

October 30, 2020

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

Re: Petition for Rulemaking; Custody Rule 206(4)(2)

Dear Ms. Countryman:

I respectfully request that the U.S. Securities and Exchange Commission (the “Commission” or “the SEC”) amend Rule 206(4)(2) in accordance with the recommendations that I have outlined below. I also respectfully request that the Commission support legislation that would strengthen the Investment Advisers Act of 1940 (“Advisers Act”) and that it invoke its existing authority, as outlined below.

In accordance with the Commission’s instructions, I state that I am submitting these recommendations for the purpose of improving the law to enhance investor protection. I do not represent any client; these views are strictly my own.

A version of the discussion below appeared in a publication of the American Bar Association.<sup>1</sup>

## **Summary**

The Federal Government should make two changes to enhance the regulation of investment advisers.

- First, the SEC should strengthen the custody requirements for investment advisers.
- Second, Congress should grant the SEC more flexibility to tailor its adviser rules to an increasingly sophisticated marketplace; the SEC should invoke its existing authority.

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<sup>1</sup> Kaswell, *Congress and the SEC Should Enhance the Regulation of Investment Advisers*, [Business Law Today](#), American Bar Association, June 23, 2020 © Stuart J. Kaswell, Esq., used by permission. See footnote 1 of that article and acknowledgements therein.

## Part I: The SEC Should Strengthen the Custody Rule for Investment Advisers.

### Introduction

The Securities and Exchange Commission (SEC or Commission) should strengthen the custody rules for investment advisers. The SEC's current rules may not be sufficiently rigorous to prevent the "next Madoff." Although the Commission amended its custody rule, *i.e.*, Rule 206(4)-2<sup>2</sup> in 2009, these amendments would not prevent a determined fraudster from repeating Bernie Madoff's heinous financial crimes. This article explains why the SEC should strengthen the rule to require that an investment adviser keep client assets at a custodian that is unaffiliated with that adviser.

### Background

In 1962, the SEC adopted a custody rule for registered investment advisers under the authority of the general antifraud provision of section 206.<sup>3</sup> In its adopting release, the Commission explained the rule's requirement.<sup>4</sup> Briefly, the SEC required registered advisers to hold

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<sup>2</sup> 17 C.F.R. § 275.206(4)-2 (the custody rule or the rule).

<sup>3</sup> Section 206 of the Advisers Act provides:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
- (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
- (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; or
- (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

The Commission stated that it also was relying on authority that Congress granted in another portion of the Advisers Act. Part II of this article highlights the limitations of the Commission's rulemaking authority under the Advisers Act and recommends an alternative.

<sup>4</sup> The Commission stated that:

The rule makes it a fraudulent, deceptive or manipulative act, practice or course of business for any investment adviser who has custody or possession of funds or securities of clients to do any act or

customers' securities in a reasonably safe place, to provide clients with an itemized statement of their holdings every three months, and to retain an independent accountant to conduct a surprise audit of the customers' funds and securities.

The SEC made only minor changes to the custody rule between 1962 and 1997.<sup>5</sup> In 2003, the Commission amended the rule to eliminate the requirement that the adviser retain an independent public accountant to conduct a surprise audit under certain circumstances.<sup>6</sup> The Commission noted in the 2003 Adopting Release:

Under the amended rule, when qualified custodians send quarterly account statements directly to advisory clients, the adviser is no longer required to send its own quarterly statements or to undergo an annual surprise examination. Receiving quarterly account statements directly from the qualified custodians will enable advisory clients to identify questionable transactions early and allow them to move more swiftly than relying on an annual surprise examination.<sup>7</sup>

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to take any action with respect to any such funds or securities unless (1) all such securities of each such client are segregated, marked to identify the particular client who has the beneficial interest therein, and held in safekeeping in a reasonably safe place; (2) all funds of such clients are deposited in one or more bank accounts which contain only clients' funds; such accounts are maintained in the name of the investment adviser as agent or trustee for such clients; and the investment adviser maintains a separate record for each such account showing where it is, the deposits and withdrawals, and the amount of each client's interest in the account; (3) the adviser, immediately after accepting custody or possession, notifies the client in writing of the place and manner in which the funds and securities will be maintained; (4) the adviser sends each client, at least once every three months, an itemized statement of the funds and securities in his custody or possession at the end of such period and all debits, credits and transactions in the client's account during the period; and (5) at least once each calendar year the funds and securities are verified by actual examination by an independent public accountant in a surprise examination and a certificate of the accountant, stating that he has made the examination and describing the nature and extent of it, is sent to the Commission promptly thereafter.

