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October 30, 2023

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

Re: File No. S7-04-23 – Proposed Rule on Safeguarding Advisory Client Assets

Dear Ms. Countryman:

Investor Choice Advocates Network ("ICAN")[1] is pleased to submit this response to the Securities and Exchange Commission ("Commission" or "SEC") request for comment on its rule proposal, "Safeguarding Advisory Client Assets" ("the Proposal"), for which the comment period was recently re-opened. Although this extension was provided to enable comment following the adoption of the private fund adviser audit rule – which intersects with the current Custody Rule's audit provision – our comments relate to the Proposal as a whole, which we were unable to provide during the prior open period.

We have significant concerns with the Proposal, which is intended to update the requirements for the safeguarding of client assets by SEC-registered investment advisers ("RIAs"). The Proposal is intended to modernize the existing Custody Rule, bolstering the safeguards for client assets that RIAs are deemed to have custody of. Instead, the Proposal's functional conflicts and numerous other unintended consequences will harm investors served by the financial industry, offering an impractical framework for RIA custody and unworkable conditions for service providers – many of whom may need to reduce or curtail operations where RIAs are involved. It is doubtful whether the Proposal will bolster custody safeguards, but the Proposal is certain to sharply reduce investor choice and increase costs meaningfully. We strongly encourage the SEC to withdraw the Proposal, for reasons we highlight in this letter.

[1] Investor Choice Advocates Network (ICAN) is a nonprofit public interest litigation organization dedicated to breaking down barriers to entry to capital markets and pushing back against regulatory overreach, serving as a legal advocate and voice for investors and entrepreneurs whose efforts help fuel vibrant local and national economies driven by innovation and entrepreneurship.

The Proposal is a Harmful Departure from Existing Standards and Will Upend Custody

The existing ruleset the Proposal would replace, commonly known as the Custody Rule, was originally promulgated over 60 years ago. Although the Custody Rule has been subject to repeated amendments since inception, its intent has been consistent: To govern the requirements for RIAs with custody over client assets, safeguarding them from loss, misuse, and misappropriation and from the insolvency or financial reverses of the adviser.

The Commission highlighted three primary goals of the Proposal in the fact sheet[2] that accompanied the proposing release:

- Expand the current custody rule to protect a broader array of client assets and advisory activities to the rule's protections;
- Enhance the custodial protections that client assets receive under the rule; and
- Update related recordkeeping and reporting requirements for advisers.

As ever, the devil is in the details. In order to achieve these goals, the SEC has redefined core aspects of the custody framework in a way that makes it unworkable in practice, in conflict with other jurisdictions, and – by using RIAs as a regulatory proxy – attempts to extend the Commission's authority to assets and entities for which it has no regulatory oversight. The Proposal represents a substantial rewrite of the business of custody, and the harm it poses lies in stark contrast to the long-held protective nature of the Custody Rule.

The SEC has not identified any notable weaknesses or risks stemming from the existing Custody Rule that would warrant the Proposal's sweeping changes. The growth of assets under management with private fund advisers and the growth of the market for privately offered securities as noted by the SEC in the Proposal is evidence the current Custody Rule meets investor expectations and is not a basis for concern. Further, the Proposal fails to adequately consider the costs and other negative consequences the Proposal's changes would inflict on RIAs and certain asset classes and markets – all of which will be borne, directly or indirectly, by investors.

Instead of enhancing protections, the Proposal will thwart growth and prevent reasonable access to custodial services by:

- Materially disrupting the markets for assets that are not currently under the SEC's supervision;
- Compel RIAs to enforce SEC rules and regulations on those outside the SEC's authority, including Foreign Financial Institutions that would need to submit to US law;
- Significantly disadvantaging investment advisers registered with the SEC versus those exempt from registration;
- Creating uncertainty and conflict for service providers subject to oversight by other regulators and/or subject to legal obligations of foreign jurisdictions; and
- Spurring the exit of RIAs and currently qualified custodians from certain asset classes and related markets in which they trade.

[2] Proposed Safeguarding Rule Fact Sheet, February 15, 2023 (https://www.sec.gov/files/ia-6240-fact-sheet.pdf)

The Proposal, if promulgated, will upend custody as we know it and generate practice conflicts with parties who are not currently subject to SEC oversight.

