it wants to continue any advisory relationship. Fourth, custodians will need to determine what it will request for in consideration for entering into the agreement (*e.g.*, what increased compensation or other terms would be required for it to be in the best interests of the custodian to enter into the agreement?). Fifth, in addition to the involvement in the above steps, the investment adviser would need to engage in search costs for new qualified custodians when (as appears inevitable) at least some portion of qualified custodians refuse to continue to do business with the investment advisers whose business the custodians consider is not worth the increased costs. It is difficult to estimate what the correct amount of time is for all of these activities but it is unlikely that any individually will take only an hour (let alone in aggregate). Furthermore, all of these factors will be aggravated with respect to foreign financial institutions who are even more likely to be hostile to entering into any such agreement.

- *Internal control reports*. As noted above, the SEC appears to be drafting estimates based on a current universe of qualified custodians that is unlikely to be the same given the other changes in the Safeguarding Rule. The SEC in fact acknowledges that the cost it is using for the internal control report is based on only on covering funds and securities and not all assets.[26] The SEC estimates that 95% of qualified custodians currently obtain internal control reports. It does not, however, provide any basis for this 95%.[27] It is difficult, therefore, to evaluate its accuracy. We are particularly skeptical that such a high number of custodians' current internal control reports cover all of the assets that will be included in the Safeguarding Rule. We are also skeptical of how many foreign financial institutions undergo a qualifying internal control report, particularly since the legal concepts (including auditor independence) are not the same in such jurisdictions. Finally, there is an additional question of how many qualified custodians will be willing to provide such internal control reports to investment advisers.

- <u>Reasonable assurances</u>.

  - *Drafting and Negotiation Time*. Similar to our concerns with respect to the written agreement, the SEC is estimating only an hour and fifteen minutes.[28] We believe that this is a severe underestimate of the amount of time that will be required to draft and negotiate these written assurances for many of the same reasons we highlight above with respect to the drafting and negotiation of the written agreements.

[26] Proposing Release at fn. 616.
[27] Proposing Release at fn. 617 and the accompanying sentence.
[28] Proposing Release at fn. 619 and the accompanying paragraph.

- *Oversight Time*. The SEC estimates that the ongoing burden will only be ¼ of an hour because "most custodial agreements change very little from year to year."[29] This estimate is wholly detached from the burden the SEC has imposed on investment advisers as a result of the reasonable assurances requirement. The SEC states that it believes it is "requiring the adviser to maintain an ongoing reasonable belief that the custodian is complying with such client protection requirements."[30] This requirement would create an oversight and monitoring obligation on the adviser beyond merely amending the custodial agreement. The investment adviser would be required to engage in ongoing oversight activities of the custodian's compliance with the written agreement and the reasonable assurances. We do not have an estimate of such time, however, it would clearly exceed ¼ of an hour by a substantial margin.

(b) Requirements for Foreign Financial Institutions

- ***The requirements on foreign financial institutions will unnecessarily disqualify a large number of foreign financial institutions causing direct and indirect investor harm***

We have a tremendous amount of concern that the net effect of all of the requirements on foreign financial institutions (both in the definition of "qualified custodian" but also in the reasonable assurances and written agreement requirements) will substantially shrink the pool of available non-U.S. custodians that a SEC-registered investment adviser can use.

As discussed previously, we believe the SEC substantially overestimates the bargaining power of investment advisers with respect to custodians and we believe this absence of bargaining power is particularly true with respect to foreign financial institutions. U.S. investment advisers (and especially smaller investment advisers) are even more unlikely to make up a material amount of a non-U.S. custodian's business than with respect to a U.S. custodian. In fact, in certain instances the relationship may be limited to sporadic dealings (*e.g.*, with respect to isolated investments to the applicable non-U.S. jurisdiction). U.S. investment advisers and U.S. clients are also less likely to have other material business relationships with the non-U.S. custodian that may make it worthwhile for the non-U.S. custodian to engage in a less profitable relationship.

Furthermore, non-U.S. custodians are likely to be hostile to any such negotiations attempts since they may have little familiarity with the Advisers Act or other aspects of U.S. law and may not be able to access the necessary expertise without substantial legal expense. Such time, effort and costs are often likely not be worth it to the custodian where the SEC-registered investment adviser's business is not that profitable.

We discuss more fully below each particular requirement and the difficulties associated with them in a relationship with a non-U.S. custodian.

The net effect of shrinking the number of available non-U.S. custodians will also harm SEC-registered investment advisers (particularly those in the U.S.) and U.S. clients and investors.

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[29] Proposing Release at fn. 621 and the accompanying text.
[30] Proposing Release at fn. 150 and the accompanying text.

First, the lack of availability of custodians in certain non-U.S. jurisdictions will make certain non-U.S. investments impractical if not impossible. There are a range of laws and regulations that necessitate opening a bank or other account in the jurisdiction in order to facilitate making the investment or receiving proceeds relating to the investment. Removing the possibility of making such investments or increasing the costs associated with making such investments will harm clients and investors who would benefit from making such investments. There again is the potential for the Safeguarding Rule creating a conflict of interest where an SEC-registered investment adviser may face a choice between opening an account to benefit the investment of a client that violates the Safeguarding Rule and choosing an investment structure less beneficial to the client but that is compliant with the Safeguarding Rule.

It will also harm the competitiveness of SEC-registered investment advisers who will be unable to offer products investing in such non-U.S. investments whereas non-U.S. investment advisers and other unregistered investment advisers will not face such restrictions.

- ***A foreign financial institution should not have to subject itself to U.S. jurisdiction***

We strongly disagree with requiring foreign financial institutions to subject themselves to U.S. jurisdiction merely because an SEC-registered investment adviser wishes to provide investment advice to a client with an account at that institution.

First, as we noted above, U.S. investment advisers (particularly smaller investment advisers) are highly unlikely to have the bargaining power to get such a provision in a contractual agreement. Even more so than U.S. custodians, U.S. clients and U.S. investment advisers are highly unlikely to provide a material amount of business to a non-U.S. financial institution that would make it worthwhile for such non-U.S. financial institution to expose itself to the U.S. legal system (if it is not already exposed to the U.S. legal system).

There are also good reasons why a non-U.S. financial institution would not see the reason for why it should subject itself to U.S. jurisdiction. For example, if the non-U.S. custodian has a relationship with a non-U.S. client, it would not generally be exposed to U.S. jurisdiction. The Safeguarding Rule would create tremendous disruption to that commercial relationship between two non-U.S. entities simply because an SEC-registered investment adviser starts providing advice to the non-U.S. client. As noted above, this will create a tremendous competitive advantage to non-U.S. investment advisers and other unregistered investment advisers who will be able to provide such advice without disrupting this relationship.

Furthermore, non-U.S. foreign financial institutions with no existing U.S. relationships may have little familiarity with U.S. laws and not be willing to agree to contractual provisions that expose themselves to unknown legal liability. It is unrealistic to expect that non-U.S. financial institutions in all jurisdictions to be knowledgeable with respect to U.S. laws. However, such non-U.S. financial institutions may be sound, reputable institutions in compliance with the laws of their own jurisdiction and otherwise reliable custodians.

- ***Requiring a foreign financial institution to anti-money laundering laws equivalent to U.S. law is overinclusive of what is necessary to support the safeguarding of client assets***

The SEC states that a foreign financial institution subject to anti-money laundering laws and regulations that are equivalent to the Bank Secrecy Act will "help increase the likelihood that the FFI would readily identify and investigate aberrant behavior in a client account, such as activity that might suggest misappropriation or some other type of loss to a client." However, the Bank Secrecy Act requires a wide range of other actions that are irrelevant to the safeguarding of client assets in compliance with the Safeguarding Rule, including, for example, with respect to screening customers. It seems that a narrower requirement would be that the foreign financial institution should be subject to regulations concerning the reporting of fraud and other suspicious activity in client accounts.

We are concerned that this requirement is intended more to facilitate other policy aims unrelated to investment advisers and indirectly restrict the ability of investors to invest in jurisdictions that are not currently subject to OFAC or similar prohibitions.