Investment Advisers Act Release No. 123 (Feb. 27, 1962); 27 FR 2150 -1, (Mar. 6, 1962).

<sup>5</sup> 54 Fed. Reg. 32049 (Aug. 4, 1989); 62 Fed. Reg. 28135 (May 22, 1997). The 2009 Proposing Release, *infra* note 10, states at note 13:

In 1997, we amended the rule to make it applicable only to advisers who are registered, or required to be registered, with the Commission. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)] at Section II.I.5.

<sup>6</sup> Adoption of Rule 206(4)-2 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 123 (Feb. 27, 1962) [27 Fed. Reg. 2149 (Mar. 6, 1962)] cited in the 2009 Proposing Release, *infra* note 10.

<sup>7</sup> Release IA- 2176 (Sept. 25, 2003; 68 Fed. Reg. 56692 (Oct. 1, 2003), at 56697 (citations omitted). The Commission made provision for "the small group of advisers that cannot use the new approach and therefore must continue to undergo an annual surprise examination," *Id* (citation omitted).

## The Current Custody Rule

After the Madoff<sup>8</sup> and other scandals<sup>9</sup>, the SEC reexamined the custody to rule to consider whether to adopt further changes. As discussed below, on December 30, 2009, the Commission adopted substantial changes to the rule.<sup>10</sup> In particular, the SEC reexamined its decision to eliminate the surprise audit provision.<sup>11</sup> When it adopted the final rule, the Commission restored that provision.<sup>12</sup>

In its current iteration, the custody rule affords significant protections to the customers of investment advisers. Briefly, Rule 206(4)-2 requires an adviser registered or required to be registered under section 203 of the Advisers Act to comply with the following requirements:

- Use a *qualified custodian* to hold customers' funds and securities.<sup>13</sup> The qualified custodian must maintain the customers' funds and securities either in a separate account

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<sup>8</sup> Numerous government documents, [news articles](#), books, and movies have described Bernard L. Madoff's Ponzi scheme. Briefly, Madoff, who had earned respect for his broker-dealer operations, ran a massive Ponzi scheme through a separate investment adviser.

<sup>9</sup> 2009 Proposing Release, *infra* note 10.

<sup>10</sup> Release IA-287 (May 20, 2009); 74 Fed. Reg. 25354 (May 27, 2009) (2009 Proposing Release); Release IA-2698 (Dec. 30, 2009), 75 Fed. Reg. 1456 (Jan. 11, 2010) (2009 Adopting Release).

<sup>11</sup> The 2009 Proposing Release states at 25356:

In 2003, we amended the rule to eliminate the annual surprise examination with respect to client accounts for which the adviser has a reasonable belief that "qualified custodians" provide account statements directly to clients. We believed that direct delivery of account statements by qualified custodians would provide clients confidence that any erroneous or unauthorized transactions would be reflected and, as a result, would be sufficient to deter advisers from fraudulent activities.

We have decided to revisit the 2003 rulemaking in light of the significant enforcement actions we have recently brought alleging misappropriation of client assets. [footnotes omitted.]

<sup>12</sup> Rule 206(4)-2(a)(4).

<sup>13</sup> Rule 206(4)-2(a)(1). The custody rule provides certain exemptions from the qualified custodian requirement. Rule 206(a)(4)-2(b) provides six exceptions from the qualified custodian requirement. For example, subsection (2) exempts certain privately offered securities:

- (i) You are not required to comply with paragraph (a)(1) of this section with respect to securities that are:
  - (A) Acquired from the issuer in a transaction or chain of transactions not involving any public offering;
  - (B) Uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and
  - (C) Transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

The SEC staff also has provided guidance exempting privately placed securities in certificated form from the custody rule under certain circumstances.

under each client's name or in accounts that contain only the clients' funds and securities in the adviser's name as agent or trustee.<sup>14</sup> Rule 206(4)-2(d)(6) defines a "qualified custodian" as a regulated bank, savings association, broker-dealer, futures commission merchant, or certain foreign financial institutions.<sup>15</sup>

