NEW YORK CITY BAR

May 8, 2023


**COMMITTEE ON PRIVATE INVESTMENT FUNDS**

**MICHAEL S. HONG**
**CHAIR**
450 LEXINGTON AVENUE
NEW YORK, NY 10017
(212) 450-4048
Michael.Hong@DavisPolk.com

**MICHAEL W. BRASHER**
**SECRETARY**
450 LEXINGTON AVENUE
NEW YORK, NY 10017
Michael.Brasher@DavisPolk.com

**COMPLIANCE COMMITTEE**

**PATRICK T. CAMPBELL**
**CO-CHAIR**
45 ROCKEFELLER PLAZA
NEW YORK, NY 10111
(212) 489-4200
pcampbell@bakerlaw.com

**ADAM B. FELSENTHAL**
**CO-CHAIR**
165 MASON ST #3
GREENWICH, CT 06830
afelsenthal@gppfunds.com

**TIFFANY ARCHER**
**SECRETARY**
25 HARBOR PARK DR
PORT WASHINGTON, NY 11050
tiffany_archer@pall.com


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

Re: File No. S7-04-23

Dear Ms. Countryman:

The Committee on Private Investment Funds and the Compliance Committee of the New York City Bar Association (“**Committees**”) submit this letter in response to the request of the Securities and Exchange Commission (“**Commission**”) for comment in connection with Investment Advisers Act Release No. IA-6240 (Feb. 15, 2023) which proposes a new rule under the Investment Advisers Act of 1940 (the “**Advisers Act**”) that would amend and redesignate Rule 206(4)-2 (the “**Custody Rule**”) into Rule 223-1 (the “**Safeguarding Rule Proposal**”, the


**About the Association**
*The mission of the New York City Bar Association, which was founded in 1870 and has over 23,000 members, is to equip and mobilize a diverse legal profession to practice with excellence, promote reform of the law, and uphold the rule of law and access to justice in support of a fair society and the public interest in our community, our nation, and throughout the world.*

"**Proposal**", the "**Release**" or the "**Proposed Rule**").[1] The Committees are composed of lawyers with diverse perspectives on investment management issues, including attorneys from law firms, counsel and compliance professionals to financial services firms, investment company complexes and investment advisers.

The Committees appreciate the opportunity to comment on the Safeguarding Rule Proposal and appreciate the effort of the Commission and its staff (the "**Staff**") in putting forward these thoughtful proposals for public input. The Safeguarding Rule Proposal clearly reflects the hard work and dedication of the Commission and the Staff in discharging their mission to protect investors and their assets.

In the sections that follow, we discuss various portions of the Proposal in turn, beginning with the Committees' thoughts with regard to the Proposed Rule's expansion to include additional assets and advisory relationships (Section I), the obligations on advisers to procure certain minimum custodial protections for clients' assets through entering into written agreements with, and obtaining certain reasonable assurances from, qualified custodians (Section II), and considerations around specific assets (Section III).

Throughout the various sections of the letter, the Committees touch upon two common themes that warrant emphasis from the outset and that present themselves with frequency in this letter. First, many of the Proposed Rule's requirements, in our view, are impractical for advisers, custodians, and their clients and would be very difficult (if not impossible) to implement. Second, the Proposed Rule would fundamentally disrupt current market practices around how assets are held by a custodian. The Proposed Rule, if enacted in its current form, would prevent advisers from participating in a broad swath of transactions and investments and therefore impede capital formation and the efficient functioning of markets. Given that this is the case, the Committees emphasize the importance of grandfathering existing agreements and the need for a longer period to implement the Proposed Rule.

## I. Expanding Scope to Include Additional Assets and Advisory Relationships

### A. Inclusion of "Discretionary Authority" to Transfer Beneficial Ownership of Client Assets

The Proposal would explicitly include discretionary authority to trade within the definition of custody. In the Release, the Commission emphasized, "When an adviser has discretion to trade client assets, it has an arrangement in which it may instruct the adviser's custodian to dispose the client's assets."[2] The Release then includes explanations and examples which the Commission claims exemplify the types of risks presented by such discretionary authority. We do not agree that client assets are at greater risk of misappropriation by virtue of an adviser's discretionary authority because we believe that the current rule is an effective safeguard against adviser misappropriation of client assets that are held pursuant to such discretionary authority. Adding discretionary authority to trade within the definition of custody also carries various implications

[1] Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023), https://www.sec.gov/rules/proposed/2023/ia-6240.pdf. (hereinafter "**Safeguarding Rule Release**").

[2] Safeguarding Rule Release, at 20.

that will materially affect the industry, including bringing SMAs under the Custody Rule's independent verification requirements (*i.e.*, the surprise examination requirement).

**1. Client assets are not at greater risk of misappropriation by virtue of an adviser's discretionary authority.**

Under the current Custody Rule, custody includes three prongs:

1. possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless the adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them;

2. any arrangement (including a general power of attorney) under which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian; and

3. any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the adviser or its supervised person legal ownership of or access to client funds or securities.

Although the Proposal seeks to retain these categories, the Commission proposes to "provide specificity" regarding the second prong by explicitly stating that discretionary authority is itself an "arrangement" triggering custody under the Custody Rule. This amendment is a direct reversal of the Commission's prior statements that an adviser's authority to issue instructions to a broker-dealer or a custodian to effect or settle trades, or authorized trading, would not constitute custody.[3] In the Release, the Commission clarified that, at the time those prior statements were made, it had "explained then that the risk of an adviser withdrawing or misappropriating funds and securities are minimized when a client's custodian is under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account."[4] In the Commission's view, such a transaction presents minimal risk. Greater risk, however, is present in the Commission's opinion, when the adviser can act with discretionary authority and thus is not operating under a strict mandate to only effectuate corresponding exchanges.

The examples that the Commission provides in the Release, however, do not demonstrate that it is the possession of discretionary authority over a client's assets that poses risk to that client. For example, the Release warns that "an adviser may instruct an issuer or a transfer agent that recorded ownership of a client's privately offered security to redeem the client's interest to a particular account."[5] The Commission reiterates this perceived risk later in the Release, stating an adviser "could use its discretionary authority over a client's assets to instruct an issuer's transfer

---

[3] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. IA-2176, 68 Fed. Reg. 56,692 (Sept. 25, 2003) (hereinafter "**2003 Adopting Release**"), at n.10, https://www.sec.gov/rules/final/ia-2176.htm.

[4] Safeguarding Rule Release, at 32-33.

[5] *Id.*, at 13.

agent or administrator (*e.g.*, the administrator for a loan syndicate) to sell its client's interest and to direct the cash proceeds of the sale to an account that the adviser owns and controls, thereby depriving the client of ownership, unbeknownst to the client or its qualified custodian."[6] However, in our view those examples do not demonstrate that it is the possession of discretionary authority over a client's assets that poses risk to that client or that the new "discretionary authority" language would provide new protection.

**a) Withdrawal of Client Assets Already Covered by the Current Custody Rule**

These examples seem to conflate trading (which should not involve custody) with redemption and withdrawal of client assets (which is a separate concept that does involve custody). Regardless of whether trading may be taking place in the cited examples, the concern the Commission is expressing relates not to the trading itself but, rather, to the second stage in the process – the withdrawal of the client's assets from the client's account.

This difference is not only semantic because the substantive issue – *i.e.*, the ability to withdraw assets from a client's account – is already covered by the second prong of the definition of custody. Adding discretionary authority to that prong is unnecessary to avert the risk the Commission has expressed in the Release.

**b) New "Discretionary Authority" Language Does Not Create Any New Client Protections**

These examples in the Release of risks that the new discretionary authority language is intended to address appear to be instances of misappropriation of client assets, and it is unclear how that new discretionary authority language would prevent that. In the cited examples, the adviser is wrongfully redeeming client assets and transferring them to an adviser-owned account. There are already several terms for this sort of action: "theft," "misappropriation," "fraud" and "violation of fiduciary duty."

We do not see actual instances cited in the Release in which advisers have stolen client assets in this manner by taking advantage of the existing definition of custody under the Custody Rule. It is likely that relevant examples could not be cited because the absence of discretionary authority from the definition of custody under the existing Custody Rule has not been exploited by advisers to take advantage of their clients. Investment advisers are currently subject to an extensive regime of legal and regulatory duties – including fiduciary duties imposed by the Investment Advisers Act of 1940 as well as other anti-fraud mandates – which already requires them to act in a manner consistent with those duties. If an adviser is willing to violate those duties and tear through the web of protections that is already in place, it is doubtful that such a bad actor would be deterred from that course of action simply because the Custody Rule now imposes a "custody obligation" whenever the adviser has discretion.

**2. Additional Burdens Imposed by the Proposed Rule's Requirements**

[6] Safeguarding Rule Release, at 33.

Adding discretionary authority to trade within the definition of custody carries various implications that will materially affect the industry. First, with that addition, an investment adviser could be deemed to have custody even when it lacks the authority to direct the client's qualified custodian to transfer the client's assets to third parties. For example, an investment adviser that provides a portfolio model to a managed account provider could be deemed to be subject to the Proposal's requirements simply because it has discretionary authority over that model, despite not having any execution authority over the platform itself. Consequently, the Proposal would expand the universe of investment advisers subject to the Custody Rule.

The Proposal would also introduce, without further guidance or limitations, ambiguity into certain situations that are common in the asset management industry. For example, at present, an investment adviser may have discretionary authority over only a portion of a client's account or act as a sub-adviser to another investment adviser. In situations where multiple investment advisers have discretionary authority over a client's assets, the Proposal will lead to confusion, with multiple advisers claiming custody of a client's assets (in addition to the other requirements of the Proposal, such as entering into written agreements with the qualified custodian and ensuring the surprise audit/verification of those client assets are met).

If enacted as written to include discretionary authority in the definition of custody, the Proposal would consequently cover many separately managed accounts ("**SMAs**") that are not currently covered by the Custody Rule. In many situations, the account holder for the SMA sets up an SMA precisely because it wishes to have greater control over the SMA, including with respect to the selection of service providers and custodians for the SMA. Under the Proposal, however, an investment adviser that has discretionary authority over an SMA – but otherwise has not been involved in the selection of counterparties and custodians for that account – would be required to ensure that the custodian selected meets the standard of "qualified custodian." Without the authority to select the custodian for the SMA, it will be difficult, if not impossible, for the investment adviser to ensure that such custodian is a qualified custodian under the Proposal.