The Proposal Would Cover <u>All</u> Assets, Irrespective of Feasibility

The Proposal expands custody rules from client funds and securities to any client assets of which an adviser has custody, including ''other positions held in a client's account.''[3] These "other positions" include, but are not limited to: (1) assets that may not necessarily be recorded on a balance sheet for accounting purposes, such as short positions and written options; (2) holdings that may not meet the definition of funds or a security, specifically noting all crypto assets (despite continued regulatory uncertainty), financial contracts held for investment purposes, and collateral held in connection with swap contracts); and (3) physical assets (including artwork, real estate, precious metals, and physical commodities). Notably, the Proposal disregards the established authority other regulators have over certain of these asset classes.

Certain "other positions" as listed above cannot practically be held by a qualified custodian, and, even if it were feasible to do so, most custodians would decline to hold certain assets due to extremely burdensome requirements or the associated liability risk. This therefore limits the types of assets RIAs can trade on behalf of their investors. The American Investment Council noted this impact to RIAs in its May 2023 letter[4]:

> *Without an ability to custody these assets or usable exception, the Proposal would effectively ban many of the nonphysical assets and positions that have historically provided attractive returns to investors and funded innovation, while likely forcing the sale of existing investments at prices that may be unattractive given the Proposal's one-year compliance period."* It further added that *"…the SEC is creating a situation in which an investment adviser would be unable to comply with the law for the custody of certain physical assets.*

The Proposal Conscripts RIAs to Enforce Requirements that the SEC Otherwise Cannot

The Proposal compels RIAs to effectively insert provisions into private contractual relationships between its clients and their service providers, prescribing additional terms, conditions, and obligations as dictated by the Proposal. Currently, many RIA fund clients contract directly with service providers for many services including custody. A fund may appoint custodians, administrators, accountants, auditors and the like at their discretion, many of whom are not regulated by the SEC. RIAs typically do not play a role in selection as long as the service providers are reasonably assured to be qualified and suitably perform their contractual and legal duties in compliance with existing rules of other regulators and federal laws. Should an RIA disagree with a fund client's service provider selection on any grounds, its simplest recourse is to cease to be the fund's adviser.

[3] Proposed rule 223–1(d)(1).

[4] https://www.sec.gov/comments/s7-04-23/s70423-185839-339964.pdf

Further, the Proposal requires RIAs to force Foreign Financial Institutions ("FFIs") to consent to the jurisdiction of U.S. Courts for the purpose of being able to enforce judgments upon them. These FFIs would have to adhere to the Proposal's safekeeping practices, procedures, and internal controls, and the Proposal also dictates the manner in which assets are held to protect them from an FFI's insolvency or failure in a manner comparable to US regulation – provisions that may not be compatible with requirements in the FFI's domestic jurisdiction(s).

Setting aside this extremely troubling precedent of enlisting RIAs to do what the SEC otherwise cannot, is the arrangement is all but certain to fail in practice because RIAs typically do not wield the bargaining power to force additional contractual terms upon a relationship they is not party to between RIA clients and those clients' service providers. The same practical limitation exists regarding FFIs: RIAs simply do not have the ability to compel FFIs to submit to SEC regulatory requirements and U.S. law.

The Proposal's requirements will result in limitations on investor choice. We note the following observation from the Investment Adviser Association in their June 2023 letter[5]:

> *If the adviser were unable to get a custodian to agree to any of the specific required terms under either of these proposals, the adviser would not be able to use that custodian, but nor would its clients. The adviser's clients would need to switch custodians if they wanted to stay with the adviser, or switch advisers if they wanted to stay with the custodian. We do not believe that the Commission intends to limit clients' choice this way or for these rules to be so disruptive to clients.*

The result from the Proposal's deputizing RIAs to compel certain outcomes will be either: (1) reduced choices for investors, or (2) vastly higher prices for services provided by RIAs who are able to navigate the new roles imposed on them by the Proposal. Investors suffer either way.

Equating Trading Authority with Custody Would Restrict Choices for SMA Investors and Others

In order to impose the Proposal's rules on an RIA, the RIA must be deemed to have custody of investor assets. The current condition for being deemed to have "custody" is straightforward: An adviser has custody if it holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. This captures most RIAs, even those who do not hold assets in a traditional sense but are permitted to deduct agreed fees from the funds under management, as generally is the case with pooled investment vehicles.