- Notify each client of the name and other information about the custodian;<sup>16</sup>
- Have a reasonable basis for believing that the custodian sends account statements to the customers.<sup>17</sup>
  - *NB:* In the 2009 Amendments, the Commission "eliminate[d] an alternative to the requirement under which an adviser can send quarterly account statements to clients if it undergoes a surprise examination by an independent public accountant at least annually."<sup>18</sup>
- Have an independent public accountant perform a surprise audit at the custodian to verify the customers' funds and securities.<sup>19</sup>
  - *NB:* Hedge fund managers are exempt from the surprise audit requirement if they retain an independent accounting firm that is subject to oversight by the Public Company Accounting Oversight Board (PCAOB) to conduct an annual audit of the custodian.<sup>20</sup> The hedge fund industry did not believe that the surprise audit

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The Division would not object if an adviser does not maintain private stock certificates with a qualified custodian, provided that (1) the client is a pooled investment vehicle that is subject to a financial statement audit in accordance with paragraph (b)(4) of the custody rule; (2) the private stock certificate can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer; (3) ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client; (4) the private stock certificate contains a legend restricting transfer; and (5) the private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

SEC, Division of Investment Management, IM Guidance Update, Aug. 2013, No 2013-04 [citations omitted], as referenced in Lemke & Lins, *infra* note 25, at §3:63, n.3.

<sup>14</sup> Rule 206(4)-2(a)(1)(i) and (ii).

<sup>15</sup> Rule 206(4)-2(d)(6)(i) – (iv).

<sup>16</sup> Rule 206(4)-2(a)(2).

<sup>17</sup> Rule 206(4)-2(a)(3).

<sup>18</sup> 2009 Adopting Release at 1457.

<sup>19</sup> Rule 206(4)-2(a)(4).

<sup>20</sup> Rule 206(4)-2(b)(4) provides:

was workable and urged the SEC to adopt a more rigorous audit requirement for custodians for private funds than is otherwise required. The SEC agreed.<sup>21</sup>

When the Commission proposed amendments to the rule, it proposed additional safeguards for when an adviser or related person maintains client funds or securities as a qualified custodian. In addition,<sup>22</sup> the Commission asked whether it should require that custodians be independent of the investment adviser:

We request comment on whether, as an alternative to our proposal to impose additional conditions on advisers that serve as, or have related persons that serve as, qualified custodians for client assets, we should simply amend rule 206(4)-2 to require that an independent qualified custodian hold client assets. The use of a custodian not affiliated with the adviser would address the conflict, and potentially greater risks to client assets, that may be presented when an adviser or its related person acts as custodian for client assets.<sup>23</sup>

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*Limited partnerships subject to annual audit.* You are not required to comply with paragraphs (a)(2) and (a)(3) of this section and you shall be deemed to have complied with paragraph (a)(4) of this section with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit (as defined in rule 1-02(d) of Regulation S-X (17 CFR 210.1-02(d)))*[if]*:

- (i) At least annually [the investment adviser] and [sic] distributes its [i.e., the partnership's] audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year;
- (ii) [Such audited financials are reviewed] By an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules; and
- (iii) Upon liquidation [of the fund, the adviser] and [sic] distributes its [i.e., the partnership's] audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) promptly after the completion of such audit.

<sup>21</sup> 2009 Adopting Release at 1460 and discussion at note 47. *See also* letter from Stuart J. Kaswell, Executive Vice President and Managing Director, General Counsel, Managed Funds Association, July 28, 2009, and Testimony of Stuart J. Kaswell, Hearing Before the Committee on Financial Services, U. S. House of Representatives, 111th Cong., 1st Sess., Oct. 6, 2009, Serial No. 111-84, at 55–56.

<sup>22</sup> 2009 Proposing Release at 25374, Proposed Rule 206(4)-2(a)(6)(i) and (ii).

<sup>23</sup> 2009 Proposing Release at 25361.

The Commission declined to require that the custodian be independent from the adviser.<sup>24</sup> It made only modest changes to that portion of the proposed rule. The final rule provides that if the adviser maintains, or has custody because a related person maintains, client funds or securities pursuant to this section as a qualified custodian in connection with advisory services that the adviser provides to clients,” then the independent public accountant that the adviser hires to perform the independent verification (including the surprise audit) required in subsection (a)(4) must be registered with and subject to the regular inspection by the PCAOB. In addition, the adviser must obtain (or receive from its related person) a periodic internal control report prepared by that independent public accountant. That report must:

- opine on whether the controls are adequate to protect the customers’ funds and securities;
- verify that the funds and securities are reconciled to a custodian other than the adviser or its related person; and
- subject the independent reporting accountant to PCAOB oversight.<sup>25</sup>