In addition, under the Proposal, investment advisers must enter into written agreements and obtain reasonable assurances from custodians. Thus, even if the custodian to an SMA meets the qualified custodian standard, if the investment adviser has not been involved in the custodian's selection (and thus is without the ability to remove or replace that custodian), the investment adviser will lack any effective leverage to ensure that the custodian enters into a written agreement with the investment adviser containing the reasonable assurances mandated by the Proposal.

### 3. Discretionary Authority and the Surprise Examination Requirement

In addition, with the inclusion of discretionary authority as part of the definition of custody under the Proposal, SMAs would thus be brought under the Custody Rule's independent verification requirements (*i.e.*, the surprise examination requirement). As noted above, in a situation where the investment adviser has limited control over the SMA other than discretionary authority, it could be difficult for the adviser to comply with those requirements.

The Proposal does contain an exception from the surprise examination requirement for client assets if the adviser's sole basis for having been deemed to have custody is that the adviser has discretionary authority with respect to those assets. That exception, however, only applies to

client assets that are maintained with a qualified custodian and to accounts where the adviser's discretionary authority is limited to instructing that qualified custodian to transact in assets that settle exclusively on a delivery versus payment ("**DVP**") basis. The Release states, when a custodian is instructed to transfer assets out of a client's account only upon a corresponding transfer of assets into the account (the heart of the DVP basis), "there is a reduced risk that the adviser could misappropriate the assets, and when the transaction settles on a DVP basis there is a reduced risk of theft of the asset because, on a non-DVP basis, the seller of an asset could deliver the asset but not receive payment or the buyer of an asset could make payment but not receive delivery of the asset."[7] This is a limited exception, however, and it may not be available to many SMA managers whose clients have granted them broad trading authority.

The focus on non-DVP transactions in the context of the Custody Rule inappropriately shifts the risk of those transactions wholly onto the investment adviser. Although there may be increased risks with transactions that settle on a non-DVP basis, such as settlement risk of one party failing to fulfil its obligations to pay for or deliver the securities in question or credit risk where the seller is exposed to the risk of non-payment by the buyer, in the Release, the Commission continually equates those risks with the risk that an investment adviser will misappropriate client assets in a non-DVP transaction. Even in the adopting release for the 2003 amendments, the Commission noted that "[a]n investment adviser that holds clients' stock certificates or cash, even temporarily, puts those assets at risk of misuse or loss."[8]

The Commission, however, has previously acknowledged that investment advisers are under additional obligations to safeguard client assets separate and apart from the Custody Rule.[9] Consequently, the investment adviser community is already subject to numerous restrictions against misappropriation of client assets, and the existing Custody Rule is sufficient for preventing that misappropriation without the need to expand the definition of custody to encompass discretionary authority as contemplated by the Proposal.

Finally, on the topic of DVP versus non-DVP transactions, the Release seemingly contains an expansion of the existing Custody Rule with which we disagree. In any event, if adopted, the Release should be further clarified. Specifically, the Release cites in a footnote the same language from the 2003 Adopting Release that includes the authorized trading exception. The Release continues, however, by stating, "Absent this narrowly drawn exception for 'delivery versus payment' transactions, authorized trading comes within the definition of custody."[10] This position was implied in interpretative guidance issued by the Commission in 2017,[11] and as mentioned

---

[7] Safeguarding Rule Release, at 207.

[8] *See* 2003 Release.

[9] *See* SEC Staff Letter "Engaging on Non-DVP Custodial Practices and Digital Assets," (Mar. 12, 2019). The Commission noted "registered investment advisers also have an obligation to review internal controls to reduce the risk of misappropriation or loss, and should address this risk in their compliance policies and procedures required by Rule 206(4)-7 under the Advisers Act." In a footnote in the Staff Letter, the Commission further explained that, when Rule 206(4)-7 was adopted in 2003, the adopting release stated, "an [investment] adviser's policies and procedures, at a minimum, should address . . . to the extent . . . relevant to the [investment] adviser . . . [s]afeguarding of client assets from conversion or inappropriate use by advisory personnel."

[10] Safeguarding Rule Release, at 21 n.37.

[11] *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.

above, it was discussed in the Staff Letter. Notwithstanding those discussions, however, the position remained uncertain and was never officially adopted by the Commission. It is therefore surprising to have the position seemingly codified in a footnote buried within this expansive Proposal. Such an interpretation of the existing Custody Rule could have implications for investment advisers, regardless of the ultimate disposition of the Proposal.

### B. Qualified Custodian "Possession or Control" of Client Assets

The Proposed Rule would require that an investment adviser that has custody of client assets maintain those assets with a qualified custodian that has "possession or control" of those assets.[12] A custodian would have "possession or control" if it held assets such that the custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.[13]

It is the Committees' understanding that many assets required to be maintained by custodians for advisory clients under the Proposed Rule would not meet these proposed requirements because these assets are currently evidenced by agreements between parties other than qualified custodians such as partnership or LLC agreements, subscription documents, loan documents, swap contracts, and ISDA agreements. There is not an appropriate method for custodians to insert themselves into such arrangements, nor can we imagine a willingness by custodians to do so. These documents, on their own, do not give a holder "legal standing" and therefore do not make it feasible for the holder to meaningfully participate in the transfer of the underlying asset. Importantly, a considerable number of privately offered securities will not technically meet the requirements of the "privately offered securities" exception under the Proposed Rule, primarily because they can be transferred without the consent of the issuer or its shareholders.

In order for custodians to move to actually have "possession and control" of these assets, the way these assets are owned and transferred would have to change entirely. Even if this were possible, the industry would have to completely rework current market practices, which have worked well to date. Turning these agreements into bearer-like instruments such that the custodian can have "legal standing" to participate in the transfer of such assets, creates a significant amount of additional risk that the assets can be misappropriated or lost. Bearer instruments by their nature lend themselves to misappropriation or loss as possession is all that is required to be entitled to the assets evidenced by that agreement.

In support of its overhaul of current market practice, which in our view, as noted above, has worked well to date, the Commission proposed requirements that could disrupt the way many assets are currently custodied and expose them to greater risk of misappropriation. In so doing, the Commission could deny clients access to many investments. Thus, we recommend that the

[12] Proposed Rule 223-1(a)(1).

[13] Proposed Rule 223-1(d)(8).

Commission not institute the "possession and control" requirement, as it would cause significant issues, if not impossibilities, for a range of assets that are not freely transferable.

### C. Privately Offered Securities Exemption

The Committees urge the Commission to retain the exception to continue to permit advisers that have custody of privately issued securities not to maintain them with a qualified custodian, subject to the current condition that the securities are not transferable without the involvement of the issuer. As the Commission explained in the 2003 Adopting Release amending rule 206(4)-2, the impediments to transferability of these securities provide external safeguards against the kinds of abuse the rule seeks to prevent.[14] Privately issued securities are, for example, often held by clients that are private equity funds, which hold substantial or majority interests in companies. Those interests bear almost no risk of being lost or stolen, yet the advisers to those funds, unable to meet the conditions of the new exemption, would have to find some way maintain them with a qualified custodian.

In our experience, there are few custodial risks associated with privately offered securities, and the Release fails to explain the basis on which the Commission believes that the current conditions of the exemption have not worked as the Commission believed they would in 2003. The Release cites no enforcement actions, civil actions by harmed clients, or even examination experience that support the need for the proposed amendments. It also fails to acknowledge the substantial costs that would be incurred and will ultimately be paid by clients and investors if these proposed amendments are implemented.

#### 1. Conditions for Exemptions

The exemption for privately offered securities is currently available for securities that are (i) acquired from the issuer in a transaction not involving any public offering; (ii) uncertificated and ownership is recorded only on the books of the issuer or its transfer agent in the name of the client; and (iii) transferrable only with prior consent of the issuer or shareholders.[15] As discussed below, the Commission proposes to substantially narrow the utility of the exemption by imposing new conditions, one of which would specifically address the proposed expansion of the rule to include physical assets.

#### 2. Unable to be Maintained by a Qualified Custodian

The proposed amendment would require, in order to take advantage of the exemption, that an adviser reasonably determine and document that ownership of the security cannot be recorded and maintained with a qualified custodian.[16] This presents several problems. First it would require an adviser to prove a negative—that there was no other way permissible under the rule to custody the security. Although the proposed rule would require only a "reasonable" determination, such determinations will be evaluated with the benefit of hindsight. The adviser will thus be exposed to regulatory risk for not having identified, in the moment, a permissible means of custodying an

[14] 2003 Adopting Release.

[15] Rule 206(4)-2(b)(2)(i).

[16] Proposed Rule 223-1(b)(2)(i).

asset that is later identified as having been available. This risk would be exacerbated by the need to keep the determination "evergreen." All of these inquiries and accompanying documentation will require increased staffing and costs, diverting resources away from pursuing matters that are important to clients, such as the successful management of the investment portfolio.

Second, the proposed amendment would appear to require an adviser to a fund to employ a custodian, even if only available at a prohibitive cost, or a custodian whose systems are incompatible with those of the advisory clients but is under no corresponding legal obligation to make its systems compatible, or a custodian in which the adviser (or its client) does not have confidence.[17] Encouraged by this requirement, a cottage industry of nominally qualified custodians may develop, which advisers may be required to use when their preferred custodians are not willing to accept custody of a security. It would be unfortunate if a rule designed to protect client assets operated to expose them to new custodial risks.

#### 3. Requirement that Independent Public Accountants Promptly Verify the Purchase, Sale of other Transfer of Such Assets

The proposed amendments would also require advisers relying on the exemption to have each transaction promptly "verified" by an independent public accountant, which must notify the Commission of any material discrepancy.[18] It is not clear which processes would or could be used or the level of certainty accountants would be required to have before verifying. We are very concerned that the accounting firms will view such a service as exposing them to potential liability stemming from claims post-transfer. With such attendant potential liabilities, we question whether accounting firms would choose to expand their business lines into offering this new service to a degree required to support the resulting demand. If the services are available, they are likely to be provided at a prohibitive cost, both due to the potential risks for which accountants will require compensation and to the large volume of transactions that will be involved.

