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May 16, 2023

Via Electronic Mail: rule-comments@sec.gov

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

Re: Comments to SEC's Proposed Rulemaking on Safeguarding Client Assets, File No. S7-12-22

Dear Ms. Countryman:

We are responding to the request of the Securities and Exchange Commission (the "Commission") for comments to the proposed new rule of the Investment Advisers Act of 1940 (the "Advisers Act") that would amend and redesignate Rule 206(4)-2 (the "Custody Rule") as Rule 223-1 (the "Proposed Rule").

Schulte Roth & Zabel LLP is an international law firm with offices in New York, London and Washington, D.C. Our firm has been representing private investment funds for more than 50 years. We have dedicated teams specializing in private funds regulation, broker-dealer regulation and the regulation of banks and other financial institutions that advise a substantial cross section of the private funds industry and other market participants that would be significantly impacted by the Proposed Rule. We work with our private fund manager clients on structuring their firms and their funds from a corporate and tax perspective and on making investments and operating their businesses in compliance with the Advisers Act and other applicable laws. We also work closely with our private fund manager clients in connection with examinations by the Commission's Examinations Division and investigations by the Commission's Enforcement Division.

These comments, while informed by our experience in representing our clients, are our own views and are not intended to reflect the views of the clients of the firm.

A fundamental question looms large here: what problem is the overhaul and expansion of the Custody Rule seeking to solve? We have not observed widespread risks of theft or loss of client assets that are not addressed by the existing Custody Rule, and the Commission does not cite

enforcement actions or examination findings to the contrary. The Commission notes the growth of assets under management with private fund advisers and the growth of the market for privately offered securities. But growth in these areas does not in and of itself suggest greater risk of theft or loss of client assets. Cryptocurrency is prominently cited in connection with the Proposed Rule, and custody issues with respect to digital assets are certainly novel and important. The Proposed Rule, however, does not offer a practical framework for investors to get the benefits of advice from a registered investment adviser ("RIA") when investing in digital assets. Rather, the Proposed Rule would drastically reduce such opportunities.

Even putting aside the monetary costs the Proposed Rule would impose, there are significant drawbacks. The Proposed Rule is not workable. It would disrupt important financial markets, require the re-negotiation of custody, funding and related agreements on a massive scale, create confusion about longstanding and well-functioning banking and prime brokerage practices, and likely limit the numbers of qualified custodians.

We believe it is useful to identify a few practical bars to the new requirements of the Proposed Rule (though this is by no means an exhaustive list).

The Expansion of Assets Subject to the Rule Would Cause Confusion, Disruption and Non-Compliance. The Proposed Rule would dramatically expand the types of assets that must be maintained at a qualified custodian, while also changing what it means for a qualified custodian to maintain client assets. Like other commenters on the Proposed Rule, we question the legal basis for the expansion of the Commission's jurisdiction to regulate a vast array of non-securities investments, many of which are subject to competing regulatory schemes, and to effectively regulate custodial firms and other businesses. Moreover, there is no practical mechanism for qualified custodians to create new gatekeeper roles for themselves with respect to a broad range of assets (e.g., private financial contracts, commodities interests, loans, real estate, art) not covered by the Custody Rule. Hoping that "ideally, a robust market for custodial services"[1] for all such assets will spring up, and do so in time for compliance with the Proposed Rule, is not a sufficient basis for holding RIAs to standards they cannot, as a practical matter, satisfy.

The Limitations on the Privately Offered Securities Exemption Are Unworkable. The Custody Rule recognizes that qualified custodians like banks and broker-dealers are not useful "custodians" for privately offered securities that are only transferrable with the consent of the issuer. The exemption of such securities from the requirement that funds and securities be maintained at a qualified custodian has not lead to widespread theft or loss of client assets. The Commission cites increased investment by RIAs in privately offered securities, but nothing about the safety of such assets has changed. The Commission assumes that the custodial requirements applicable to securities will be feasible for non-securities and would be beneficial if they could be applied. Similarly unwarranted and impractical is the requirement under the Proposed Rule that an independent auditor verify every transaction involving a privately offered security in real time. The explanation provided with respect to this novel requirement is that there should be sufficient time for auditor verification where there is a lengthy corporate closing, with closing memoranda, signature pages and other "time consuming tasks related to closings for these types of assets" and

[1] Safeguarding Advisory Client Assets, 17 CFR Parts 275 and 279, https://www.sec.gov/rules/proposed/2023/ia-6240.pdf at 14705.

that independent auditor verification would be "a normal audit procedure."[2] The markets for privately offered securities, however, are varied and dynamic, including many transfers of privately offered securities being effected pursuant to standardized documentation where the timing and volume would make the real-time verification by an independent auditor an impossibility.