The custody rule also includes an exemption from the surprise examination requirement in subsection (a)(4) where the adviser is operationally independent of the related person custodian.<sup>26</sup>

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<sup>24</sup> The Commission noted:

Some commenters supported requiring an “independent” qualified custodian, although many commenters opposed the requirement. Several argued that use of an independent custodian would be an impractical requirement for many types of advisory accounts held by smaller investors with broker-dealers, such as wrap fee accounts, in which a client receives bundled advisory and brokerage services from a single firm (or related firms) regulated as both an investment adviser and a broker-dealer. It is common for institutional clients to maintain assets in a custodial account, often with a bank that is unaffiliated with the client’s adviser. We are concerned, however, that requiring an independent custodian could make unavailable many advisory accounts popular with smaller investors, which are today maintained by the adviser or its affiliated brokerage firm or bank. Therefore, we are not amending the rule to require use of an independent custodian, although we encourage the use of custodians independent of the adviser to maintain client assets as a best practice whenever feasible.

2009 Adopting Release at 1462 [citations omitted].

<sup>25</sup> Rule 206(4)-2(a)(6)(i), (ii)(A), (B), and (C).

<sup>26</sup> Rule 206(4)-2(b)(6)(i) and (ii). As one treatise explains:

The rule includes an exception to the surprise examination requirement where the adviser is “operationally independent” of the related person custodian. In these situations, the surprise examination requirement would not apply, although the requirements relating to client notification, custodian account statement and an internal control report would continue to apply.

An adviser is operationally independent if: (i) the client assets are insulated from creditors; (ii) the adviser’s personnel do not have access to the clients’ assets; (iii) the advisory personnel and the custodian are not under common supervision; and (iv) the advisory personnel do not hold any position with or share premises with the related person.

In the intervening years, the SEC and its staff have identified significant concerns regarding investment advisers' compliance with the custody rule.<sup>27</sup> The SEC's Office of Compliance, Inspections, and Examinations (OCIE) stated in its 2014 Exam Priorities:

[The National Examination Program] continues to observe non-compliance with . . . the Custody Rule. In March, 2013, the NEP published a Risk Alert, sharing observations regarding the most common issues of non-compliance. Given the importance of this requirement for a fiduciary, the staff will continue to test compliance with the Custody Rule and confirm the existence of assets through a risk-based asset verification process. Examiners will pay particular attention to those instances where advisers fail to realize they have custody and therefore fail to comply with requirements of the Custody Rule.<sup>28</sup>

That document refers to another OCIE *Risk Alert* documenting a wide variety of violations of the custody rule that OCIE identified during investment adviser examinations.<sup>29</sup> The SEC continues to bring enforcement actions against investment advisers for custody rule violations, even if the amounts of the settlements have been relatively modest.<sup>30</sup>

## Recommendation

As outlined below, the SEC could do more to enhance the investor protections of the custody rule. The 2009 Amendments, and in particular the changes that the SEC added in subsection (a)(6) of the rule, are very helpful. Requiring that the adviser retain an independent accounting firm under PCAOB oversight to verify custody should reduce the likelihood that a fraudster will not deposit the necessary funds and securities with the custodian or remove them illegally. Nonetheless, it is my view that the SEC should take the next step and require the adviser to use a custodian that is unaffiliated in any way with the adviser.

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Lemke & Lins, *Regulation of Investment Advisers* § 2:53 (2017); See also Rule 206(4)-2(d)(5). One can only wonder if Bernard Madoff would have asserted that the separation of its broker-dealer from its adviser qualified as “operationally independent” under this exception.

<sup>27</sup> Lemke, Lins, Hoenig & Rube, *Hedge Funds and Other Private Funds: Regulation and Compliance* § 3:62 (2017–18) (“the SEC staff has identified investment adviser and fund manager custody issues as an examination priority.”) (emphasis in original).

<sup>28</sup> National Exam Program, OCIE, [Examination Priorities for 2014](#).

<sup>29</sup> OCIE, [Significant Deficiencies Involving Advise Custody and Safety of Assets](#), Vol. III, Issue 1, Mar. 4, 2013.