- ***We believe that the specific requirements for foreign financial institutions should not include the due care, segregation and internal controls requirements that duplicate the reasonable assurances and custodial agreement requirements.***

While we have noted concerns with many of the requirements be proposed for qualified custodians, we do not believe that the definition of "qualified custodian" should include specific requirements for foreign financial institutions that duplicate other requirements in the Safeguarding Rule. This duplication of requirements can create interpretative issues with respect to whether they are intended to be read different and when exceptions or guidance apply to one or the other.

Specifically, we believe the following provisions are unnecessarily duplicative for foreign financial institutions and can raise questions of whether foreign financial institutions are being held to an unnecessarily different standard than domestic custodians.

Specific to Foreign Financial Institutions	General Qualified Custodian Requirements
Rule 223-1(d)(10)(D) – "Holds financial assets for its customers in an account designed to protect such assets from creditors of the foreign financial institution in the event of the insolvency or failure of the foreign financial institution"	Rule 223-1(a)(1)(ii)(D) – "The qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities"
Rule 223-1(d)(10)(E) – "Has the requisite financial strength to provide due care for client assets"	Rule 223-1(a)(1)(ii)(A) – "The qualified custodian will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will

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	implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss”
Rule 223-1(d)(10)(F) – “Is required by law to implement practices, procedures, and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets”	Rule 223-1(a)(1)(i)(C) – “At least annually, the qualified custodian will obtain, and provide to you a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year)”

- ***Analogies to Rule 17f-5 under the Investment Company Act are flawed because of the material differences between U.S. registered fund products and the much more varying investment products advised by SEC-registered investment advisers***

The SEC points to its experience under Rule 17f-5 under the Investment Company Act as the basis for the new requirements on foreign financial institutions.[31] There are several reasons why such an analogy does not make sense when apply to SEC-registered investment advisers. U.S. registered funds are organized in the United States, but SEC-registered investment advisers have clients who are resident or organized in many non-U.S. jurisdictions. The vast majority of U.S. registered funds are open-end funds or otherwise subject to liquidity requirements that limit the types of assets they can hold and are focused on making investments in the United States.[32] However, investment advisers provide advice to range of closed-end vehicles or other accounts with no similar liquidity constraints or similar restrictions on investing primarily in the United States. These products are also overwhelmingly publicly offered, including to retail investors. There are a wide range of vehicles and accounts offered to sophisticated investors and institutional investors. The considerations with respect to regulation of funds registered under the Investment Company Act are wholly different from the considerations with respect to the regulation of the much wider variance of products offered by SEC-registered investment advisers.

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[31] *See*, *e.g.*, Proposing Release at fn. 99 and the accompanying text.

[32] *See*, *e.g.*, Investment Company Institute, 2022 Investment Company Fact Book, available at https://www.ici.org/system/files/2022-05/2022_factbook.pdf.

(c) Requirements for Banks and Savings Associations

- ***The SEC should clarify that state-chartered trust companies and banks may act as qualified custodians under the Safeguarding Rule***

The SEC staff has previously solicited comment on whether state-chartered trust companies and other state-charted banking entities are able to act as "qualified custodian" under the existing Custody Rule.[33] We believe that state-chartered companies and other banking entities can provide similar safeguards as other banking institutions and should not be excluded from the definition of "qualified custodian." State-chartered entities, including trust companies, provide custodial services in a range of contexts not limited to investment advisers and are subject to regulatory oversight from the relevant state regulatory agencies.[34]

Furthermore, as discussed above, the SEC should not be further restricting the pool of potential custodians when it is requiring not just more assets to be maintained with a qualified custodian but also imposing more costs on custodians. Furthermore, the Proposing Release explicitly envisions new innovations in the custodial markets to provide custodial services with respect to physical assets and privately-offered securities that are not currently required to be maintained with qualified custodians. In addition, we would argue that the proposed Safeguarding Rule is implicitly also expecting innovations in custodial market to cover other assets (other than physical assets and privately-offered securities) that will also be required to be maintained with qualified custodians. In order to reach the "robust" market that it is envisioning, the SEC should ensure that there is broad participation by custodians in competing to provide these services.[35] Otherwise, clients will be left paying inefficiently high levels of costs for custodial services.

(d) Futures Commission Merchants

- ***Futures commission merchants should be permitted to hold assets other than client funds, security futures and other securities incidental to transactions in commodities.***

As noted above, we believe that futures commission merchants should not be limited in the types of assets that should be held if the Safeguarding Rule has expanded the universe of assets that an SEC-registered investment adviser is required to maintain with a "qualified custodian." While it may have made sense to limit the types of assets that a futures commission merchant can custody to funds and securities when the Custody Rule only covered such assets, it does not make sense to continue that limitation under the new Safeguarding Rule.

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[33] SEC Division of Investment Management, Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020) ("Staff Letter on State-Charted Entities"), available at https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets.

[34] *See*, *e.g.*, comments in response to State-Chartered Entities, including Fidelity Digital Asset Services, LLC (Jan. 22, 2021); Coinbase (May 25, 2021).

[35] *See*, *supra* note 5 and the accompanying text.

4. Adviser Segregation Requirements

- ***The SEC should incorporate an exemption for loan syndication accounts similar to those covered by the Madison Capital no-action letter***

The SEC staff provided important no-action relief to certain accounts used for loan syndications in the no-action letter provided to Madison Capital Funding LLC.[36] This no-action letter provided greater assurance with respect to situations where an SEC-registered adviser (or affiliate) acted as administrative agent with respect to an account (an "Agency Account") used for syndication of a loan where one or more participants ("Participants") in the syndication were advisory clients of the SEC-registered adviser. As noted in the letter, in certain circumstances, certain of the Participants are also affiliates of the SEC-registered investment adviser and, therefore, there is potentially a commingling of the clients' assets and the adviser's affiliates' assets.

We believe that the SEC should incorporate the conditions of this relief with additional considerations for the complications introduced by the Safeguarding Rule. Taking into consideration the conditions already set forth in the Madison Capital no-action letter, the SEC should provide the following additional specific relief:

First, there should be an exception from Rule 223-1(a)(3) with respect to the segregation of client assets. As noted above, Agency Accounts may include the assets of affiliates who are also Participants. We believe the limited purpose of the accounts and the restrictions provide adequate safeguarding protections.[37]

Second, there should be an exception from Rule 223-1(a)(1)(i)(B) with respect to providing quarterly account statements. As noted in the original no-action relief, such accounts statement "would not be very meaningful to those Advisory Clients (and could even be confusing) because the Loan Syndicate account contains assets belonging to Advisory Clients and assets belonging to Third Parties invested in multiple syndications; a client would be unable to identify its own holdings in these statements."

Third, there should be an exception from Rule 223-1(a)(1)(i)(C) with respect to the internal control report of the custodian. The conditions of the no-action letter already require the receipt of an internal control report of the investment adviser and their activities by an PCAOB-

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[36] Madison Capital Funding LLC, SEC Staff No-Action Letter (Dec. 20, 2018) ("Madison Capital No-Action Letter").

[37] *See*, *e.g.*, Madison Capital No-Action Letter condition 1 ("The Agency Account will be maintained with a Qualified Custodian, as defined in the Custody Rule."), condition 2 ("Only the assets of Loan Syndicate Participants will be placed in the Agency Account."), condition 3 ("No cash will be deposited in or withdrawn from the Agency Account except pursuant to the credit agreements for the Loan Syndicates."), and condition 4 ("Madison will receive payments from Loan Syndicate Participants or underlying obligors only as agent for the Loan Syndicate Participants (and such payments would not be a part of Madison's estate in bankruptcy).").

registered independent public accountant.[38] Any internal control report of the custodian would be unnecessarily duplicative.

Fourth, there should be an exception from Rule 223-1(a)(1)(i)(D) with respect to the specification of an agreed-upon level of authority. While the agreement could include the limitations of the Administrative Agent as agent; however, since the account is being held in the name of the agent for distribution to a range of Participants, some of which are advisory clients and some of which are not, it would not be possible to permit Participants to reduce the agreed-upon level of authority. We do not believe that such a provision is required given the constraints contained in the credit and other similar agreements.