#### 4. Proposed Definition of Privately Offered Security

The Commission proposes to include a new definition of "privately offered securities," which would be similar to the current definition. We are particularly concerned with two aspects of this definition.

##### a) Certification

Like the current definition, the availability of the exception would be limited to securities that are uncertificated.[19] In August 2013, the SEC staff issued guidance that effectively eliminated this requirement.[20] But in doing so, the staff accepted the argument put forth by industry participants that instruments evidencing ownership of non-transferrable interests in privately issued securities present no custodial risks because the clients' "ownership interest in the security

---

[17] For similar considerations in the context of crypto assets, *see infra* Section III D(3).

[18] Proposed Rule 223-1(b)(2)(iii)-(v).

[19] Proposed Rule 223-1(d)(9).

[20] Privately Offered Securities under the Investment Advisers Act Custody Rule, IM Guidance Update (Aug. 2013).

is not impacted by the existence (or lack thereof) of the certificate."  We urge the Commission to instead codify the staff position for the reasons set forth in the guidance.

#### b) Cryptocurrency[21]

The Commission also proposed to limit the scope of "privately offered securities" so that it would not include cryptocurrencies.  While the Committees do not object to this restriction, we would point out that it would seem to be unnecessary because the exception for privately issued securities requires them to be non-transferrable.  Transferability on the blockchain is one of the key features of cryptocurrency utilizing a public blockchain, thus making the new restriction superfluous for nearly all current crypto assets.  Further, this restriction might incorrectly exclude from the definition of "privately offered securities" any future (and limited current) crypto assets that exist on private or permissioned blockchains that impose restrictions on transferability.

### D. Segregation of Client Assets

The Proposed Rule would require that the assets of an investment adviser's client over which the adviser has custody be segregated from the adviser's assets, and that an adviser obtain reasonable assurances that a custodian holding advisory client assets will segregate the client's assets from its own.  The Committees appreciate the Commission's efforts to enhance the protection of client assets in this regard but recommend that the Commission consider more specifically the effects that the asset segregation requirements may have on banking institutions. In particular, it is not clear that bank custodians can operationalize the requirements set forth in the Proposed Rule, and if they could, what costs may result that advisory clients would be forced to bear, including a smaller universe of willing custodians.  To the extent the Proposed Rule would be workable for the banking industry, the Committee recommends that the rule provide more flexibility for commingling assets in connection with lending arrangements where asset pooling is customary and practical, and for which a blanket prohibition would disadvantage advisory clients due to significant operational and commercial challenges.

Many pooled investment vehicle clients of investment advisers engage in credit transactions structured as loan syndicates or that involve the primary lender selling participation interests in the loan. This effective pooling of lenders is viewed by many advisers as necessary and beneficial to originate for advisory clients a competitive base of assets that is sufficiently large and diverse to absorb typical market risks. These transactions typically necessitate comingling of the assets of the syndicate members or participants into a single administrative account with respect to which all members or participants who benefit from the commingled account – including a relevant investment adviser that participates as a lender – are accountable to the other participants, and which typically provides specific asset monitoring and tracking provisions that seek to ensure that each account participant has accurate information about its assets in the program. Commingling assets also has the benefit of reducing the administrative burden and cost of requiring a borrower or an administrative agent to the syndicate or participations to wire payments to all members of the syndicate or to all participants (in the case of loan participations, loan

[21] For a more complete discussion of considerations in the context of crypto assets, *see infra* Section III D.

participants are not even in contractual privity with the borrower and only the lender of record who sells the participations can legally receive direct payments from the borrower).

The Commission staff has acknowledged the existence and need for comingling of assets in these circumstances, and provided no-action relief to permit commingling of client and adviser assets, in these scenarios, in *Madison Capital Funding, Inc.* ("**Madison Capital**")[22]. The Committees believe that the Commission should reflect this acknowledgement and relief by including an exception in the Safeguarding Rule to allow commingling of client and adviser assets in the circumstances described above when client assets are held in custody with a qualified custodian.

Support for an exception exists in the Proposed Rule itself. The Commission noted in the Release that "[the] proposed adviser segregation provision is critical in light of the fact that some client assets are not maintained with a qualified custodian."[23] Requiring assets to be maintained with qualified custodians would work to eliminate this risk. Additional support for this approach is provided by the Proposed Rule's custodian segregation requirement that requires an adviser to obtain reasonable assurances from a custodian that the custodian clearly identifies the client's assets. In this respect, the Commission recognized that proper identification "of commingled accounts allow qualified custodians to identify readily an owner's commingled assets at any point in time." Specific identification of client assets as required by the Proposed Rule – coupled with the qualified custodian requirement noted above – mitigates (and in most cases eliminates) the types of risks the Commission cites in connection with commingling adviser and client assets, namely, unidentifiable client assets and increased risk of loss from adviser misuse or adviser insolvency. As a result, imposing a requirement to segregate an adviser's assets is unnecessary.[24]

The Committees therefore recommend that the Safeguarding Rule include an exception to permit commingling of client and adviser assets (or client and an adviser's related person's assets) in connection with a client's participation in loan servicing or loan administration accounts where the account is maintained by a qualified custodian. As an alternative to an express exception from the adviser segregation requirement, the Committees recommend that the final rule contain a conditional exception based on the conditions included in Madison Capital, or, alternatively, the Commission clarify in the adopting release of the final rule that an adviser's assets and client assets would be permitted to be commingled in connection with loan administration functions that advisers might engage in on behalf of their clients, as described in Madison Capital.

The Committees also believe that the Proposed Rule should be modified to allow for commingling of client and adviser assets. The Proposed Rule would require an adviser to obtain reasonable assurances from a custodian that the custodian will both segregate client assets from

---

[22] *See* Madison Capital Funding, Inc., SEC No-Action Letter (Dec. 20, 2018). While the incoming letter described loan syndications, loan participation transactions raise the same commingling issues, as described above.

[23] Safeguarding Rule Release, at 165.

[24] The Commission should also clarify that adviser segregation is not required in circumstances where an adviser or its related persons do not serve as administrative agent of the loan servicing or loan administration account, consistent with the staff's views expressed in Madison Capital. The Committees note, however, that the vast majority of the lending arrangements described above do not use unaffiliated agents, as market-standard agreements and procedures with unaffiliated agents do not exist, and implementing such arrangements would result in considerable costs and operational modifications that may not serve the best interests of advisory clients.

the custodian's proprietary assets and clearly identify the client assets. As a result, the Proposed Rule would permit commingling of client and non-client assets in a single account. The Committee commends the Commission's flexibility in this regard, as this approach is particularly helpful for advisers whose clients, as described above, engage in loan syndicates and participation arrangements with non-clients that result in commingling of parties' assets. The Proposed Rule, however, should specifically recognize that the custodian requirements to segregate and identify client assets also provide a basis to allow for commingling an adviser's assets (and its related persons' assets) with client assets, consistent with the staff's position in Madison Capital.

## II. Minimum Custodial Protections

### A. Written Agreements

Under the Proposal, investment advisers would be required to enter into a written agreement with a qualified custodian that contains certain terms for minimal custodial protections for advisory client assets, as well as reasonable assurances from the custodian. These requirements are a substantial departure from current industry practice and existing rules, which the Commission acknowledges, but then dismisses, stating universally standard custodial protections are necessary to protect investors.[25]

Specifically, the written agreements required by the Proposal would have to include particular provisions regarding document production, handling statements, receiving internal control reports, and specifying an adviser's investment authority, as well as reasonable assurances that the custodian will exercise due care, indemnify investors, retain responsibility regardless of sub-custody agreements, segregate client assets, and not subject client assets to any security interest or lien. By dictating certain core terms, the Proposal would give the Commission the ability to nullify or rewrite private contracts regardless of what the parties negotiated or the sophistication of the parties. As Commissioner Peirce noted in her statement of February 15, 2023, various market participants have negotiated for these conditions, and set their fees based on mutually agreeable allocations of risk and responsibility.[26] The Commission is proposing to unnecessarily insert itself into private commercial relationships and subvert the freedom to contract found in the due process clause of the U.S. Constitution to fix a problem that the market already accounts for.[27]

In addition, the market and existing laws already require custodians to provide a standard level of protection to advisory client assets that are similar to the required terms in the Proposal. The Commission itself recognizes this fact in its statement that "many of these important protections are already provided – through contract or practice – by certain custodians to certain custodial customers in the current market."[28] The Proposal, if adopted, would make custodians and advisers formalize these practices, which is both unnecessary for investor protection, because such standards already exist, and will result in increased costs for custodians, advisers and

---

[25] Safeguarding Rule Release, at 77.

[26] *See* SEC Statement on Safeguarding Advisory Client Assets Proposal (Feb. 15, 2023), https://www.sec.gov/news/statement/crenshaw-statement-custody-021523.

[27] *Id.*

[28] Safeguarding Rule Release, at 77.

investors that outweigh the benefits. This is because, for example, not all custodians will be able to indemnify their custodial clients or afford insurance that would do the same, and as a result, such custodians would have to cease offering their services or be noncompliant. This would create a demand for custodial services that substantially outweighs the supply, of course leading to higher fees.

Currently, the majority of written agreements are solely between the advisory client and custodian and do not include the adviser as a party, in particular because the duties owed by and obligations of a custodian are to the advisory client, not an adviser. Further, where the client retains discretion to select and retain the custodian and independently negotiates the terms of its custodial agreement, the adviser may or may not offer an opinion about the custodian, but often disclaims liability for the client's ongoing selection and retention. Nothing in the Proposal purports to shift the duties owed by the custodian to the adviser; instead, the Proposal would force advisers into an oversight role for custodians which are already heavily regulated by state or federal banking authorities. Negotiating and executing documentation will be extremely burdensome to an adviser's staff, particularly given the volume of client relationships, the number of custodians that might exist with respect to each client relationship and the bespoke negotiation that will need to be undertaken in each instance. Such negotiation will likely be impacted by idiosyncrasies over which the adviser has no control (including, without limitation, the level of revenues and profitability the custodian derives from the relationship or other potential strategic benefits). The Proposal does not take into account potential conflicts between regulatory regimes, nor provides solutions for such conflicts. For example, the Commission and banking authorities may apply different meanings to certain terms (such as due care or safeguarding assets), but the Proposal does not advise advisers what course of action it should take while overseeing a custodian in such circumstances. Due to this and the fact that the Commission does not have authority to direct a custodian to follow its rules, it is likely that an adviser could be deemed to be in violation of the proposed rules simply because the custodian applied a different interpretation to a term. The Committees believe that the Proposal would put advisers in an untenable position regarding compliance with the Proposal and believe that the Commission is overstepping its authority by trying to dictate what a custodian, which is not subject to the Commission's authority, must do by requiring an adviser, which is subject to the Commission's jurisdiction, to enter into a written agreement that direct a custodian's actions and makes that adviser liable for such custodian's actions.