<sup>30</sup> See, e.g., [In the Matter of ED Capital Management et. al.](#), Investment Advisers Act Release 5344 (Sept. 13, 2019). Among other things, the adviser “failed to distribute annual audited financial statements prepared in accordance with Generally Accepted Accounting Principles (“GAAP”) to the investors in the largest private fund that it advised in each fiscal year from 2012 through 2016, in violation of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder. . . .” See also [In the Matter of Hudson Housing Capital, LLC](#), Investment Advisers Act of 1940, Release No. 5047 (Sept. 25, 2018).

The Madoff fraud itself indicates that an adviser using an affiliated custodian may more easily commit fraud than if the custodian were unaffiliated. The indictment and plea notes that Bernard L. Madoff Investment Securities (BLMIS) was registered with the SEC as both a broker-dealer and as an investment adviser.<sup>31</sup> The indictment alleges that “the BLMIS ADV contained false statements made for the purpose of deceiving the SEC and hiding the defendant’s unlawful conduct. . . . The BLMIS ADV filed with the SEC provided, among other things, that BMLIS had custody of advisory clients’ securities.”<sup>32</sup> In the Plea Allocation of Bernard L. Madoff, Mr. Madoff states, “I . . . knowingly gave false testimony under oath that . . . my firm had custody of the assets managed on behalf of my investment advisory clients.”<sup>33</sup>

If the SEC had required BLMIS to use a separate entity, Mr. Madoff would have needed many more confederates to commit his fraud. The current requirement that a PCAOB-inspected auditor review the custody arrangements is an important reform, but a clever fraudster might be able to circumvent that requirement. It is obvious that the more people necessary to commit a fraud, the less likely it is that the fraudsters will be able to keep their scheme a secret.<sup>34</sup>

The SEC should amend the custody rule so that a registered investment adviser must use a custodian that has no relation to the adviser. When the Commission declined to adopt the independent custodian requirement, it expressed concern that the requirement would be inconsistent with some business models.<sup>35</sup>

Although I commend the Commission for its consideration of cost factors and varying business models,<sup>36</sup> I believe that it should reconsider this decision. After the SEC adopted its rule, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which includes the Volcker Rule.<sup>37</sup> As a consequence of that requirement and pressure from institutional investors, nearly all hedge fund managers use unaffiliated

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<sup>31</sup> U.S. District Court, Southern District of New York, [Information 09 Cr.](#), at 1.

<sup>32</sup> *Id.* at 16.

<sup>33</sup> The Plea Allocation of Bernard L. Madoff at 3, included in *United States of America v. Bernard L. Madoff*, U.S. District Court for the Southern District of New York, 09 CR 213 (DC), included in Full Madoff Court [Transcript](#), Mar. 12, 2009.

<sup>34</sup> B. Franklin, *Poor Richard’s Almanack* (1735) (“Three may keep a Secret, if two of them are dead.”).

<sup>35</sup> *See supra* note 24.

<sup>36</sup> *See* section 202(c) of the Advisers Act.

<sup>37</sup> Section 619 of the Dodd-Frank Act added section 13 of the Bank Holding Company Act of 1956 (BHC Act), also known as the Volcker Rule. The Volcker Rule “generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund.” Department of the Treasury *et al.*, 12 C.F.R. pt. 44, [Docket No. OCC–2018–0010] RIN 1557–AE27, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 84 Fed. Reg. 61974 (Nov. 14, 2019). Given that the Volcker rule prevents banks and certain affiliates from sponsoring hedge funds, they may not sponsor and serve as a custodian for the same fund.

custodians. In addition, many retail investment advisers use platforms operated by large broker-dealers to execute trades and maintain custody.

If the Commission revises the custody rule, it should examine the existing exemptions. After 10 years of experience with the rule, the Commission should consider whether it needs to expand, retain, or reduce current exemptions.<sup>38</sup>

Some investment advisers probably could reconfigure their arrangements to accommodate a requirement of an independent custodian, though others might not be able to do so easily. It is my view that the benefit of requiring a separate custodian substantially would outweigh the cost. Retail and institutional investors would have many investment advisers from which to choose, and their assets would enjoy a greater level of protection.<sup>39</sup>

The current custody rule is a substantial improvement over the 2003 iteration. Nonetheless, we should not wait for another Madoff to steal yet another horse before locking the barn door.