FFI Requirements Will Make It Riskier, if not Impossible, to Invest in Certain Jurisdictions. Foreign financial institutions ("FFIs") that serve as qualified custodians under the Custody Rule will be ineligible or disincentivized to do so under the Proposed Rule. The Proposed Rule requires FFIs to consent to jurisdiction of the U.S. courts in order for the Commission or the RIA to enforce money judgments against them. This condition (coupled with the requirement that qualified custodians provide indemnification for loss associated with their own ordinary negligence as well as assume the liability for their sub-custodians) will be particularly problematic for FFIs that do not have a presence in the U.S. and do not engage otherwise in activities that would subject them to costly U.S. litigation. This requirement may have a chilling effect on foreign custody arrangements and seems unduly onerous and unnecessary in light of the Proposed Rule's requirement that such institutions are regulated by a foreign government. The Proposed Rule also would impose specific U.S. regulatory requirements on FFIs including "practices, procedures, and internal controls designed to ensure the exercise of due care with respect to safekeeping client assets,"[3] which could limit access to entire jurisdictions due to technical differences in the foreign jurisdiction's rules and regulations. The Proposed Rule also would require that custodied assets be maintained in accounts that are bankruptcy remote. Bankruptcy remoteness will have different meanings in each jurisdiction, which unnecessarily and impractically puts the focus on counterparty risk rather than the risks of the instrument itself.

The Proposed Rule Would Dramatically Impact Digital Assets. The Proposed Rule could drastically limit the opportunities for investors to get the benefit of advice from RIAs when investing in digital assets. There is a significant appetite among investors, including institutional investors, for exposure to digital asset investments. We believe that the Commission can appropriately seek to protect such investors while also maintaining fair, orderly and efficient markets and facilitating capital formation. The Proposed Rule, however, may make it difficult or impossible for RIAs to invest in most digital assets. The requirement that "all assets" – securities and non-securities alike – be maintained with a qualified custodian with exclusive possession of the assets may not be workable for digital assets. The "exclusive possession" requirement is particularly noteworthy in the context of digital assets, where it may be safer when no single entity has exclusive possession of the asset. In addition, the value of many digital assets is premised, in part, on a holder's ability to "stake" the assets and/or to exercise voting rights, which the exclusive possession requirement would not allow. Limiting the potential scope of firms that can serve as qualified custodians and requiring such firms to obtain insurance and indemnify RIAs for negligence, recklessness or willful misconduct will have an outsized impact on the digital asset custodial market and could result in fewer custodial options than are presently available. The Proposed Rule also may effectively exclude most digital assets (if they are deemed to be securities) from reliance on the "privately offered securities" exemption from the requirement that assets be held at a qualified custodian, leaving RIAs unable to self-custody such assets. We believe that the

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[2] *Id.* at 14707.

[3] *Id.* at 14708.

Proposed Rule is not a workable approach to regulating digital assets and that it might lead U.S. investors to transact in these markets without the benefit of the expertise that RIAs can provide, either by relying on unregistered advisers or by investing directly.

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Based on the foregoing, we respectfully request that the Commission consider withdrawing the Proposed Rule and undertake a study of current custodial arrangements and the risks of theft and loss they present. Any further proposals with respect to custody should be informed by rigorous cost-benefit analysis that accounts for the costs of disrupted markets and limitations on investment opportunities through RIAs. We would be pleased to respond to any inquiries you may have regarding our letter or our views on the Proposed Rule more generally. Please feel free to direct any inquiries to Marc Elovitz, Kelly Koscuiszka or Christopher Avellaneda at (212) 756-2000.

Respectfully submitted,

SCHULTE ROTH & ZABEL LLP

cc: The Honorable Gary Gensler, SEC Chairman
The Honorable Caroline Crenshaw, SEC Commissioner
The Honorable Jaime Lizárraga, SEC Commissioner
The Honorable Hester Peirce, SEC Commissioner
The Honorable Mark T. Uyeda, SEC Commissioner
William Birdthistle, Director, Division of Investment Management