### B. No Grandfathering and Insufficient Timeline for Implementation

The Proposed Rule mandates sweeping changes to the current Custody Rule and the relationships between registered investment advisers and qualified custodians. The Commission states in the Release, "an agreement between the custodian and the adviser would be a substantial departure from current industry practice"[29] and "certain of the protections that the rule text would promote are not *universally* provided to all custodial customers today."[30] This significantly understates the magnitude of the proposed changes and their impact on (1) existing contractual arrangements between advisory clients (whether separately managed accounts or fund clients) or investment advisers, as applicable, and custodians and (2) the investment advisory and custodial

[29] Safeguarding Rule Release, at 77.

[30] *Id.*

industries. As described throughout this letter, the proposed changes, especially certain of the required contractual provisions, are more extensive and complicated to implement than any previous custody-related reforms under the Advisers Act. The Proposed Rule requires expansive revisions of existing custodial arrangements regarding, among other sensitive matters, the (a) establishment of a negligence standard for custodian liability, (b) custodian's indemnification of the advisory client, (c) limitation on liability regarding sub-custodians and (d) segregation of client assets and attachment of liens to client assets, which seems to exclude the use of deposit accounts for advisory clients absent the banking industry developing new types of accounts. In our experience, these contractual obligations that the Proposed Rule requires are rarely found in custody agreements. If adopted as proposed, the new rule would necessarily lead to fundamental and difficult changes in custody arrangements and a restructuring of custodial industry practices applicable to the services provided to the clients of registered investment advisers.

As outlined in the Release, the initial adoption of the Custody Rule in 1962 established the most basic of the Custody Rule requirements.[31] Neither of the later amendments [32] involved changes to custodial arrangements on the scale of what the Proposed Rule requires and were quite modest compared to, e.g., the requirement for an investment adviser to have a written agreement with the qualified custodian that includes a number of sensitive and costly assurances and

---

[31] The initial Custody Rule adopted in 1962 established the following requirements, which the Commission believed were "necessary and reasonably designed to prevent fraudulent, deceptive and manipulative acts and practices by investment advisers":

- Segregate the securities, which are marked to identify the beneficial owner and held in a reasonably safe place;
- Deposit all and solely client funds in one or more bank accounts maintained in the name of the investment adviser as agent or trustee for the clients with separate detailed records for each account;
- Immediately upon receipt provide notifications to the client in writing of the place and manner in which the funds and securities will be maintained and held in safekeeping;
- Send each client at least quarterly, an itemized statement of the funds and securities in the adviser's custody or possession at the end of such period and other details as to activity in the client's account during the period; and

at least once each calendar year verify the funds and securities by actual examination by an independent public accountant in a surprise examination certificated by the accountant with the details of the examination and provide the same to the SEC (subject to exemptions for registered broker-dealers and members of exchanges)." The stated purpose of the new rule was for an investment adviser with custody to maintain client funds or securities "in such a way that they will be insulated from and not jeopardized by financial reverses, including insolvency, of the investment adviser." Adoption of Reg. Section 275.206(4)-2 under the Investment Advisers Act, Advisers Act SEC Release No. 123 (Feb. 27, 1962).

[32] The 2003 amendment added the requirement that such funds or securities be maintained with a "qualified custodian" and provided a definition of "qualified custodian" and "custody" and included the illustrations of "custody." *See* 2003 Adopting Release. The 2009 amendment provided the audit exception for pooled investment vehicles and required that an investment adviser to consider its access to client assets through a related person to be "custody", to conduct a surprise exam under a somewhat broader range of circumstances, to enter into a written agreement with an independent public accountant within a specified period to obtain a surprise examination, to obtain or receive an internal control report where it or a related person maintained client assets as a qualified custodian, and to respond to revised Form ADV questions. *See* Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2968 (Dec. 30, 2009) (hereinafter "**2009 Adopting Release**"), https://www.sec.gov/rules/final/2009/ia-2968.pdf.

provisions that were not agreed to by the advisory client and the custodian negotiating independently.

We believe that applying the Proposed Rule requirements to the many thousands of existing contractual arrangements would (1) require onerous (and potentially impossible) renegotiations of such arrangements, (2) not meet the judicial standards for retroactive rulemaking and (3) represent a stark departure from the approach the Commission has taken in the past regarding rules that affect existing contractual arrangements. Therefore, if the Proposed Rule is enacted, the Committees recommend that the Proposed Rule should not be applied retroactively so that existing custodial arrangements and relationships remain intact. This means that current agreements/arrangements between an advisory client or adviser, as applicable, and a custodian must be grandfathered, and the investment adviser must have no obligation to attempt to renegotiate the existing arrangement or impose another agreement with the custodian that would alter, impair, or impose additional requirements or liabilities on any party in such existing custodial arrangements.

#### 1. Lack of Basis for Retroactive Rulemaking

The Supreme Court has established a presumption against retroactive measures with respect to administrative rulemaking,[33] 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."[34] The Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") provides the SEC's mandate for the Proposed Safeguarding Rule in Section 223:

> 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.[35]

Notably, the authorization does not provide an express statutory grant for retroactive rulemaking regarding existing custodial arrangements or agreements.

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

> (1) whether the particular case is one of first impression, (2) 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, (3) the extent to which the party against whom the new rule is applied relied on the former rule, (4) the degree of the burden

---

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

[34] *Id.*

[35] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 411, 124 Stat. 1376 (2010).

> which a retroactive order imposes on a party, and (5) the statutory interest in applying a new rule despite the reliance of a party on the old standard.[36]

In connection with these factors, we note that: (1) this is not a case of first impression as the Custody Rule has a long history; (2) the Proposed Rule represents an abrupt and substantial departure from the well-established Custody Rule; (3) for the past 60 years, all registered investment advisers have been required to adhere to, and have relied upon, the Custody Rule with amendments that are relatively minor in comparison to the Proposed Rule; (4) custody agreements are detailed and closely negotiated contracts—renegotiating and amending existing custody agreements or negotiating and adopting new custody agreements will be highly burdensome to investment advisers, advisory clients and qualified custodians, impair existing agreements/arrangements and result in substantial additional costs[37]; and (5) the Commission does not provide in the Release examples of actual issues caused by Custody Rule inadequacies or evidence of actual harm to investors. We believe therefore that the circumstances strongly support the position that the requirements of the Proposed Rule should not be applied retroactively to existing contractual arrangements meeting the current requirements of the Custody Rule.[38]

### 2. The Commission Has Historically Provided for Grandfathering

Historically, the Commission has provided grandfathering to avoid affecting existing contractual agreements between investment advisers and other parties. For example, when the Commission adopted Rule 205-3 under the Advisers Act preventing advisers from charging performance-based fees to non-"qualified clients," the Commission expressly allowed existing investment advisory agreements and arrangements in which advisers received performance-based

---

[36] *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).

[37] In the Safeguarding Rule Release, the SEC Staff estimates that based on Item 9.F. of the current Form ADV, on average, investment advisers will enter into four written agreements with custodians, the timing of which will be one hour per written agreement (pg. 352), and that the additional required written assurances will separately take one hour per agreement (pg. 358). First, the SEC Staff does not take into account that the average number of written agreements between investment advisers and custodians will be materially higher than four, considering that the Proposed Safeguarding Rule expands the types of assets that must be held by a qualified custodian. Further, these estimations are not grounded in any empirical data and drastically underestimate the amount of time it will take investment advisers and custodians to negotiate, draft and agree to contractual agreements that satisfy the written agreement and assurances requirements. The written agreement requirements contain three substantial, expensive and technical undertakings by custodians the costs of which will be closely negotiated between investment advisers and custodians. Additionally, such written agreements must contain a specification of the investment adviser's legal authority over a custody account, which the SEC Staff admits takes a material amount of time (pg. 352). Drafting these agreements initially without market-accepted precedents and related negotiations will be time intensive. The written assurances requirement involves an additional set of five even more extensive and economically costly requirements of custodians that also must initially be drafted without market-accepted precedents and necessarily involve negotiations between custodians and investment advisers regarding who incurs the costs of the written assurances. Further, the written assurances in particular will need to be tailored to reflect the specific asset class, custody agreement and potential sub-custodial agreement of each custodial account, which does not allow for widespread use of boilerplate contractual provisions necessary to allow for written assurances to be drafted in anything close to one hour.

[38] To the extent the final rule permits existing custodial agreements to be grandfathered, the Committees also recommend that mere addition of funds or assets to such existing contracts, or amendments to such existing contracts to address issues unrelated to the custodial relationship, should not automatically trigger application of the new rule.

fees from non-"qualified clients" to remain intact.[39] This allowance was adopted in order to avoid "disrupting existing arrangements."[40] Another example is the adoption of Rule 203(*l*)-1, the venture capital fund adviser exemption, under Section 203(*l*) of the Advisers Act where the Commission adopted a grandfathering provision for existing venture capital funds that did not meet the new definition of "venture capital fund."[41] The core basis for this grandfathering was that the Commission determined 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."[42] We submit that requiring the renegotiation of existing custodial agreements, or the negotiation of new custodial agreements that will conflict with existing custodial agreements, also "would likely be impossible in many cases and yield unintended consequences for the funds and their investors," including, e.g., the potential modification of investment conditions, characteristics or guidelines and/or the liquidation of portfolio company holdings where certain assets become unsuitable investments due to difficulty in securing compliant custodial arrangements. We further submit that these concerns apply as well to separately managed accounts.