## **Part II: Congress Should Augment the SEC’s Rulemaking Authority; the SEC Should Invoke Existing Authority.**

### **Introduction**

The SEC should ask Congress to enact a general rulemaking provision for the Advisers Act that is analogous to section 15 of the Securities Exchange Act of 1934 (Exchange Act) for broker-dealers. Initially, Congress enacted the Advisers Act as a broad statement of principles with relatively few specific mandates. As fiduciaries, the Advisers Act requires investment advisers to act in the best interests of their clients. Given that advisers are fiduciaries, the SEC adopted relatively few rules under the Advisers Act compared to the SEC’s and FINRA’s regulation of broker-dealers.

Over time, Congress and the SEC have imposed more specific requirements on investment advisers. Unfortunately, Congress did not grant the SEC general rulemaking authority under the Advisers Act. Accordingly, the SEC has had to use its broad antifraud authority under section 206 as the basis for adopting a number of rules that, arguably, the Commission could better address under a grant of general rulemaking. Consequently, an investment adviser that fails to satisfy rules that are prophylactic in nature will find that it has violated an antifraud rule, which

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<sup>38</sup> As noted, Rule 206(a)(4)-2(b) provides exceptions from the qualified custodian requirement. In the absence of evidence to the contrary, it would be wise to continue such exemptions.

<sup>39</sup> I am not suggesting that the Commission should make any changes to other aspects of the rule. For example, I would not alter Rule 206(4)-2(b)(3)(i) that exempts the adviser from obtaining an independent verification of client funds and securities if the adviser has custody solely as a consequence of having the authority to make withdrawals from client accounts to pay its advisory fees. In addition, I am not suggesting that the SEC should not permit broker-dealers to retain possession and control of customers’ funds and securities. Congress and the SEC have instituted requirements to ensure the protection of customer property. *See* the discussion, *infra*, of section 15(c) of the Exchange Act and Rules 15c3-1 and 3-3.

may have unduly harsh consequences for the adviser. To remedy this problem, Congress should grant the SEC broader authority to adopt prophylactic rules under the Advisers Act. The SEC should have the authority to delineate those offences that are inconsistent with its regulatory mandates from those that are deceptive and fraudulent. The SEC itself has the authority to begin this process, which Congress could then augment. I explain the basis for my suggestions below.

## Discussion

In the seminal case *SEC v. Capital Gains Research Bureau*,<sup>40</sup> the Supreme Court explained the general purpose and operation of the Advisers Act. The court rejected the adviser's argument that it was legal for it to recommend a stock that it secretly bought for itself and then sold, even if its recommendation was legitimate. The court explained:

The Investment Advisers Act of 1940 was “directed not only at dishonor, but also at conduct that tempts dishonor.” *United States v. Mississippi Valley Co.*, 364 U.S. 520, 549. Failure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as the experience of the 1920s and 1930s amply reveals, the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive. To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute. Reading the Act in light of its background we find no such requirement commanded. . . . The statute, in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested. To insure this it empowers the courts to require disclosure of material facts. It misconceives the purpose of the statute to confine its application to “dishonest” as opposed to “honest” motives. . . . The high standards of business morality exacted by our laws regulating the securities industry do not permit an investment adviser to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in these recommendations to his clients. [Emphasis added.]<sup>41</sup>

In the intervening years, the SEC adopted rules that impose obligations on investment advisers that are more specific than a general fiduciary standard would require. For example, the SEC adopted Rule 206(4)-7 in 2003 requiring advisers to have written policies and procedures to

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<sup>40</sup> 375 U.S. 180 (1963).

<sup>41</sup> *Id.* at 200–01.

prevent a violation of the Advisers Act and its rules, to review the adequacy of those policies annually, and to appoint a chief compliance officer.<sup>42</sup> There are several others.<sup>43</sup>

A compliance rule probably is wise policy, but the failure to appoint a chief compliance officer without any other wrongdoing should not be fraudulent conduct by the adviser that is a violation of section 206 of the Advisers Act. Investment advisers operated for decades under the Advisers Act without appointing a chief compliance officer, and most did so without violating their fiduciary obligations to customers or committing fraud. Given the limitations of the Advisers Act, the SEC had little choice but to adopt this rule under section 206. However, a violation of Rule 206(4)-7 does not mean that an adviser behaved wrongfully with respect to its clients; that rule is only a means to the end of ensuring that the adviser complies with the law and protects its clients. Indeed, it is possible that a tenacious litigant and a friendly court might conclude that Rule 206(4)-7 is not an antifraud rule. If a court so concluded, it could find that the custody rule exceeds Congress's grant of authority.