Fifth, there should be an exception from Rule 223-1(a)(1)(ii) with respect to reasonable assurances from the qualified custodian. As noted in the Madison Capital No-Action Letter, the account is used for a range of loan syndicates, some of which have participants that are advisory clients and some that do not. In addition, within a loan syndicate, some participants are advisory clients and some are not. For this reason, we believe that an adviser should be able to rely on commercially reasonable terms that are in line with the current loan syndicate market rather than seeking to conform the Agency Account to the specific requirements set forth in the Safeguarding Rule. We believe that taking a different approach would impose the costs associated with Safeguarding Rule compliance on a range of loan syndicate participants who are not advisory clients and who may not believe the increased costs are worth the increased protection. For these reasons, it could result in advisory clients missing out on participating in certain loan syndicates where there is significant opposition from the other participants to incurring the costs associated with Safeguarding Rule compliance.

Sixth, there should be an exception from Rule 223-1(a)(2) with respect to the written notice to clients for the opening of an account. We believe that this requirement is addressed by the Form ADV disclosure requirements in the no-action letter.[39]

We would also recommend providing relief from the specific requirements in the definition of "qualified custodian" with respect to foreign financial institutions. As we noted above, there are a number of duplicative requirements in the definition that would be similar to the above and, for similar reasons, should not apply to an Agency Account. We also are concerned that these requirements would severely restrict the ability of advisory clients of SEC-registered investment

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[38] *See*, *e.g.*, Madison Capital No-Action Letter condition 7 ("Madison will obtain a written internal control report ("Control Attestation"), no less frequently than once each calendar year, prepared by an independent public accountant ("Accountant")…"); condition 8 ("Madison will promptly seek to resolve any control activity exceptions identified in the Control Attestation on the part of Madison and/or its employees to comply with or fully implement the controls to meet the Control Objectives."), condition 9 ("Madison will include the annual Control Attestation, including any qualified opinion, as part of its books and records under Rule 204-2 under the Advisers Act."), condition 10 ("If the Accountant issues a qualified opinion with respect to any Control Attestation, Madison will promptly notify Advisory Clients that are Loan Syndicate Participants and inform them of the issue(s) that resulted in such qualified opinion and how such issue(s) will be avoided going forward.").

[39] *See*, *e.g.*, Madison Capital No-Action Letter condition 5 ("In addition to disclosing on its Form ADV Part 1A the Advisory Client assets over which Madison has custody and each qualified custodian with which such assets are maintained, Madison will provide disclosure in its Form ADV Part 2A to reflect its custody of the assets in the Agency Account and that the account commingles Advisory Client and Third Party assets.").

advisers from participating in loan syndicates in certain non-U.S. jurisdictions where it is necessary to have an Agency Account open in such jurisdiction to receive loan proceeds but with respect to which it is impractical (if not, impossible) to locate a qualified custodian willing to hold the account in compliance with the Safeguarding Rule.

5. <u>Annual Audit Exemption</u>

- ***The Safeguarding Rule should cover all different types of legal entities that undergo an annual audit***

We support the expansion of the annual audit exemption under the Safeguarding Rule to a wider range of legal entities.[40] We believe that an annual audit will provide the same type of protections for other types of legal entities as for limited partnerships, limited liability companies, or pooled investment vehicles. We do not believe the form of organization of an advisory client affects the misappropriation risks associated with the assets held by such client.

- ***The Safeguarding Rule should incorporate the existing SEC staff guidance for the audit of non-U.S. legal entities.***

We support the incorporation of the existing SEC staff guidance that permits a non-U.S. legal entity to undergo an annual audit in compliance with a different auditing standard than U.S. GAAP. We believe that such flexibility recognizes that there are different accounting standards throughout the world and the fact that an SEC-registered investment adviser that provides advice to such legal entity should not force the legal entity to deliver to its investors financial statements according to a different auditing standard then is the commercial standard in those jurisdictions.

- ***The Safeguarding Rule should clarify that no U.S. GAAP reconciliation is required where there are no U.S. persons to whom the statements would be delivered.***

We believe that the flexibility for non-U.S. legal entities should clarify that the requirement to provide reconciliation to U.S. GAAP is only required if the financial statements will be delivered to U.S. investors. The Safeguarding Rule permits delivery of the reconciliation to U.S. GAAP only in the financial statements to U.S. investors. However, absent the requested clarification, one could interpret the requirement to require the non-U.S. legal entity to incur the significant costs of reconciling the financial statements to U.S. GAAP without such reconciliations being required to be delivered to any investor. We do not believe that requiring a non-U.S. legal entity to incur such significant costs serves any purpose under the Safeguarding Rule.

- ***The Safeguarding Rule should permit regulated entities to rely on the annual audit if such annual audit is done in compliance with the requirements of the primary regulator***

Certain advisory clients are themselves regulated entities that are subject to existing regulations with respect to their annual audits. We believe that the SEC should permit such clients to rely on such audits for compliance with the Safeguarding Rule without causing them to undergo a

[40] Rule 223-1(b)(4).

separate duplicative audit. If the client can undergo a single audit that is compliant both with its existing applicable regulations and the Safeguarding Rule, then we believe that the client should do so. However, if the client would be required to undergo a separate audit for the Safeguarding Rule, we believe that the client should be able to rely on the audit that complies with the other applicable law. We believe that such an approach keeps the costs on clients lower (since the client is the one who generally bears the cost of the audit and not the investment adviser) while also providing substantially similar protections under the Safeguarding Rule.

- ***The Safeguarding Rule should permit investors or clients to waive the requirement for a stub audit and have a first-year audit that exceeds 12 months***

The SEC asks the question of whether the Safeguarding Rule should permit the ability to provide an audit in excess of 12 months for the first year. We believe that such an exception would be advisable. In many circumstances, investors seek to waive the "stub audit" requirement where there is only a limited amount of time left in the fiscal year. These types of waivers generally receive investor support given that the costs of a stub audit are often not substantially less than a full year audit. In addition, the first few months of a fund often do not involve a significant amount of investment activity that could raise significant misappropriation risks. These risks are also reduced by the fact that the time period will be ultimately subject to an audit in the following year. We believe that providing such flexibility would reduce costs to investors and provide substantially similar protections under the Safeguarding Rule.

- ***The SEC should provide additional flexibility to avoid annual audits for end-of-life closed-end funds***

A common issue that private fund advisers face is that at the end of the life of a closed-end fund, the cost of incurring an audit often exceeds its value to investors. Closed-end funds near the end of their life often have few if any investments. These investments also are typically difficult to dispose (which is the reason they are being held) and for similar reasons they are typically difficult to value. For example, sometimes these assets may relate to ongoing litigation for which it can be difficult to estimate both the likelihood of success, the timing of any resolution, and the potential value of such success. There are also circumstances where there are no investments, but the legal entity is held open to address outstanding liability issues in accordance with applicable state law.

In many circumstances, private fund advisers seek to reduce the costs incurred by these end-of-life funds. This can include no longer charging the vehicle for management or similar fees. The cost of audits can also remain significant at this stage in comparison to the assets that remain in the fund. The private fund adviser may be forced to maintain an inefficient amount of cash in the fund to cover the audit expenses, when it would be better for investors to distribute the cash. For this reason, investors are often themselves interested in ending the audits. However, the current Custody Rule does not provide any mechanism for ending the audits prior to liquidation.

We recommend that the SEC include flexibility in the Safeguarding Rule for a private fund adviser to end audits of a closed-end fund that has sold substantially all of its assets, other than a limited number of illiquid assets. The SEC staff has previously provided guidance on reducing

the burdens associated with liquidating entities with respect to Section 7 under the Investment Company Act of 1940.[41] Similar to that guidance, we recommend that an exception from the annual audit be provided to a private fund not offering redemptions in the ordinary course of business where (i) the private fund continues to exist solely to liquidate its assets and distribute the proceeds, (ii) other than the pre-existing securities or other assets, the private fund limits any future investments to temporary investments in short-term government securities, certain time deposits, certificates of deposit, bankers' acceptances, commercial paper, and money market funds, (iii) the private fund will terminate as soon as practical following the liquidation of the remaining assets and distribution of the proceeds, and (iv) the private fund adviser has received consent from a majority-in-interest of investors (or, if applicable, any limited partner advisory committee or equivalent).