### 3. Renegotiation of Existing Custodial Contracts will be Exceedingly Difficult and May Necessitate a Restructuring of Existing Custodial Business

No one can predict how long negotiations or renegotiations of custodial arrangements would take or if it will be possible to include the proposed terms and assurances. Notably, in 2017 the Commission attempted to force one such negotiation between advisers and custodians in the context of its inadvertent custody guidance.[43] In our experience, the effort failed as custodians declined to negotiate their existing agreements (which were generally between the custodian and the advisory client) with a non-party to the agreement or even acknowledge that advisers had limited authority regarding client assets based on the adviser's own investment advisory agreement with the client. To our knowledge, custodians also largely declined to include the Commission's desired changes in new custodial arrangements.[44] In 2018, the Commission issued two FAQs

---

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

[40] Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333 (Dec. 2, 2004), https://www.sec.gov/rules/final/ia-2333.htm#P438_212082, at Section H. Amendments to Rule 205-3, nn.259–64,

[41] Rule 203(l)-1(b) under the Advisers Act.

[42] 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.").

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

[44] The Safeguarding Rule Release itself notes the issue: "We understand that 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. This contractual requirement of the proposed rule is designed to mitigate these concerns and empower advisers to

substantially backing away from their position on inadvertent custody.[45] Based on this experience, it is not at all clear that custodians, who generally have contracts with the advisory client and, it should be noted, are subject to their own regulators and regulatory obligations, will be willing enter into an agreement with the investment adviser or accept the Proposed Rule requirements in such agreements. In fact, recent history strongly suggests that custodians will not do so.

In addition, compliance with the Proposed Rule will require an extensive amount of time and effort by investment advisers, custodians and advisory clients as the proposed requirements necessitate a restructuring of the custodial business. First, the expanded types of assets that must be custodied under the Proposed Rule requires custodians to expand their scope of services. Considering that certain of these proposed custodial services have not necessarily been offered before and certainly not pursuant to Advisers Act regulatory requirements, it will take a significant amount of time for the markets for such services to develop to the point where investment advisers can make an informed decision regarding the quality of services offered and the price of such services. This may take a particularly long time for niche assets in real estate, physical assets and commodities. Second, it will take custodians a material amount of time to develop business practices that allow for them to adhere to the written agreement requirements, assuming they agree to them at all.[46] For example, creation of segregated accounts against which there are no liens may implicate the custodians' own regulatory obligations, e.g., they may implicate the reserve requirements of commercial banks overall. Moreover, it will take time for custodians to price the value of the increased liabilities and the indemnity required of them pursuant to the written agreement requirements. Third, the written agreement requirements necessitate a rigorous market search for qualified custodians by all investment advisers subject to the written agreement requirements, not solely renegotiation of existing agreements for those advisers who have clients with agreements in place. This process would materially disrupt the advisory client's existing arrangements unless grandfathered. Compliance with the written agreement requirements also will cause custodians to increase prices for their services, which will result in higher costs to advisory clients. In turn, investment advisers would not be acting in their client's best interests if they solely renegotiate advisory clients' existing custody agreements with their existing custodians, whose services may be suitable but whose rates may be significantly higher than comparable custodians. [47] Unless existing agreements are grandfathered, all investment advisers

---

modify this aspect of the custodial agreement to better reflect client intentions and to be consistent with the adviser's contractual obligations to its clients." It is unclear why the Commission believes the new rule for investment advisers who are not parties to the custodial agreements will enhance their bargaining power with custodians whose business model did not accommodate the Commission's expectations in 2017 and does not accommodate the Commission's expectations outlined in the Proposed Rule. *See* Safeguarding Rule Release, at 105.

[45] 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).

[46] In referring to the "written agreement requirements," we are referring to the requirement that custodians deliver account statements to clients and investment advisers, obtain written internal control reports that include the opinion of an independent public accountant, and provide certain legal assurances.

[47] To the extent that an investment adviser incurs the higher custodial fees itself pursuant to an investment advisory agreement, private fund constitutive documents or any other contractual arrangement, the Proposed Safeguarding Rule is unfair with respect to such advisers, because they could have negotiated higher advisory fees and/or expenses paid by clients and/or investors to account for the higher custodial fees. Additionally, clients and investors have no incentive to renegotiate and amend such contracts to address this issue, because it only negatively impacts investment advisers. Further, it seems likely the advisory clients along with the custodian will resist the investment advisers' efforts to

would therefore need to engage in a market search for an appropriate qualified custodian, once custodians have established such a market. In addition to the complications presented by the proposed contractual requirements, custody agreements are extensive, technical, and closely negotiated, and it will inherently take a significant amount of time to amend or negotiate any new custody agreement.

It is also not clear if and when investment advisers, especially smaller advisers who have less negotiating leverage and advisers of assets not previously required to be held by a custodian, will be able to effect these proposed contractual provisions and assurances, even in new agreements. Given the issues that arose during the Commission's unsuccessful effort in 2017 to require changes to custodial agreements, we recommend that the Commission allow for a significant amount of time for such advisers to engage in good faith efforts to try to persuade custodians to accept the required contractual provisions and comply with the new rule's contractual requirements, if adopted as proposed. We further note that coordination between the Commission and the regulatory rule-making authorities for qualified custodians could facilitate compliance for advisers and achievement of the Commission's goals for the Proposed Rule. We further urge that the Commission be prepared for the possibility that advisers encounter resistance from custodians similar to what they encountered in 2017.

### 4. The Commission Should Grant a Longer Transition Period

Considering the comprehensive scope of the Proposed Rule, including various enhancements of policies and procedures of advisers, establishment or renegotiation of custody agreements, and further engagement with independent auditors, the Committees emphasize that existing contractual arrangements must be grandfathered, and also urge the Commission to grant longer transition period of at least 18 months which would be consistent with other recently proposed or adopted rules. In the event the existing contractual arrangements are not grandfathered, then the transition period regarding new contractual custody arrangements should be extended to at least 36 months for advisers that manage more than $1 billion in RAUM, and at least 48 months for advisers that manage $1 billion or less in RAUM.

Other recently adopted rules had similar transition periods to the period proposed for the Proposed Rule. The Marketing Rule, for example, had an 18-month transition period,[48] although it was far less sweeping and complex that the Proposed Rule and notably did not primarily involve the establishment or negotiation of such highly sensitive provisions in agreements with third parties. Similarly, components of the Proposed Enhanced ESG Disclosures Rule[49] and the Adopted Electronic Recordkeeping Requirements for Broker-Dealers, Security-Based Swap

modify an existing custodial arrangement that both parties have found satisfactory and may view such efforts as an impairment to the existing agreement

[48] Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020), https://www.sec.gov/rules/final/2020/ia-5653.pdf, at 252.

[49] Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, SEC Release No. IA-6034 (May 25, 2022), https://www.sec.gov/rules/proposed/2022/ia-6034.pdf, at 168-69.

Dealers, and Major Security-Based Swap Participants[50] each provided 18-month transition periods despite (1) involving far fewer and much narrower changes to policies and procedures and (2) not involving negotiations of highly sensitive, currently non-market, contractual provisions as a core aspect of implementation. The time consuming and arduous process of negotiating new custodial agreements, particularly regarding sensitive provisions and assets not previously subject to the Custody Rule, warrants a much longer transition period than any of these recently proposed or adopted rules.

The transition period for the proposed changes regarding Form ADV and Rule 204-2 under the Advisers Act should match the transition period for new Rule 223-1. Each of the proposed Form ADV and books and records requirements correspond to the substance of the Proposed Rule. It would be premature to require investment advisers to adhere to updated Form ADV reporting or books and records requirements tailored to the Proposed Rule before advisers are required to adhere otherwise to the substance of the new rule. Further, Rule 223-1 will likely cause advisers to materially alter their custody arrangements. Advisers would unnecessarily duplicate efforts if required to adhere to the revised Form ADV and books and records requirements and subsequently update the same Form ADV and books and records after coming into substantive compliance with the other requirements of that same rule.

Lastly, the amendments to the surprise examination requirements (*e.g.*, the annual audit exception) and the exceptions from the surprise examination requirements may have an implementation date that is sooner than the other components of the Proposed Rule, because they (1) can be independently implemented separate from the other sections of the Proposed Rule, (2) represent more incremental changes to the existing Custody Rule, and (3) provide exemptions from the surprise examination requirements that reduce the compliance obligations of certain investment advisers.

### C. Reasonable Assurances

As noted in our discussion of the "written agreements" requirement of the Proposed Rule, the Proposed Rule would require a registered investment adviser to obtain certain "reasonable assurances" from each qualified custodian.[51]

---

[50] Electronic Recordkeeping Requirements for Broker-Dealers, Security-Based Swap Dealers, and Major Security-Based Swap Participants, SEC Release No. 34-96034 (Oct. 12, 2022), https://www.sec.gov/rules/final/2022/34-96034.pdf, at 68-70.

[51] Under the Proposed Rule, a registered investment adviser would be required to obtain certain "reasonable assurances" from each qualified custodian that the custodian will:

- exercise due care in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation or other similar type of loss;
- indemnify the client (and have insurance arrangements in place that will adequately protect the client) against the risk of loss of the clients assets maintained with the qualified custodian in the event of the qualified custodian's own negligence, recklessness, or willful misconduct;
- remain liable for its client obligations without regard to any sub-custodial, securities depositary, or other similar arrangements with regard to the client's assets;
- clearly identify the clients assets as such, hold them in a custodial account, and segregate all client assets from the qualified custodian's proprietary assets and liabilities;

The obligation to obtain such "reasonable assurances" imposes an ongoing diligence and monitoring requirement upon advisers that extends beyond the contractual undertakings required by the "written agreement" component of the Proposed Rule. The adviser will need to independently assess and evaluate a custodian's ability to satisfy these statutory and contractual requirements. The Proposed Rule will require not only the conduct of a heightened diligence exercise, but the documentation of the steps taken by the adviser to verify the services, infrastructure, and management of its appointed custodians.

It is reasonable to expect that this initial diligence exercise will require advisers to dedicate additional resources to the selection of qualified custodians. These resources will include personnel time and additional expense conducting and documenting the due diligence process.

The Proposed Rule will also require advisers to engage in ongoing monitoring of the services, infrastructure and management practices of its appointed custodians, and periodic updates of these monitoring and diligence exercises.

We address below the individual issues comprising "reasonable assurances" as identified by the Proposed Rule.