The Proposal fails to identify any shortcomings of the existing Custody Rule since it underwent substantial changes in 2009. The SEC has not provided any evidence that wrongdoing can be attributed to RIAs acting in compliance with the existing Custody Rule. Despite any identifiable need for change, the SEC now has proposed dramatically expanding the condition for having custody to include discretionary trading authority (even in the absence of an RIA having authority to obtain client assets) thereby including separately managed accounts ("SMAs").

SMAs exist as a means for sophisticated investors to dictate the terms of their investment vehicle, including the service providers they select on their own terms. Currently, RIAs do not typically have direct

[5] https://www.sec.gov/comments/s7-04-23/s70423-206999-417002.pdf

contractual relationships with SMA custodians, yet the SEC now would require the RIA to – once again – insert themselves into contractual relationships between clients and SMA custodians to impose the Proposal's requirements. If the SMA client disagrees, its recourse is to move its business to an adviser that is not encumbered by the Proposal's requirements.

Conflating trading authority with custody, as the Proposal would do with SMAs and others, is one of many examples where the Proposal specifically disadvantages RIAs registered with the SEC. Whether an investor is in a co-mingled fund or an SMA, the Proposal creates an uneven playing field for investment advisers based on their SEC registration status, disproportionately harming RIAs with unworkable requirements to a degree that either drives them out of consideration or ultimately out of business. The result is reduced investor choice in the long term.

The Proposal Will Limit Feasible Investment Adviser Options for Many Investors

The Proposal only applies to advisers registered with the SEC; those exempt from registration are not in scope.

By unevenly applying restrictive and unworkable conditions on RIAs, the SEC will reduce the feasible investment adviser options for investors to advisers who are not encumbered by the Proposal's rules. This is a very troubling likelihood – in the absence of the burdens that would be imposed by the Proposal, many investors choose RIAs precisely because they are subject to strict standards, reporting to, and supervision by the SEC that those exempt from registration are not.

As a practical matter, the Proposal will in many cases narrow the adviser options to those not registered with the SEC – i.e., those advisers who will not be restricted from trading all assets an investor wants exposure to. This is a substantially smaller cohort of investment advisers, who are exempt from registration with the SEC for reasons such as small size or foreign status. Investment opportunities will be severely limited, with investors having to choose from far fewer investment advisers who may otherwise be less desirable to them – and then only from those who trade the particular assets the investor wants.

The Proposal's Unintended Consequences are Obvious, Yet Persist

We find ourselves once again having to highlight substantial unintended consequences from a rule proposal that will materially change industry practice. We recognize that rules must be periodically updated to better align with the modernization of industry practices. However, this is a process that must occur with the utmost care in order to avoid harm. Time and again, we have seen sweeping changes proposed – or recently enacted – that, in the name of investor protection, pose significant harm to investors and risk disrupting or curtailing healthy, necessary functions of our financial markets. Investors may have many reasons to elect to work with an RIA who does not have custody as that term would be expanded to mean under the Proposal. Eliminating investment adviser options for investors will not protect investors. As Commissioner Peirce has said, "Regulators, risk-averse by nature, also should avoid imposing their own risk tolerance on investors, many of whom are comfortable with taking risks that regulators would not themselves take in choosing their own investments."[6] As set forth above, the Proposal would impose unintended, negative consequences.

[6] Hester M. Peirce, *Investors Have the Right to Make Their Own Decisions Without Regulators Standing in the Way*, CNN Business (October 11, 2021) (available at https://www.cnn.com/2021/10/11/perspectives/sec-commissioner-investors-regulators/index.html).

The Proposal Should be Withdrawn and Thoroughly Reconsidered Before Further Action

In light of the foregoing concerns, ICAN urges the Commission to withdraw this Proposal in order to reassess the custody process in full with all stakeholders, conduct an adequate economic analysis that considers the realistic costs of the requirements in proportion to any benefits, and address what we view to be fundamental flaws. Although the Proposal would inflict significant damage on the entire custody ecosystem, the Proposal ultimately will be exceedingly, specifically harmful to investors, who will suffer from reduced choices and dramatically higher costs where services can continue to be obtained.

We would welcome the opportunity to elaborate further on the points raised in this letter. For further information, please contact me by email.

Sincerely,

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cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
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