- ***The SEC should provide an exception for employee vehicles from the annual audit and surprise examination requirements***

The SEC should not seek to impose the costs and burdens of the Safeguarding Rule on employee investment vehicles since the misappropriation risks in that situation are lower. The SEC has recognized that the employee-employer relationship significantly mitigates many risks under the federal securities laws.[42] We believe that that special relationship along with the increased access to information for the employees (in many circumstances, these employees are also "knowledgeable employees") make the risks of misappropriation materially lower. In addition, such employees are often the most likely to not want the costs associated with Safeguarding Rule compliance (including with respect to custodians but also the accountant performing the surprise examination or the annual audit). For this reason, we recommend the SEC provide an exception for employee vehicles from the requirements of the Safeguarding Rule.

6. <u>Delivery Requirements for Pooled Investment Vehicle Clients</u>

- ***Pooled investment vehicles should not be required to send a notice to investors with respect to the opening of an account at a qualified custodian if it satisfies the annual audit exemption***

The new requirement to deliver the notice of opening of custodial account to investors of a pooled investment vehicle has been added without any statement of why it is necessary for the protection of investors. In fact, it is likely to be met with confusion from investors as to why they are now receiving notices that they were not previously receiving and from which they can

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[41] *See*, *e.g.*, Integrated Resources, Inc., SEC Staff No-Action Letter (Aug. 5, 1994); Western Air Lines, Inc., SEC Staff No-Action Letter (Jan. 28, 1992); Fund American Cos., Inc., SEC Staff No-Action Letter (Nov. 16, 1990); Hutton/Energy Assets Insured Oil and Gas Completion Program A, Ltd., SEC Staff No-Action Letter (May 17, 1990); Timber Realization Co., SEC Staff No-Action Letter (Jun. 15, 1987); Merit Clothing Co., SEC Staff No-Action Letter (Mar. 29, 1982).

[42] *See*, *e.g.*, Investment Company Act, Section 6(b) (providing a process for exempting employees' securities companies); Lockheed Martin Investment Management Company, SEC Staff No-Action Letter (Jun. 5, 2006) (discussing exemption for employee benefit plans).

glean little (if any) useful information. Interested investors are already able to see the qualified custodians used with respect to their applicable private fund on Form ADV.[43]

The investors in pooled investment vehicle have no contractual relationship with the custodian and no direct interest in the assets in the account (since they are assets of the fund and not the investors in the fund). Custodians may be subject to privacy and other limitations if an investor were to attempt to contact the custodian directly. For these reasons, the investors may have little ability to do anything with the information they are receiving in the notices.

This requirement appears to be imposing unnecessary administrative costs on investment advisers (that would most likely be passed on to the pooled investment vehicles and, therefore, indirectly the investors) so that the investors can receive unnecessary paper or e-mails.

- ***The SEC should provide exemptions for special purpose vehicles, blockers, and other aggregators that are formed below the pooled investment vehicle***

The SEC staff has previously provided exemptions for the delivery to related persons and separate audit requirements with respect to certain investment special purpose vehicles.[44] Specifically, the guidance provided relief where the special purpose vehicle had no owners other than the adviser, the adviser's related persons and pooled investment vehicles controlled by the adviser or its related persons and the assets of the special purpose vehicle are considered within the scope of the pooled investment vehicle's financial statement audits. We recommend that this exception be added to the Safeguarding Rule to apply to the requirements relating to the delivery to pooled investment vehicle clients (as well as the annual audit exemption).

- ***The SEC should provide an exemption for fund of funds investing in underlying funds managed by related persons***

In addition, the SEC should provide exception from the requirements relating to the delivery to pooled investment vehicles where the "upper tier" pooled investment vehicle is a fund-of-funds that is not formed for the purpose of investing in the "lower tier" pooled investment vehicle.[45] An investor in a fund-of-funds does not expect to receive financial statements or other notices with respect to underlying funds, even if those funds are managed by the same investment adviser or its related persons. This would be particularly true with respect to notices of the custodians used by the underlying funds. Requiring this type of delivery would unnecessarily inundate investors with materials that are not directly related to their investments and may be difficult to understand.

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[43] Form ADV, Schedule D, Section 7.B.(1), Question 25, which is publicly available at www.adviserinfo.sec.gov.

[44] SEC Division of Investment Management, Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows, IM Guidance Update No. 2014-07 (Jun. 2014), *available at* https://www.sec.gov/investment/im-guidance-2014-07.pdf.

[45] *See*, *e.g.*, Investment Company Act Section 48(a) and Rule 2a51-3 and the related SEC staff guidance.

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7. <u>Recordkeeping</u>

- ***The SEC should not require an investment adviser to maintain a memorandum that indicates the basis of the investment adviser's custody***

We do not believe that the amendments to the Recordkeeping Rule should include a requirement to maintain a memorandum or other record that indicates the basis of the investment adviser's custody.[46] While such a memorandum or other record may in certain situations be considered a best practice, there are other scenarios where creating such a memorandum or other record would be unnecessary. For example, a small private fund adviser with a single private fund for which it or a related person acts as general partner would clearly have "custody" for purposes of the Safeguarding Rule. It seems unnecessary for such a small private fund adviser to need to develop a memorandum to state that fact. While it would appear to be a small burden, creating such a memorandum requirement increases the likelihood of immaterial foot fault violations of the Recordkeeping Rule, particularly by smaller and mid-size investment advisers with correspondingly smaller compliance staff and resources. We believe instead that an investment adviser should be able to produce upon the request of the SEC staff during an examination the basis of the investment adviser's custody with respect to its clients.[47]

- ***The SEC should not require an investment adviser to maintain the account identification information in the format that the amended Recordkeeping Rule would require***

Similar to the above, we do not believe that all SEC-registered investment advisers should be required to maintain an account identification record in the specific format set out in the proposed amendments to the Recordkeeping Rule.[48] In certain circumstances, such a chart would be considered best business practice; however, the amendments do not take into consideration the circumstances where such a chart would be unnecessary. For example, requiring the investment adviser to maintain a record with the private fund's contact information (which is typically a related person of the investment adviser) is unnecessary. In fact, for this reason, the SEC staff does not typically request such information in its standard examination of private fund advisers. Similar to the above, we believe that instead that the adviser should be able to produce such information upon the request of the SEC staff during an examination.

- ***The SEC should not require an investment adviser to maintain a record of each asset (and related information)***

We have similar concerns with respect to the requirement to maintain a record of each asset in which each client has a position.[49] For the same reasons as above, we believe that this requirement should instead be a required to produce such information upon request of the SEC

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[46] Rule 204-2(b)(2)(iii) (as proposed to be amended).

[47] Compare to Rule 206(4)-1(a)(2)(requiring an investment adviser to have a reasonable basis for believing it will be able to substantiate a material statement of fact included in an advertisement upon demand by the SEC).

[48] Rule 204-2(b)(2)(i) (as proposed to be amended).

[49] Rule 204-2(b)(2)(v)(C) (as proposed to be amended).

staff during an examination and not a requirement that the investment adviser maintain updated records of such assets in the format specified by the SEC.

- ***The SEC should clarify that confirmation of trades are not necessary where they are not otherwise produced***

The SEC is proposing to require that an investment adviser maintain copies of the confirmations of all trades effected by or for the account of each client.[50] However, given the range of assets now being captured by the Safeguarding Rule, it is not standard business practice in all cases to create confirmations of such trades. There may be many reasons why such confirmations are unnecessary, including an abundance of other documentation that serves similar functions and also situations where the client is a pooled investment vehicle managed by the adviser or a related person. For this reason, we recommend that this requirement be clarified to indicate that such a record is only required to be maintained where it is already being created.