**1. Assurances with Respect to Foreign Financial Institutions (FFIs)**

The Proposed Rule will have a significant impact on custodial arrangements outside the United States, including the prospective disintermediation of qualified custodians in the US and the prospect that FFIs in particular jurisdictions will not be able to satisfy each of the seven requirements that the Proposed Rule seeks to apply to FFIs. Absent a lengthier transition period, the rule may limit access to non-US financial markets that is currently available to investors that are not registered investment companies.

**2. Due Care**

We believe that the explicit requirement that a qualified custodian represent a covenant to exercise "due care in accordance with reasonable commercial standards in discharging its duty as custodian" and to develop and apply "appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar types of loss" is a salutary one. We further believe that this obligation is broadly in keeping with current obligations and practices. In your request for comments, you ask whether it is necessary to "obtain reasonable assurances that a qualified custodian meets certain minimum commercial standards and then specify some not all applicable standards". Given the different attributes of different asset classes, prescriptive standards that apply on a universal basis are likely to present material challenges on a real world basis.

**3. Indemnification**

---

- not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors except to the extent agreed to or authorized in writing by the client.

*See* Safeguarding Rule Release, at 83-95.

The proposed requirement that a custodian indemnify client against the risk of loss in the event of the qualified custodians own "negligence, recklessness, or willful misconduct" may have significant industry repercussions. The proposed obligation is materially more onerous than current practices and would go beyond current custodian indemnification practices. We expect that insurance costs will rise significantly. These increases may be accompanied by significant insurance coverage driven operational requirements. Each of these developments will increase operational expenses and can be expected to increase costs imposed upon advisory clients.

We further anticipate that many custodians will find it impossible or impracticable to obtain commercially reasonable levels of indemnity insurance. Imposing specific requirements with respect to the nature, qualification or rating of insurance underwriters will likely exacerbate this challenge. We expect that in at least some circumstances it may be appropriate for some qualified custodians to "self-insure". It is unclear at this time what the industry profile of custodians that might elect to "self-insure" might look like relative to custodians that are more readily able to secure or afford third-party indemnity insurance. As a result, many currently qualified custodians may elect to cease to offer such services. It is possible that the indemnification risks and the dynamics of the insurance market may result in smaller custodians, or custodians of higher risk assets, seeking to self-insure. Advisers may in turn avoid such custodians. Any such development is likely to reduce the number of available custodians thereby increasing industry concentration and potentially increasing systemic risk.

It is not clear that this increased industry concentration, and the associated higher cost structures resulting from increased operational risk and the costs of third-party insurance will operate to the benefit of advisory clients, particularly in the short-term. We note that the proposed transition period (12 months for advisers with regulatory assets under management in excess of $1 billion, and 18 months for advisers with regulatory assets under management of less than $1 billion) is likely to cause significant industry turmoil.

As a result of these considerations, we believe that the current indemnification proposal may in fact be counterproductive particularly insofar as it imposes a simple negligence standard. Consequently, we recommend that the proposed simple negligence indemnification requirement in the written agreements between qualified custodians and their clients be deleted.

**4. Sub-Custodial Arrangements**

While the Release suggests that treatment of sub-custodian or other similar arrangements can be addressed through the receipt of reasonable assurances in writing from the qualified custodian, the rule proposal is likely to have more far-reaching operational consequences that in turn will increase costs and reduce market competition. The extension of liability for the acts and omissions of sub-custodians also presents the prospect of diligencing and monitoring multiple levels of sub-custodians across asset classes and jurisdictions. The complexity of such custodial arrangements may present material risks to upper-tier custodians in circumstances involving attenuated custodial chains.

**5. Segregation of Client Assets**

Please see our discussion above for an assessment of the proposed segregation of client assets requirements, and potential consequences that may result from the Proposed Rule.

#### 6. No Liens Unless Authorized in Writing

As with other aspects of the Proposed Rule, we anticipate significant evolutionary operational requirements, with particular regard to margin accounts and derivatives relationships that entail the posting of collateral. We expect that these challenges will be materially amplified in a non-US context, and will pose transitional obstacles in numerous non-US markets. See our implementation timeline discussion above.

#### 7. Recordkeeping and Reporting Requirements

In keeping with the broader requirements of the Proposed Rule, we note that advisers will be required to maintain and retain (and be able to immediately disseminate upon to regulators, auditors, and clients) copies of, among other items, all records received from the qualified custodian relating to client assets, of required reasonable assurances that the adviser obtains from the qualified custodian, and – if applicable – copies of the advisers' written reasonable determination that ownership of certain specified client assets cannot be recorded and maintained (book – entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets.

In a similar vein, the rule proposes the issuance of mandatory quarterly account statements, including statements that look through pooled investment vehicles to report on allocable interests in underlying portfolios.

These recordkeeping and reporting obligations are consonant with the other requirements that the rule seeks to impose (which we have sought to address at least partially elsewhere in this letter), and again present significant cost, resource, and transitional challenges. See our implementation timeline discussion above.

## III. Considerations Specific to Certain Assets

### A. Credit Funds

The Committees respectfully suggest that if the Proposed Rule is adopted, certain registered advisers to private credit funds should not be required to comply with the new conditions to the private securities exception that would require (i) the adviser to reasonably determine and document in writing that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership, of such asset (the "**reasonable determination requirement**"), and (ii) an independent public accountant to verify any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets (the "**verification requirement**").[52]

[52] Safeguarding Rule Release, at 132-33.

The Committees believe that the reasonable determination requirement is superfluous with respect to certain loan instruments beneficially owned by private credit funds. As the Commission states in the Release, the "current market for custodial services of privately offered securities is fairly thin."[53] The Committee notes that, unless a lender specifically requests a physical note (which generally only occurs in certain limited circumstances), ownership and transfers of loan instruments held by private credit funds generally are recorded and tracked on the books of a loan administrator, which is often a third party that is unaffiliated with either the borrower or the lender. The incremental benefit that investors may receive from requesting a different form of documentation would be outweighed by the added costs and complexity of potentially creating a new system for recording ownership and transfers of loans, when a sufficient system is already in place. In the event that a physical note is requested in connection with a loan agreement, the lender often custodies the physical certificate with a qualified custodian or delivers the note to the loan administrator, which in turn deposits the certificate in a vault maintained with a third-party bank or custodian.

As discussed above, the reasonable determination requirement also would introduce uncertainty and the risk of hindsight judgment for private credit fund advisers seeking to facilitate compliance with the proposed amendment. There is ambiguity in complying with the proposed amendment with respect to the policies and procedures registered advisers would need to establish in order to conduct the proper due diligence required by this added condition – e.g., whether there would be a duty to alter the terms of the transaction so that the assets may be held by a qualified custodian, and whether there would be a duty to perform ongoing due diligence to determine whether custodians have developed new methods to custody assets. Given that certain loans held by private funds represent the type of instrument that, on its face, cannot be held by a qualified custodian, such instruments should not be subject to the proposed amendment's reasonable determination requirement.

The Committees also believe that, where the loan administrator is independent of the borrower and lender, the verification requirement is overbroad and duplicative. Importantly, each loan administrator maintains a register where ownership of the loan is recorded. Further, loans may only be transferred through an assignment and assumption agreement, where the lender assigns its rights and duties under the loan agreement and the assignee accepts, or "assumes," those rights and duties, and the administrator must "acknowledge" the assignment and assumption in its register in order for the transfer to consummate. The administrator therefore serves a supervisory role with respect to the transfer of loan agreements akin to the role of the independent auditor contemplated by the Proposal's verification requirement. This external safeguard is consistent with the Commission's original intent underlying the privately offered securities exception in that a third party, and not the adviser, maintains control over loan transfers.

To decrease compliance burdens, the Committees respectfully suggest that advisers to private credit funds be permitted to rely on the acknowledgement of an independent administrator in lieu of the verification requirement in the event of a loan transfer, so long as the administrator is subject to certain minimum standards (e.g., the administrator is independent). In the limited circumstances where a physical note is obtained, the Committees suggest that the proposal require credit fund advisers to either custody the note at a qualified custodian or entrust the loan

[53] *Id*. at 128.

administrator to custody the note with a bank or qualified custodian (which is consistent with current practice), or otherwise take appropriate measures to safeguard the note. In this case, both the reasonable determination requirement and the verification requirement would be superfluous.

### B. Buyout Funds and Co-Invest Arrangements

The Release states the following in connection with audits of special purpose vehicles ("**SPVs**"):

> …[if an adviser] uses an SPV to purchase one or more investments for one or more pooled investment vehicle clients and third parties that are not pooled investment vehicles controlled by the adviser or the adviser's related person(s), the adviser may not treat the SPV's assets as assets of the pooled investment vehicle clients of which the adviser or the adviser's related person(s) has custody indirectly for purposes of the safeguarding rule. The adviser would, instead, be required to treat the SPV's assets as a separate client for purposes of the safeguarding rule because the SPV has owners other than the adviser, the adviser's related person(s) or pooled investment vehicles controlled by the adviser or the adviser's related person(s).[54]

Private fund advisers, and private equity fund advisers in particular, commonly structure co-investment vehicles in which one or more of their funds will co-invest in an issuer alongside a third party that is not a client. Certain third party co-investors, however, may themselves be private funds that obtain an annual audit to comply with the existing Custody Rule. The Committees believe that, in this circumstance, investor protection is not furthered by requiring an audit of the co-investment SPV and is counterproductive since any additional audit will result in increase costs to the underlying investors in the co-investment SPV. Instead, the Committees believe that the adviser to the co-investment SPV should be excepted from the audit requirement (and the surprise examination requirement) at the co-investment SPV if it can obtain reasonable assurances from the third party co-investor that it undergoes an annual audit that considers such third party co-investor's investment in the co-investment SPV within the scope of its audit and is otherwise in compliance with the audit and safeguarding requirements.

### C. Real Asset Considerations

Under the Proposed Rule, assets required to be held with a qualified custodian would include a wide range of assets that are not funds or securities, including, but not limited to, physical assets (such as artwork, real estate, precious metals or physical commodities) and evidences of ownership of such physical assets (such as real estate deeds and warehouse receipts). Inclusion of these assets raises several significant issues as described below.