A better answer is for Congress to amend the Advisers Act and to grant the SEC authority analogous to its authority over broker-dealers. The Exchange Act grants broad authority to the Commission to prohibit fraudulent practices at broker-dealers, but Congress also granted the SEC authority to adopt prophylactic rules.

Below are two examples of antifraud rules that the SEC adopted to regulate broker-dealers. The SEC adopted these rules under section 10 of the Exchange Act, that statute's broad antifraud provision:

- Regulation SHO, which governs short sales. Subsection 10(a)(1) of the Exchange Act grants the Commission specific authority to regulate short selling.<sup>44</sup>

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<sup>42</sup> 17 C.F.R. § 275.206(4)-7 (compliance procedures and practices):

If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3), it shall be unlawful within the meaning of section 206 of the Act (15 U.S.C. 80b-6) for you to provide investment advice to clients unless you:

(a) Policies and procedures. Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act;

(b) Annual review. Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and

(c) Chief compliance officer. Designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under paragraph (a) of this section.

<sup>43</sup> Other rules under section 206 of the Advisers Act that are prophylactic in nature are 17 C.F.R. §§ 275.206(4)-1 (advertisements by investment advisers); 275.206(4)-3 (cash payments for client solicitations); 275.206(4)-5 (political contributions by certain investment advisers; and 275.206(4)-6 (proxy voting).

<sup>44</sup> In the release proposing Regulation SHO, the SEC notes that "[s]ection 10(a) of the Exchange Act gives the Commission plenary authority to regulate short sales of securities registered on a national securities exchange (listed

- Rule 10b-3, which prohibits broker-dealers from engaging in certain fraudulent activities.<sup>45</sup> The better-known Rule 10b-5 applies to any person.

By comparison, in section 15(c)(3) of the Exchange Act,<sup>46</sup> Congress grants the SEC authority to establish financial responsibility rules, separate and apart from the antifraud authority in section 10. The SEC used this authority to adopt the net capital rule<sup>47</sup> and the customer protection rule<sup>48</sup>, both of which are essential to protecting customers' assets held at a broker-dealer. A broker-dealer must be able to demonstrate "moment to moment" compliance with the net capital rule.<sup>49</sup> A broker-dealer that violates the net capital rule must begin liquidation. Neither rule is an antifraud rule.

Congress should enact legislation analogous to section 15 of the Exchange Act that would grant the SEC authority to adopt additional prophylactic rules under the Advisers Act without having to invoke the antifraud authority of section 206.

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securities), as necessary to protect investors." Release 34-48709 (Oct. 28, 2003); 68 Fed. Reg. 62972, 62973 (Nov. 6, 2003). In the adopting release for Regulation SHO, the Commission invoked the following provisions as the basis for its authority: "pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10, 11A, 15, 17(a), 17A, 23(a), and 36 thereof, . . ., the Commission is adopting §§ 242.200, 242.202T, 242.203, along with amendments to Regulation M, Rule 105, and interpretative guidance set forth in part 24." 69 Fed. Reg. 48008, 48029 (Aug. 6, 2004). As a matter of caution, the SEC always cites to multiple statutory provisions as the basis for its rules.

<sup>45</sup> Rule 10b(3)(a) provides:

It shall be unlawful for any broker or dealer, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security otherwise than on a national securities exchange, any act, practice, or course of business defined by the Commission to be included within the term "manipulative, deceptive, or other fraudulent device or contrivance", as such term is used in section 15(c)(1) of the act.

<sup>46</sup> That provision provides:

(3)(A) No broker or dealer (other than a government securities broker or government securities dealer, except a registered broker or dealer) shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security (except a government security) or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall (A) require the maintenance of reserves with respect to customers' deposits or credit balances, and (B) no later than September 1, 1975, establish minimum financial responsibility requirements for all brokers and dealers.

<sup>47</sup> 17 C.F.R. § 240.15c3-1.

<sup>48</sup> 17 C.F.R. § 240.15c3-3.

<sup>49</sup> NASD Notice to Members 07-16 (Apr. 2007). *See also* FINRA, [Accuracy of Net Capital Computations](#); News Release, [FINRA Expels Maximum Financial for Net Capital, AML, Other Violations](#), Aug. 18, 2009.