8. Form ADV

- ***The definition of discretionary authority on Form ADV should be consistent with the definition of discretionary authority in the Safeguarding Rule***

The proposed definition of "discretionary authority" under the Safeguarding Rule includes "authority to decide which assets to purchase and sell for the client." Meanwhile, the proposed definition in Form ADV is different and includes" the authority to decide which assets to purchase and sell for the client without consulting the client" and "the authority to decide which investment advisers to retain on behalf of the client without consulting the client." We believe that having two definitions would result in substantial confusion among investment advisers when completely Form ADV (and also determining compliance with the Safeguarding Rule). For this reason, we recommend using a single definition in both the Safeguarding Rule and Form ADV. (We note that for this reason, we believe that the authority to decide which investment advisers to retain should be separated into its own term, since it does not create any misappropriation risk.). Please see above for a discussion of the definition of "discretionary authority" under the Safeguarding Rule.

- ***The SEC should consider whether there are sufficient benefits to the SEC's examination program to justify the administrative burden on investment advisers completing the new table in Item 9.A.(2)***

The new table in Item 9.A.(2) will impose a varying amount of administrative burdens on investment advisers and also, in some circumstances, unnecessary confusion. As acknowledged in the instructions, there will be a substantial amount of overlap among these questions. For example, a standard private fund adviser would likely have to answer a lot of the questions in the same fashion given that it has multiple avenues to the same authority, whether through a related

[50] Rule 204-2(b)(2)(v)(B) (as proposed to be amended).

person who is the general partner (which is often reporting on the same Form ADV[51]) and through its authority under the investment management agreement (or equivalent). It may also raise questions of how to handle "related person" custody where the filing adviser is filing on the same Form ADV as a general partner that is a related person.

We recommend considering one or more of the following options: (i) combining (a), (b) and (f) and limiting to where those are the sole bases for custody (to prevent overlap with the other categories), (ii) combining (c), (d) and (e) (and clarifying how to treat related person custody with respect to a general partner, managing member or other entity filing on the same Form ADV), or (iii) moving the chart to Schedule D and requiring it only be completed where the investment adviser presents characteristics such that the SEC considers this level of detail necessary for its examination program.

- ***Qualified custodians reported on Section 7.B.(1) of Schedule D should not be required to be reported on Section 9.C.(1) of Schedule D***

Similar to how there is an instruction that states that "You do not have to list independent public accountant information in section 9.C of Schedule D if you already provided this information with respect to the private funds you advise in section 7.B.(1) and that accountant only performs audits required by rule 223-1(b)(4) for those private funds," we believe there should be an equivalent instruction to Item 9.C. that states that "You do not have to list qualified custodian information in section 9.C. of Schedule D if you already provided this information with respect to the private funds you advise in section 7.B.(1) and that qualified custodian only maintains assets for those private funds."

- ***The SEC should revise or remove the question with respect to client assets that are not maintained by a qualified custodian in accordance with the Safeguarding Rule***

Proposed Item 9.D.(1) asks: "Are any client assets of which you or a related person have custody not maintained by a qualified custodian in accordance with rule 223-1 under the Advisers Act?" This question is confusingly written. It is unclear whether it is seeking information that is relying on the exception for certain assets unable to be maintained with a qualified custodian in Rule 223-1(b)(2) or if it is asking if assets that are being maintained with a qualified custodian are not being maintained by such qualified custodian in accordance with the Safeguarding Rule. Proposed Item 9.D.(2) suggests that the interpretation should be the former. In that case, we recommend that the question simply be: "Are any client assets of which you or a related person have custody not maintained by a qualified custodian in reliance on an exception provided in rule 223-1 under the Advisers Act?"

[51] *See* American Bar Association, SEC Staff No-Action Letter (Jan. 18, 2012); American Bar Association, SEC Staff No-Action Letter (Dec. 8, 2005)(describing the conditions when a general partner can rely on the filing of a Form ADV by a related investment adviser).

- ***The SEC should remove the requirements to update Form ADV for audit opinions and internal control reports that contain an unqualified opinion***

There already exists a requirement for an investment adviser to report an unqualified opinion with respect to their private funds' audited financial statements.[52] The SEC has also shown a willingness to bring an enforcement action solely on the basis of failing to update the Form ADV for this question (even in the absence of such an unqualified opinion).[53] We believe that this question is now unnecessary given the notification requirement added to the annual audit exception.[54] Given that the SEC will already be receiving some notification from the accountant, it is duplicative and unnecessary for an investment adviser to provide such notification to the SEC. We recommend removing the question from Form ADV. If the SEC would like to know the date of the distribution of the audited financial statements, then that question should be added without a requirement to update on an other-than-annual basis (similar to the existing question on the date of the surprise examination in Item 9.E. of Part 1 of Form ADV).

The SEC is proposing to add a similar requirement in Schedule D, Section 9.C.(3) with respect to reports on a surprise examination, audit, or transaction verification by each independent public accountant. Similar to the issue above, each of these requirements independently already require reporting by the accountant to the SEC if there is a material issue. The most likely issues to arise will be "foot faults" where an adviser forgets to update its Form ADV on an other-than-annual basis. This would particularly be the case with respect to a surprise examination, which could occur at any point during the year. The SEC is already receiving the date of the surprise examination in the existing Item 9.E. of Part 1A of Form ADV, so the investment adviser's updating of the Form ADV should provide no additional information to the SEC. Finally, it is unclear how this requirement should be interpreted with respect to reports on the transactions involving assets unable to be maintained with a qualified custodian. Since in most situations there are likely to be several of those transactions in a given year, the choices between "Yes", "No", and "Report Not Yet Received for Most Recent Fiscal Year End" are likely to lead to essentially reporting to the SEC the first date of any such transaction in that year but no need to update for any transactions following that first transaction. It is unclear why the SEC would want information on the first date of a transaction involving assets not maintained with a qualified custodian.

The SEC is also proposing to add a similar requirement with respect to the internal control report received by qualified custodians in the proposed amendments to Schedule D, Section 9.C.(1) with respect to each qualified custodian.[55] The Safeguarding Rule places no date requirement on this internal control report, so in the event that such a report is received near the end of the fiscal year end, the Form ADV reporting information would appear to be of little use. We are also

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[52] Form ADV, Part 1A, Schedule D, Question 23(h).

[53] In the matter of QVR, LLC, SEC Release No. IA-6116 (Sep. 9, 2022).

[54] Rule 223-1(b)(4)(v)(A) (requiring the accountant to report to the Division of Examination "[w]ithin one business day of issuing an audit report to the entity that contains a modified opinion").

[55] We note that there appears to be an error where the investment adviser is instructed only to complete the internal control report section with respect to qualified custodians that are related persons. *See* Question 7 "Is the qualified custodian listed above a related person" and Question 7(i) "If so, provide the following information about the independent public accountant that prepared the internal control report required by Rule 223-1(a)(1)(i)(C)."

concerned that it is likely to again create unnecessary foot faults on Form ADV updating. We recommend removing this question.

9. Treatment of Crypto Assets

We urge the SEC to consider more carefully the practical effects of adopting the Safeguarding Rule on the ability of investors to receive specialized advice on investments in crypto assets. Many of the same points noted above would also apply to crypto assets. The Safeguarding Rule also does not fully consider the technological innovations underlying crypto assets and why such a prescriptive rule hinders efficient capital markets. For example, the SEC has even acknowledged that "it may be difficult actually to demonstrate exclusive possession or control of crypto assets due to their specific characteristics (*e.g.*, being transferable by anyone in possession of a private key)."

It is undeniable that there is investor demand with respect to investing in crypto assets. While depriving the ability of these investors to receive investment advice from SEC-registered investment adviser may deter certain investors from investing in crypto assets, a substantial number of other investors will simply invest in crypto assets (i) based on the investment advice of investment advisers who are not subject to the Safeguarding Rule (*e.g.*, state-registered advisers, exempt reporting advisers, or non-U.S. investment advisers), (ii) utilizing inefficient structures where the SEC-registered investment adviser does not have "custody" over crypto assets (which with expanded definition of "custody" includes discretionary investment advice) or (iii) without the assistance of any investment adviser. We believe that none of these outcomes would further the SEC's mission of protecting investors and, in fact, would likely lead to greater harm to investors.