#### 1. Expansion of Types of Assets Required to be Maintained by a Qualified Custodian Without a Corresponding Expansion of the Privately Offered Securities Exception or Definition of Qualified Custodian

[54] 88 Fed. Reg. 14,672, 14,722 (Mar. 9, 2023)

Although under the Proposed Rule the types of assets would be expanded to include assets that are not funds and securities, the Commission did not propose corresponding expansions to the privately offered securities exception or the types of custodians that could safeguard assets that are not funds or securities.

First, the definition of "qualified custodian" under the existing Custody Rule was adopted when the only assets that were covered were funds and securities. Therefore, it makes sense that the types of custodians included in the definition are those that typically hold funds and securities (i.e., principally, banks and broker-dealers). However, an expansion of the types of assets that are required to be maintained with a qualified custodian should be accompanied with an expansion of the types of custodians. In many circumstances, the financial institutions currently included in the definition of "qualified custodian" are not permitted under their own applicable regulatory regimes to maintain assets other than funds or securities. The Commission does not appear to consider that there may be no qualified custodians available who are able to maintain certain types of assets (beyond privately offered securities and physical assets) in a manner that satisfies the Proposed Rule. The Commission has in prior iterations of the Custody Rule shown a willingness to include other custodians or provide exceptions, for example with respect to the existing exception for shares of mutual funds maintained at a transfer agent. Furthermore, the tension between the expansion of the types of assets and the definition of "qualified custodian" is further evidenced by the fact that the definition of "qualified custodian" with respect to futures commission merchants is still limited to funds, security futures, and other securities and no other assets that a future commission merchant can maintain under their applicable regulations.

Second, the exceptions for privately offered securities and physical assets is too limited in the assets that are permitted to rely on the exception and also impractical in its requirements.

Like the existing Custody Rule, the proposed exception for privately offered securities is limited to privately offered securities that are uncertificated and recorded on the books of the issuer or its transfer agent in the name of the client, and transferable only with the prior consent of the issuer or the holders of the outstanding securities of the issuer. We do not see a justification for why this exception is limited to "securities" and not other assets (including evidence of ownership of physical assets) that exhibit similar characteristics. As discussed more fully below, there are a range of other assets that exhibit similar characteristics (including limited transferability and the participation of third parties other than a custodian in the transfer) that should receive similar exceptions.

The Proposed Rule presents problems for certain assets that do not meet the requirements of the exception. For example, in the context of real estate, although the Commission indicated that land and physical buildings would qualify for the exception, it further stated that a deed or similar evidence of ownership that could be used to transfer beneficial ownership of a property would not qualify. Generally, given that this is a matter of state law, advisers investing in real property or mortgage loans on behalf of clients record the deed or mortgage related to the asset with the registrar of deeds or clerk of courts or other local government official responsible for maintaining such records. These registrars, clerks and government officials do not maintain ownership or control over the assets but, rather, serve as public notice of ownership of the asset. Unless the Commission provides an exception for deeds and other indicia of ownership or recognizes local government registrars, clerks of court or officials as qualified custodians, advisers

will be forced to choose between established industry practice and state law for protecting assets and compliance with the Proposed Rule.

In addition, most investment advisers cause the funds they manage to purchase assets through wholly or majority-owned SPVs, which include limitation of liability and risk mitigation, tax efficiency and flexibility to bring in co-investors. Currently, evidence of ownership of the interest in the SPV is an operating or subscription agreement between the investment fund and the SPV. We further note that in most circumstances, the audit of the fund would include the SPV within its scope and, therefore, the accountant is verifying the ownership of both the SPV and also the assets held by the SPV.[55] These interests in the SPV may not be eligible for the exception for privately offered securities where the interests do not take the form of "securities."

Another example of an asset that would have significant custody issues because it may not meet the requirements of the exception for physical assets is artwork. The Commission did not discuss artwork other than to state that as a physical asset, it would be within the scope of the rule. Generally, artwork purchased in the secondary market comes with documentation and records that show the provenance or history of ownership. These provenance documents are typically old paper documents that, while they could be susceptible to forgery, were entered into so far in the past that it may not be practical or possible to reintroduce a custodian into the instrument. The FBI website describes instances of fraud involving artwork and encourages potential victims of art fraud to contact its Art Crime Teams. Auction houses such as Sotheby's have entire departments devoted to the research of provenances. It is difficult to see how requiring a qualified custodian as currently defined under the Proposed Rule could protect artwork owned in an advisory account or fund when fraud involving this asset is typically committed through forgery and misleading valuations and the financial institutions currently included in the definition of qualified custodian are not equipped to prevent fraud.

The Proposed Rule further requires that the asset either be a privately offered security or a physical asset over which a qualified custodian is unable to maintain possession or control. The term "possession or control" means holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and that the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.

Requiring an adviser to make a reasonable determination that a qualified custodian cannot maintain possession or control of assets in order to meet the privately offered securities and physical assets exception would be difficult because qualified custodians could simply maintain possession or control of assets by being named as nominee on documents evidencing ownership of physical assets. This mechanism, however, would not increase the protection of physical assets. As nominee, the participation of the qualified custodian in transactions involving a change in beneficial ownership would require the qualified custodian to ensure the authenticity of instructions to effectuate the transaction by an authorized person of the investment vehicle or account and the authenticity of the assets themselves and the documents evidencing their

---

[55] Similar to the guidance in SEC IM Guidance Update No. 2014-07 (June 2014), https://www.sec.gov/investment/im-guidance-2014-07.pdf.

ownership. Although banks generally have expertise in authenticating authorized signatures for the transfer of beneficial ownership of assets, those documents are typically signed by the adviser and, accordingly, no further protection of physical assets is provided by the bank if the adviser executes documents it has falsified to transfer assets. With respect to the authenticity of the assets themselves and their ownership, although bank employees may be trained in authenticating certain physical assets such as gold backing ETFs, banks do not have the expertise to authenticate assets such as artwork and the ownership thereof as described above. In addition, requiring qualified custodians to maintain and possess title to real property and mortgages would conflict with other laws and upset a well-functioning and established system. Requiring qualified custodians to maintain possession and control of these types of physical assets would require a complete overhaul of the manner in which physical assets are currently maintained and protected. This overhaul would be expensive and the cost would likely be passed on to investors.

#### 2. Creation of Incentive for Investment Advisers to Eliminate Securities Investments and Strategies in Physical Asset Accounts or Portfolios

Because the Proposed Rule would apply to other positions held in a client's account that are not funds or securities, advisers may be incentivized to decline to provide advice to clients on non-securities assets even if such investments could be potentially beneficial to the client's objectives and strategies. In addition, the Proposed Rule's requirements create an unlevel playing field between advisers that are registered because they employ leveraging and other securities strategies in addition to their primary strategy to invest in physical assets such as real estate and artwork and unregistered advisers who take the position that they are not required to register because they only invest in physical assets and do not employ such strategies. The disparate treatment between advisers with the same primary investing strategy as a result of the Proposed Rule requirements is unfair, unjustified and potentially harmful to investors.

#### 3. Reasonably Safeguarding Real Assets

The proposed amendments also would require advisers relying on the exemption to reasonably safeguard the client assets from loss, theft, misuse, misappropriation, or the financial reverses of the adviser.[56] As the Commission and the staff have only recently reminded advisers, each adviser already has a duty of care to protect its clients' interests.[57] That duty of care extends to the safeguarding of client assets.[58] The Committees do not believe that this condition adds any substantive protections or meaningful additional requirements for advisers.

Moreover, the proposed expansion of the rule would impose unclear obligations on advisers that have control over property other than financial assets, such as advisers to private funds that invest, in whole or in part, in real estate, timber, shipping vessels, rail cars or other "real assets". Moreover, certain advisers are given broad powers of attorney over client assets. These may include financial planners, multi-family offices and other firms that act as personal representatives in addition to providing investment advice to their clients. The authority granted

[56] Proposed Rule 223-1(b)(2)(ii).

[57] Standards of Conduct for Broker-Dealers and Investment Advisers, SEC Staff Bulletin, (Apr. 20, 2023), https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers.

[58] 2003 Adopting Release, at 22.

to such advisers may give them authority over a wide variety of assets, including personal real estate, jewelry, fine art, antiques and other non-financial assets.

As just one example, it is not clear whether the proposed rule amendments would require an adviser to a real estate fund to hire security teams to protect an undeveloped parcel of land owned by the fund from trespassers, even though trespassers are highly unlikely to cause any actual diminution in value to the land. While the exception is conditioned by "reasonableness," it is unclear how that standard should guide an investment adviser in determining how to safeguard the assets against highly unlikely events. Such uncertainty seems very likely to bias advisers toward overly-cautious outcomes out of concern over not having done enough to meet the standard, leading to a correlating increase in costs, again ultimately borne by clients and investors – we feel that such balanced determinations are best made contractually between an investment adviser and its clients (who ultimately pay the cost for the protections), not imposed through regulatory requirements.

The Committee suggests limiting the scope of the proposed amendment to cover "financial," rather than "physical," assets, in accordance with the Commission's jurisdictional authority. The Commission asserts that its authority to expand the scope of the proposed amendment to include "assets" is based on the intent of Congress in including "assets" in Section 223 of the Advisers Act, as amended by the Dodd-Frank Act but the Committees respectfully submit that the legislative history of the Dodd-Frank Act does not demonstrate such congressional intent. The legislative history reflects no discussion with respect to the use of the term "assets,"[59] and discussion of the topic would likely have been included in the legislative history had Congress intended to expand the Commission's jurisdiction in this regard. Accordingly, the absence of such an express mandate supports the Committees' view that the Dodd-Frank Act did not intend to expand the scope of client "funds or securities" subject to the Commission's authority.

### D. Maintaining Crypto Assets with a Qualified Custodian

The Proposed Rule seeks to expand the definition of "custody" used in the existing Custody Rule. Among other clarifications, a custodian would have custody of assets if the custodian has "possession or control" of such assets. Specifically, a custodian has custody of an asset where it is required to participate in a *change of beneficial ownership* of the asset. In the case of crypto assets, however, it remains unclear under what circumstances a qualified custodian would be deemed to have "possession or control" of crypto assets.