- ***The SEC should be the encouraging the use of SEC-registered investment advisers to help investors protect themselves against the risks of investing in crypto assets***

We believe that the SEC should be encouraging the use of SEC-registered investment advisers with respect to investment in crypto assets, not discouraging the use of SEC-registered investment advisers. The SEC staff has emphasized its concerns about the risks of investing in crypto assets, including in a recently released Investor Alert ("**Crypto Asset Investor Alert**").[56] In the Crypto Asset Investor Alert, the SEC staff emphasized its belief that an investment in crypto asset securities "can be exceptionally risky." Furthermore, the SEC staff raises concerns about investors lacking the necessary information and the possibility of fraud ("including bogus coin offerings, Ponzi and pyramid schemes, and outright theft"). To address these risks, the SEC staff emphasized, among other things, the importance of (i) creating and following an investment plan, (ii) considering the appropriate asset allocation and diversification, and (iii) understanding the investment risks. With respect to all of these actions, it would be beneficial for investors to receive the assistance of SEC-registered investment advisers. In fact, in that same Alert, the SEC staff directs investors towards using SEC-registered investment advisers when investing in digital assets. It makes no sense to use the Safeguarding Rule to severely limit the ability of

[56] *See*, *e.g.*, SEC Office of Investor Education and Advocacy, Exercise Caution with Crypto Asset Securities: Investor Alert (Mar. 23, 2023), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/exercise-caution-crypto-asset-securities-investor-alert.

SEC-registered investment advisers to provide advice to investors when the SEC staff itself recognizes the important role that SEC-registered investment advisers can provide with respect to investing in crypto assets. The SEC should not be promoting rules that preclude investors from getting professional investment advice, particularly on investments in which the SEC has expressed concerns. Such a rule is contradictory to its public statements and its mission.

- ***The Safeguarding Rule puts SEC-registered investment advisers at a competitive disadvantage with non-U.S. and other unregistered investment advisers, which also hurts investors***

We believe that placing SEC-registered investment advisers at a competitive disadvantage with respect to advisory services with respect to crypto assets will harm U.S. investment advisers and also U.S. investors and reduce capital formation. In other contexts, the SEC staff has recognized the negative impact on U.S. investors when it limits the ability of investors to access "advisory personnel with expertise in particular specialized markets".[57] The SEC has also recognized the importance to U.S. investors to facilitate the ability of both U.S. and non-U.S. advisers to continue to participate in the U.S. market, so that investors have more choice of investment advisers.[58] Limiting the ability of U.S. investment advisers to provide advice with respect to crypto assets will lead to U.S. investors seeking investment advice (directly or through pooled investment vehicles) from non-U.S. investment advisers, who can provide lower cost and more efficient advice without the burdens and constraints of the Safeguarding Rule.

- ***The Safeguarding Rule will cause SEC-registered investment advisers to provide advice on crypto assets to clients in inefficient structures***

SEC-registered investment advisers will need to seek out advisory structures with respect to crypto assets where the SEC-registered investment adviser does not have "custody" in order to avoid the Safeguarding Rule. These types of structures could involve more non-discretionary relationships. As discussed above, non-discretionary relationships will mean less efficient investment advice, particularly where there is a time element in the investment advice being provided. Furthermore, the client will now be more responsible for navigating the range of custodial and safeguarding options without the advice and monitoring of an SEC-registered investment adviser, who will likely have more expertise in that area. Therefore, by being overly prescriptive in the safeguarding of client assets in the Safeguarding Rule, the net result will likely be that crypto assets of clients will be less protected.

Another option would be the introduction of a third party who is not SEC-registered to provide the services that the SEC-registered investment adviser would otherwise provide but cannot without having "custody" (for example, a trustee of a trust). These structures tend to be less efficient because (i) there is a third party who will need to be compensated for their role, which

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57 SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992) at 226.

58 Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3222 (Jun. 22, 2011) at 168 (discussing how they believe their "approach also should benefit U.S. investors and facilitate competition in the market for advisory services to the extent that it maintains or increases U.S. investors' access to potential advisers").

principally will be borne by the client and (ii) there is a third party who may not be subject to SEC's oversight and may not be subject to the Advisers Act, including the fiduciary duty under the Advisers Act.

- ***The SEC has previously adjusted the federal securities laws for technological and other innovations***

We believe that it is misleading and simplistic to state that the correct response to technological innovation in the capital markets is the application of the existing federal securities laws and regulations without considerations of the balancing of the benefits of the technological innovation to investors with the protection of investors and the integrity of the markets. There has been a long history of adopting or amending federal securities laws and regulations or providing exemptive relief or other guidance in response to technological innovations in the capital markets. It is beyond the scope of this comment letter to provide a complete list of this history. A few examples include:

- Following the widespread adoption of the internet and electronic communications, the SEC made changes to a number of the aspects of the federal securities laws and in doing so, the SEC acknowledged the need to be "mindful of the benefits of increasing use of new technologies for investors and the markets" and to "[encourage] experimentation and innovation by adopting flexible interpretations of the federal securities laws."[59] While few would doubt that the internet and the related technological innovations have introduced new and different risks then existed prior to the use of the internet, there are also few who would doubt the benefits to investors.

- Book-entry depository and settlement services are themselves technological innovations developed in response to what the SEC has called the "Paperwork Crisis" of the late 1960s and early 1970s.[60] The SEC was directed by Congress to "end the physical movement of securities certificates" and seek to develop "a national system for the prompt and accurate clearance and settlement of transactions in securities" in the face of rising trade volumes. Among other results, this effort led to the approval of The Depository Trust Company ("**DTC**") as a registered clearing agency, approval of rules of exchanges encouraging the use of book-entry settlement and establishment of the Direct Registration System, operated by DTC.

- Finally, as noted above, the Custody Rule itself provides (and the Safeguarding Rule would continue to provide) an accommodation for mutual fund shares.[61]

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[59] SEC, Report to the Congress: The Impact of Recent Technological Advances on the Securities Markets, available at https://www.sec.gov/news/studies/techrp97.htm (Nov. 26, 1997). This Report also provides a summary on the effects on public companies, investment companies, investment advisers, and secondary securities markets and provided references to a range of SEC releases and staff interpretative positions and other guidance.

[60] Concept Release: Securities Transactions Settlement, SEC Release Nos. 33-8398; 34-49405; IC-26384 (Mar. 11, 2004) at the paragraphs accompanying fns. 101 – 124.

[61] *See* discussion *supra* notes 3 - 4 and the accompanying paragraph.

We recommend that the SEC take a similar approach to new technologies like blockchain. We believe the SEC should be seeking to encourage innovations and not severely limiting the degrees of freedom within which such innovations can occur.

- ***The SEC is putting investment advisers (who are acting in good faith in seeking to provide investment advice on crypto assets to their clients) in an almost impossible position and causing more fiduciary duty traps***

The Safeguarding Rule (along with some of the statements on the existing Custody Rule) is putting investment advisers who are seeking to provide investment advice with respect to crypto assets and seeking in good faith to comply with the Advisers Act (and the other federal securities laws) in an almost impossible position.

There are a range of investment advisers who have been providing investment advice to clients who are interested in investing in crypto assets in a variety of structures. The innovation in crypto asset space has clearly outstripped the ability of the financial system and its regulators to react.

Similar to many of the other requirements of the Safeguarding Rule, the SEC appears to misunderstand that investment advisers are principally small end users of the financial system and rarely have the bargaining power to cause changes in the rest of the financial system. This lack of bargaining power extends to issuers who are issuing securities, exchanges and brokers who are creating markets and trading in securities, and custodians who are maintaining securities. Investment advisers generally must treat the financial system as it exists and seek to help its clients navigate that system seeking to comply with the federal securities laws and also act in the best interests of their clients.

The SEC should provide a pathway by which SEC-registered investment advisers acting in good faith can comply with the Safeguarding Rule when providing investment advice to crypto assets. Whether the SEC thinks it is advisable for clients to invest in crypto assets or not, removing the ability of SEC-registered investment advisers to provide advice with respect to crypto assets in a way in which they have "custody" will not effectively stop such clients from investing in crypto assets.