We believe it is clear that a qualified custodian would have "possession or control" of a crypto asset if the qualified custodian generates and maintains private keys for the wallets holding an adviser's client's crypto assets, such that the adviser is unable to effect a change of beneficial ownership without the custodian's involvement. However, it is not uncommon for private keys to be "sharded" (e.g., split in to two or more parts, a majority or super-majority of which are needed to initiate a transfer) or for transfers to be subject to multi-signature (e.g., private keys are obfuscated by software and may only be signed to a transaction where two or more signatories

[59] S. Rep. No. 111-176, at 76-77 (2010); Curtis Copeland, Cong. Rsch. Serv., R41472, *Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Ac*t (Nov. 3, 2010), https://www.llsdc.org/assets/DoddFrankdocs/crs-r41472.pdf.

approve, typically electronically). If the adviser and one or more qualified custodians each hold "shards" of a private key necessary to initiate a transfer, but no one of them could unilaterally initiate the transfer, would the qualified custodian(s) be deemed to have custody? Would the adviser (by virtue of holding a shard)? Could the custodian and the adviser be deemed to have "exclusive control" or "possession or control" over an asset simultaneously – even if neither could unilaterally transfer the asset? Is it possible that neither of the custodian or adviser would have custody in a sharding or multi-signature arrangement? We recommend that the Final Rule clarifies whether these sharded key or multi-signature arrangements would satisfy the requirements of the Rule, and under what conditions.

The Proposed Rule questions whether it is possible to conclusively demonstrate that a custodian has exclusive control over crypto assets on a public blockchain. We understand this question to ask whether it is possible for a custodian to prove that it has exclusive possession of the private keys applicable to the wallets in which its custodial assets are held. A requirement to "prove the negative" is, of course, a logical fallacy. However, we assume that the Commission has posed this question in good faith. For over a decade, PCAOB accounting firms have audited pooled investment vehicles that "self-custody" crypto assets and have issued those vehicles unqualified financial statements. Procedures vary from auditor to auditor, but ownership and control over self-custodied crypto assets is typically confirmed by a combination of one or more of (i) demonstration of control over the wallet (e.g., by the vehicle signing a message or "microtransaction" with the related private key), (ii) audit of the wallet creation process and private key security controls to ensure that the private keys are never exposed to unnecessary risk of loss (e.g., often including preparation of SOC 1 and/or SOC 2 reports), and (iii) audit engagement controls (e.g., requiring that all vehicles advised by the same adviser or general partner be audited by the same firm, to avoid the same crypto assets being attributed to different pools). We recommend that qualified custodians be permitted to demonstrate "possession or control" over crypto assets in a manner consistent with that used by PCAOB accounting firms in the audit context.

**1. An Adviser's Ability to Trade Clients' Crypto Assets is Substantially Limited**

The Proposed Rule would prohibit advisers from executing trades on centralized crypto asset exchanges, unless those exchanges are qualified custodians. To our knowledge, currently no crypto asset exchanges meet this requirement. Furthermore, in at least one high-profile case, we understand that the Commission refused to permit an exchange owner to transition an existing broker-dealer license to its crypto asset exchange. The proposed transition period is not practical or realistic. Existing crypto asset exchange operators cannot reasonably register as a broker-dealer within that period, nor establish the requisite compliance and operational infrastructure that would be necessary to comply as a qualified custodian. We recommend that an extended transition period be provided for crypto assets held on centralized exchanges, potentially with requirements that exchanges meet certain benchmarks and satisfy certain safekeeping requirements (e.g., segregation of assets) prior to the proposed one-year transition period. In addition, we recommend that the Commission commits to work in good faith with, and to expedite the applications of, applicants seeking to register as broker-dealers (including those operating crypto asset exchanges that facilitate trading of crypto assets that are not securities).

If the Proposed Rule will apply to all centralized exchanges and the transition period is not extended, advisers may be incentivized or forced to move their clients' trading to decentralized exchanges and other "DeFi" platforms. Decentralized exchanges do not require a user to transfer assets to the exchange in order to transact, as is the case for centralized exchanges. Instead, trades are generally matched by the decentralized exchange, executed by so-called smart contracts, and settled directly to and from the user's wallet (which could be a wallet maintained at a qualified custodian). This peer-to-peer settlement is similar to the crypto asset ATS exchanges highlighted in the Proposed Rule. We are aware of no safeguarding benefits to clients from this outcome. In fact, clients would be subjected to various new risks of loss, including hacking and malware risk, risks of fraud and malfeasance by decentralized exchange insiders or engineers, smart contract risk (e.g., the risk that the decentralized exchange, essentially a suite of smart contracts) does not operate as expected or intended, whether as the result of bad actors or negligence, and anti-financial crime risks (e.g., decentralized exchanges generally do not impose any sanctions or AML/KYC requirements on users). We are aware of proposed changes to the statutory definition of "Exchange" under the Exchange Act that may require existing decentralized exchanges that allow trading of "crypto asset securities" to register as a national securities exchange or otherwise comply with the conditions of Regulation ATS. If neither decentralized nor centralized exchanges would exist as compliant venues for advisers to transact in clients' crypto assets, trading crypto assets on behalf of clients would be substantially limited or rendered impossible at scale.

### 2. The Proposed Rule Fails to Address Staking of Crypto Assets

Although the Commission is clearly aware of and familiar with the practice of "staking" in the crypto asset ecosystem, the Proposed Rule is devoid of any guidance on how staking arrangements, which can vary broadly, will be viewed under the new requirements of the Proposed Rule.

We assume that advisers may, under the Proposed Rule, only utilize "custodial" staking arrangements – those where the relevant crypto assets are transferred to the staking service and entitle the transferee to participate in staking rewards – in circumstances where the staking service operator is itself a qualified custodian. If accurate, this should be clarified.

The Proposed Rule is even more unclear regarding "non-custodial" staking arrangements. In a non-custodial arrangement, control over the crypto assets themselves is not transferred to a third-party and the holder of the private keys associated with the crypto assets (e.g., a qualified custodian) can recall them or remove the crypto assets from the staking arrangement at any time (e.g., upon direction from the beneficial owner or its investment adviser), subject to the blockchain protocol's "unbonding" (or cool-off) period.

While unable to transfer or otherwise misappropriate crypto assets for which it has been delegated staking authority, a staking service provider or a node operator may cause the staked assets to be forfeit (e.g., through "slashing" or "burning"). If a token is slashed or burned (i.e. sent to a designated wallet with no access key) it could be viewed as constituting a change in beneficial ownership under the Proposed Rule, but there is no beneficiary of the event. In essence, burning or slashing is an investment risk, rather than a custody risk. We recommend that the Final Rule clarifies that a staking service that is granted authority over crypto assets that could result in

burning or slashing not be deemed "the ability or authority to effect a change of beneficial ownership" under the Proposed Rule, and, therefore, not constitute custody.

Likewise, we recommend that the final rule confirms that non-custodial staking arrangements satisfy the requirements of the Custody Rule, so long as the ability to transfer client assets remains under the exclusive control of a qualified custodian.

The treatment of staking rewards also raises uncertainty under the Proposed Rule. Staking rewards may be deposited to the wallet of the owner(s) of the staked asset directly (i.e. a wallet existing for a client at a qualified custodian), to an omnibus wallet at a qualified custodian for the benefit of all of the owners of staked assets, or to a wallet of the staking service provider or its agent. We believe that the first two outcomes would comply with the Proposed Rule. To the extent that rewards transferred to the wallet of a staking service cannot be withdrawn by the owner of the staked assets until its assets are withdrawn from the staking arrangement, we recommend that the Final Rule clarifies that those rewards are not "client assets" and need not be held at a qualified custodian until they are withdrawn.

### 3. Crypto Assets That Are Unable to Be Maintained with a Qualified Custodian

The Commission requests comment on how to deal with assets that cannot be maintained with a qualified custodian, which could apply to certain crypto assets. There currently exist over 20,000 crypto assets in circulation. Many of these crypto assets may not currently be held by an entity meeting the requirements of a qualified custodian. Effectively, the Proposed Rule would impose non-negotiable investment restrictions on the discretionary authority granted to registered advisers by their clients. Substituting the Commission's investment judgement for that of clients and their advisers is an improper exercise of the Commission's authority and far exceeds the intent of Section 223. We recommend that the Final Rule provides for an exception where a crypto asset cannot be custodied with a qualified custodian or where, upon reasonable vetting, no suitable qualified custodian is available to custody a crypto asset. This exception could require that, beyond the duty of care and duty of loyalty already imposed on investment advisers, an investment adviser reasonably safeguards such crypto assets in a manner comparable to the safeguarding requirements imposed on qualified custodians under the Proposed Rule. We note that this approach to crypto assets is consistent with that applicable to "privately offered securities" and "physical assets," the self-custody of the latter of which raises identical, if not heightened, risks to the loss of client assets.

* * *

The Committees appreciate the opportunity to comment on the Safeguarding Rule Proposal. If we can be of any further assistance in this regard, please feel free to contact us.

Respectfully,

Michael S. Hong
Chair, Private Investment Funds Committee

(212) 450-4048
Michael.Hong@DavisPolk.com

Patrick T. Campbell
Co-Chair, Compliance Committee
(212) 489-4200
pcampbell@bakerlaw.com

Adam B. Felsenthal
Co-Chair, Compliance Committee
afelsenthal@gppfunds.com

cc: The Honorable Gary Gensler
The Honorable Caroline Crenshaw
The Honorable Jaime Lizárraga
The Honorable Hester Peirce
The Honorable Mark Uyeda

**Acknowledgements:**

The Committees would like to express their gratitude to the following individuals for their assistance in drafting this letter: Jonathan Adler, Monica Arora, Lawrence Block, Jason Brown, Anne Choe, Rory Cohen, Stephen Culhane, Brian Daly, Sarah Davidoff, William de Cordova, Angelica Freeland, Krista Fuller, Malvika Gupta, Beth Haddock, Nicole Horowitz, Charles Humphreville, Justin Kanter, Justin Kaufman, Gregory Larkin, Isaac Lederman, Charles Parsons, Neil Patel, Sheena Paul, Brynn Peltz, Marc Ponchione, Mark Proctor, John Rupp, Devi Shanmugham, Shudan Shen, Jeffery Slavin, Robert Sutton, Joel Wattenbarger and Cynthia Wells.