Currently, with the proposed Safeguarding Rule and the statements on the current Custody Rule, SEC-registered investment advisers who provide advice to clients on crypto assets will be facing a position that providing investment advice and taking actions that are in the best interest of their clients may be in violation of the Safeguarding Rule or the Custody Rule. This "fiduciary trap" creates a significant conflict of interest that does not need to exist and harms investors. For example, SEC-registered investment advisers could be forced to decide whether to "fire sale" crypto assets for which there are not custodians who can hold them in compliance with the Safeguarding Rule. Similarly, SEC-registered investment advisers will not be able to invest their clients in such assets. Given the innovations in the crypto asset space, it is likely the less established assets for which these issues are most likely to arise; however, these are also the types of assets over which investors would most benefit from the expertise of an SEC-registered investment adviser.

10. Real Estate

- ***Real property has a long-standing set of laws reducing the risk of misappropriation that make the Safeguarding Rule unnecessary with respect to the evidence of real property ownership***

While the Safeguarding Rule focuses on providing an exception to the physical real estate property, this does not reflect how real estate transactions occur. As has been noted, "[r]eal estate is unlike other types of property that are capable of human possession and ownership" rather it "must be conveyed by some symbol of their existence" (*i.e.*, evidence of ownership).[62] However, the Safeguarding Rule provides no exceptions for evidence of ownership of real estate, which makes the exception for physical real estate assets without a real function.

The laws applicable to real estate transactions have a history that long pre-dates our country and the federal securities laws. These laws have long grappled with the prevention of fraudulent transfers, including, for example, the Statute of Frauds[63] and recording acts.[64]

The long, storied history of real estate laws and regulations should not be overridden by the Safeguarding Rule, just because they do not follow the construct of federal securities laws and regulations.

We also note that advisory clients managed by SEC-registered advisers that invest in real estate are only a small portion of the overall real estate market. We again have concerns about the bargaining power of the adviser to receive the required reasonable assurances and other contractual provisions to ensure compliance with the Safeguarding Rule. In addition, by seeking to impose non-market terms on these transactions, it is likely the net result will be that fewer such real estate investment opportunities will be presented to advisory clients because of the burdens and restrictions of the Safeguarding Rule.

11. Loans

- ***Many loans are at low risk of misappropriation making the Safeguarding Rule unnecessary with respect to the related loan documents***

Generally, we believe there is little incentive for an adviser to misappropriate a loan (*e.g.*, by redirecting the borrower's loan payments from the advisory client to the adviser), as this fraud would be picked up readily either in the advisory client's surprise verification of assets and quarterly statement or in the annual audit. Because loan payments occur over time and are traceable, the payment stream seems an unlikely target for theft. Similarly, misappropriating a loan by claiming to own the loan and selling it to someone else seems similarly unlikely and readily detectable. Provided the loan is not a negotiable instrument, the theft and sale of the loan

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[62] Powell on Real Property, Chapter 14 at § 81A.01 (2023)

[63] *See*, *e.g.*, Powell on Real Property, Chapter 14 at § 81A.02 (2023)(discussing the history of the Statute of Frauds and how it attempts to "prevent fraud and chaos in land titles").

[64] *See*, *e.g.*, Powell on Real Property, Chapter 14 at § 82.01 (2023)(discussing the history of recording acts and how they sought "to protect good faith purchasers against defective titles").

seems low risk. We believe loans that are not readily negotiable and therefore are at little risk of misuse or misappropriation (*e.g.*, privately negotiated debt instruments) should be excepted in the same manner as privately-offered securities. As noted under *Section 1 Scope of Assets Required to Be Maintained at a Qualified Custodian* above, we also believe that the exception for privately-offered securities should not require the maintenance of such securities with a qualified custodian because (i) the arrangement would not provide any meaningful additional protection to advisory clients and (ii) in our experience it is difficult to find a custodian willing to custody these assets (to our knowledge, most existing custodial arrangement for loans do not meet the proposed "possession or control" standard). Requiring maintenance of these documents in a bespoke custodial arrangement, assuming a custodian can be found, would result in substantial costs that clients would likely bear.

12. Extraterritorial Application

- ***The SEC should acknowledge that the Safeguarding Rule will be treated at least like the Custody Rule with respect to non-U.S. investment advisers providing advice to non-U.S. clients***

The longstanding position of the SEC has been that a non-U.S. adviser (even if registered with the SEC) is not required to comply with the Custody Rule (among other Advisers Act provisions and rules) with respect to non-U.S. clients.[65] We do not see any reason for changing this position of the SEC staff, but we recommend providing clarity that this position continues to be applicable to the Safeguarding Rule.

- ***The SEC should expand the limitations on the extraterritorial application of the Safeguarding Rule to ensure that U.S. advisers are not subject to a severe competitive disadvantage compared with non-U.S. advisers with respect to non-U.S. clients.***

As noted several times above, the current structure of the Safeguarding Rule would place U.S. SEC-registered investment advisers at a severe competitive disadvantage with non-U.S. investment advisers, particularly with respect to providing advice to non-U.S. clients. For this reason, the SEC should consider additional exceptions with respect to relationships with non-U.S. clients:

  - *The Safeguarding Rule should not apply with respect to any advisory relationship where the non-U.S. client has a pre-existing relationship with the non-U.S. custodian.* As noted above, we believe that seeking to apply the Safeguarding Rule to these pre-existing relationships will likely result in the non-U.S. client seeking advisory services from an investment adviser who is not subject to the Safeguarding Rule.

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[65] Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333 (Dec. 2, 2004) at the text accompanying fn. 221. *See* also SEC Division of Investment Management, Staff Responses to Questions About the Custody Rule, at https://www.sec.gov/divisions/investment/custody_faq_030510, at Question VI.5 (dated Mar. 10, 2010) ("In addition, offshore advisers registered with the SEC are not subject to the custody rule, with respect to offshore funds.")(citing ABA Subcommittee on Private Investment Entities, SEC Staff No-Action Letter (Aug. 10, 2006)).
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- *The Safeguarding Rule should not apply where the SEC-registered adviser is acting as sub-adviser or otherwise subject to the oversight of a non-U.S. third party other than the non-U.S. client*. There are a range of structures whereby an investment adviser is engaged by a third party to provide investment advice to a non-U.S. client and the investment adviser remains subject to the oversight of such third party (rather than directly subject to the client's oversight). In these circumstances, the third party is typically the primary (if not exclusive) party with a contractual relationship with the client. It would be very disruptive to that relationship if the SEC-registered adviser was required to comply with the Safeguarding Rule where it was engaged by such a third party with respect to a non-U.S. client. Similar to the situations above, we would expect that this would place U.S. investment advisers at a significant competitive disadvantage with respect to non-U.S. investment advisers, as the third parties would likely favor investment advisers who are not subject to the Safeguarding Rule.

13. Grandfathering and Transition Period

- ***Grandfathering is necessary***

As noted in the Proposing Release, most custodial agreements are between advisory clients and custodians,[66] but the Proposing Release requires that registered investment advisers execute new custodial agreements with custodians that include sensitive mandated provisions (*i.e.*, the content of the written agreement and assurances requirements). The SEC acknowledges in the Proposing Release that this would be "a substantial departure from current industry practice."[67] We agree and strongly urge that any existing custodial agreements be grandfathered for the reasons set forth below.

Based on the experience with the SEC's inadvertent custody guidance in 2017,[68] which advised that to avoid inadvertent custody of separately managed accounts where the (i) custodial agreement (to which the investment adviser was not a party) provided broad transfer authority to the adviser regarding the client's assets and (ii) investment adviser's advisory agreement with the client provided solely trading authority, the investment adviser must obtain the custodian's written acknowledgment of the limitations on the adviser's authority set forth in the advisory agreement. Due to various factors, including (i) the large discrepancy in size and scale between custodians and most investment advisers, (ii) the implication of additional gatekeeping responsibility for the custodians and (iii) the fact the advisers were not even parties to the custodial agreements, investment advisers proved to have little or no negotiating power with custodians. The custodians were unmoved by the guidance and the investment advisers' requests, which would have substantially altered the custodial industry business model. Advisers

[66] Proposing Release at 14.
[67] Proposing Release at 77.
[68] *See* Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, No. 2017-01 (Feb. 2017) (SEC, Division of Investment Management Guidance Update), https://www.sec.gov/investment/im-guidance-2017-01.pdf.

incurred significant legal costs in their efforts to comply with the SEC guidance. The SEC eventually followed up with FAQs that substantially softened the guidance.[69]

We believe the Safeguarding Rule requirements place investment advisers in a nearly identical posture. Advisers, who do not have agreements with the custodians, would be expected to somehow override existing custodial agreements between the advisory client and the custodian with a new agreement between the adviser and the custodian that must include a number of sensitive and costly mandated provisions. Given the experience in 2017, we do not understand why the SEC expects custodians to cooperate with the even more onerous requirements of the Safeguarding Rule that seek to place even more gatekeeping responsibility and potential liability on custodians and is thereby even more disruptive than the 2017 guidance to the prevailing custodial business model.

As a practical matter, it is unclear how advisers and custodians are to (i) overlay a new agreement that includes additional, different, and likely conflicting, provisions with an existing agreement between the advisory client and the custodian and (ii) allocate the additional expenses associated with the new agreement. The implications are that advisory clients' existing custodial agreements with their custodians are to be replaced with new agreements between the investment advisers and the custodians. Are advisory clients expected to consent to voiding their own agreements with their custodians in favor of agreements to which the clients are not a party with terms for which the clients did not negotiate at a price point that will necessarily reflect the custodian's far more extensive gatekeeping responsibilities and potential liability? This seems like interference with contractual relations that could cause the advisory client economic harm as the advisory client will almost certainly bear the costs of the custodian's undertakings and assurances in the new written agreement.

We believe that the retroactive measures of the Proposing Release do not meet the standards for such rulemaking that courts generally require. The Supreme Court established a presumption against retroactive measures with respect to administrative rulemaking,[70] noting that "[e]ven where some substantial justification for retroactive rulemaking is presented, courts should be reluctant to find such authority absent an express statutory grant."[71] We note that Congress did *not* include such authority in Section 223 under the Wall Street Reform and Consumer Protection Act[72] which reads:

> An investment adviser registered under this title shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe.

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[69] Staff Responses to Questions About the Custody Rule, Question II.11 and Question II.12, https://www.sec.gov/divisions/investment/custody_faq_030510 (updated June 5, 2018).
[70] *See Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208-09 (1988).
[71] *Id.*
[72] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 411, 124 Stat. 1376 (2010).

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Further, the D.C. Circuit adopted a five-factor test to determine when retroactive application should be permitted including:

> (i) whether the particular case is one of first impression, (ii) whether the new rule represents an abrupt departure from well-established practice or merely attempts to fill a void in an unsettled area of law, (iii) the extent to which the party against whom the new rule is applied relied on the former rule, (iv) the degree of the burden which a retroactive order imposes on the party, and (v) the statutory interest in applying a new rule despite the reliance of a party on the old standard. In applying these.[73]

The Proposing Release satisfies none the five factors. Regarding these factors, we note: (i), this is not a case of first impression; (ii) the new rule represents, in the SEC's words, "a substantial departure from current industry practice" and, in our view, a substantial and abrupt departure from the well-established, 60-year old, Custody Rule; (iii) registered advisers have relied for 60 years on the Custody Rule and adhered to its requirements, and, by extension, advisory clients and custodians have relied derivatively on the Custody Rule in structuring and entering into their own contractual custodial arrangements; (iv) the proposed changes will be a heavy burden to all three stakeholders—registered investment advisers, advisory clients and custodians; and, (v) the SEC has provided limited examples of harm to investors that support the SEC's "statutory interest in applying a new rule despite the reliance of a party (in this case three parties) on the old standard.[74]

When previously enacting rules that would impact existing contractual relations, the SEC has provided grandfathering. For example, in adopting Rule 205-3, which limits performance-based fees to "qualified clients," the SEC grandfathered existing performance fee arrangements to avoid disrupting these arrangements.[75] Also, in adopting Rule 203(l)-1, the SEC grandfathered existing venture capital funds that did not meet the new "venture capital fund" definition. The SEC noted that without grandfathering, Rule 203 (l)-1 would cause "existing venture capital funds to modify their investment conditions or characteristics, liquidate portfolio company holdings or alter the rights of investors in the funds in order to satisfy the definition" which "would likely be impossible in many cases and yield unintended consequences for the funds and their investors."[76] Similarly, we believe that, without grandfathering, the proposed Safeguarding Rule requirements "would likely be impossible in many cases and yield unintended consequences for…funds and their investors." This also applies to separately managed account clients.

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[73] *See Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208-09 (1988).

[74] *See Cassell v. FCC*, 154 F.3d 478 n.6 (D.C. Cir. 1998) (referring to them as the *Clark-Cowlitz* factors), *citing Clark-Cowlitz Joint Operating Agency v. FERC*, 826 F.2d 1074, 1081 (D.C. Cir. 1987), *cert. denied,* 485 U.S. 913 (1988).

[75] Rule 205-3(c)(2) under the Advisers Act.

[76] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3222 (June 22, 2011), https://www.sec.gov/rules/final/2011/ia-3222.pdf, at 75 n.311. *See also id*. at 144-43. ("We believe that the grandfathering provision will promote efficiency because it will allow advisers to existing venture capital funds to continue to rely on the exemption without having to restructure funds that may not meet the definition.").

- ***One year is not sufficient for custodians to revise their business model and for advisers and custodians to negotiate and execute thousands of new agreements***

It is not possible to predict how long it would take for registered advisers to meet the proposed Safeguarding Rule requirements, and it is not clear whether it is possible to meet them, regardless of the length of the transition period. We believe that the transition period should be extended well beyond that for any prior Advisers Act rule-making. This approach is supported by the issues set forth above among others, including: (i) numerous changes required to current custodial business models—i.e., the SEC-mandated custodian's new responsibilities and assurances to be included in the required written agreement, (ii) the expansion of asset categories requiring custody to include all client assets and the additional custodial services necessary to accommodate them; (iii) the potential complications from competing/conflicting contracts, laws and regulation, including potential litigation; and (iv) the *de novo/*market-wide search for custodians that registered advisers will likely need to undertake to satisfy their fiduciary duty in the selection of a custodian on their client's behalf. It will take time for market practices and prices to develop in order for investment advisers and advisory clients to be able to make informed decisions regarding both existing and new custody arrangements. To the extent the proposed Safeguarding Rule written agreement requirements can be implemented, we believe a long ramp-up period will be required.

Assuming existing custodial agreements are grandfathered, we recommend the SEC provide at least a 24-month transition period, although it should be understood that this period may be entirely insufficient to for the custodial industry to implement the modifications required, assuming they are willing to do so.

If existing custodial agreements and arrangements are not grandfathered, we recommend the SEC provide at least a 36-month transition period for advisers to more than $1 billion in regulatory assets under management and at least a 48-month transition period for advisers to less than $1 billion who have even less bargaining power. Again, it should be understood that these periods may be entirely insufficient to for the custodial industry to implement the modifications required, assuming they are willing to do so.

14. <u>Comment Period and Re-Proposal</u>

The proposed Safeguarding Rule, the SEC's proposed replacement for the Custody Rule—long considered by many the most complex rule under the Advisers Act, purports to replace or override existing contractual agreements between investment advisory clients and their custodians with new agreements between investment advisers and custodians that are to include certain sensitive SEC-mandated provisions. This is a sea change for the custodial and investment advisory industries. We believe that a change of this nature should have had an extended comment period with consideration given to the extensive overlap in timing with the Form ADV annual amendment and Form PF filing seasons as well as the other rule proposals and adoptions from the SEC, including the recently adopted Form PF amendments. After considering the comments, we urge that the SEC consider re-proposing the Safeguarding Rule with a new comment period.

Further, we note that the SEC requested comments regarding the impact on the economy of the proposed Safeguarding Rule. We expect the economic impact to be major, but custodians would be in a much better position to assess. Please consider soliciting their views directly regarding costs and whether they believe the proposed Safeguarding Rule is reasonable and can be implemented. We believe it is important for the SEC to take into account the perspective of the custodial industry before finalizing the new rule.