Some critics might object to this suggestion, arguing that such additional authority would water down or diminish the SEC's current prohibitions. For example, they might fear that enacting such a provision would diminish the importance of an adviser complying with the insider trading prohibitions under section 10(b) of the Exchange Act and Rule 10b-5. In fact, the opposite is true. When Congress enacted section 204A of the Advisers Act, it required advisers subject to the reporting requirements of section 204 to maintain and enforce policies and procedures reasonably designed to prevent insider trading.<sup>50</sup> Congress added this provision in section 3 of the Insider Trading and Securities Fraud Enforcement Act of 1988. An investment adviser violates section 204A if it fails to establish, maintain, and enforce such a system, even if the adviser never trades on insider information. Section 204A is a separate, prophylactic requirement and is independent of the insider trading prohibitions in section 10(b) of the Exchange Act and Rule 10b-5, as well as section 206 of the Advisers Act.<sup>51</sup> Clearly, Congress deemed it important to ensure that the SEC had independent authority to ensure that investment advisers adopted policies and procedures designed to prevent insider trading.

The SEC could use its current authority to demonstrate the importance of separate authority to adopt prophylactic rules in addition to antifraud rules. Congress added a separate and explicit custody provision to the Advisers Act itself after the financial crisis of 2008 and the Madoff scandal. Section 411 of the Dodd-Frank Act amended the Advisers Act to include the following provision:

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.<sup>52</sup>

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<sup>50</sup> Section 204A provides that:

Every investment adviser subject to section 204 of this title shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser. The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this Act or the Securities Exchange Act of 1934 (or the rules or regulations thereunder) of material, nonpublic information.

ITSFEA includes a parallel provision for broker-dealers in what is now section 15(g) of the Exchange Act.

<sup>51</sup> Pub. L. No. 100-704, 102 Stat. 4680. See Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 Bus. Law 245 (1989), revised & republished in American Bar Association, *Securities Law Administration, Litigation, and Enforcement, Selected Articles on Federal Securities Law*, Vol. III (1991) at 252.

<sup>52</sup> Aug. 22, 1940, ch. 686, tit. II, § 223, as added Pub. L. No. 111-203, tit. IV, § 411, July 21, 2010, 124 Stat. 1577. The Dodd-Frank Act also amended the Advisers Act to require registration of investment advisers to private funds, *i.e.*, hedge funds. Congress included these changes in a comprehensive expansion of the SEC's authority in Title IV of the Dodd-Frank Act. By comparison, Congress included custody requirements for registered funds in the original

Further, as noted, the SEC amended the custody rule after the Madoff fraud, but before Congress enacted section 223 as part of the Dodd-Frank Act. After notice and comment, the SEC could adopt the text of the custody rule under the authority of section 223. It then could adopt a separate rule providing that the willful violation of the custody rule is a violation of section 206, the antifraud provision.

This change would make clear that an adviser that was merely negligent did not violate the Advisers Act's antifraud provisions. It also would remove any doubt as to the validity of a custody rule because the statutory basis would not be section 206, the antifraud provision.

The SEC should have the authority to distinguish between negligence and Madoff-style fraud. Advisers who make a minor error complying with the custody rule should not have to explain to their clients why a technical error is not really fraud. This first step could demonstrate to Congress the wisdom of augmenting the SEC's power.

Similarly, if Congress expanded the SEC's power, it could adopt prophylactic rules regarding advertisements by investment advisers; cash payments for client solicitations; political contributions by certain investment advisers; and proxy voting.<sup>53</sup> The Commission could then adopt antifraud rules for each of these provisions prohibiting willful violations. Accordingly, an investment adviser that makes a minor mistake with regard to any of these rules would not be subject to a charge that it had committed fraud.<sup>54</sup> By the same token, the SEC would retain the authority to charge a violation of both the prophylactic rule and the antifraud rule in egregious cases.

The current framework does nothing to distinguish serious violations from negligent errors. An adviser that commits a minor violation must explain why a fraud charge overstates the nature of the wrongdoing. For example, an adviser to a hedge fund would find it awkward to explain a minor mistake to the board of an institutional investor. Indeed, the adviser might be reluctant to settle an enforcement action with the SEC for that reason. By the same token, an adviser that commits serious fraud may try to excuse its behavior to less sophisticated investors by saying that the SEC calls any minor transgression fraud. The law should not paint the serious wrongdoer and the minor transgressor with the same brush.

To be clear, I am not suggesting that Congress should alter the existing fiduciary duty inherent in the Advisers Act. Congress should not, as the Supreme Court cautioned, "impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify

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Investment Company Act of 1940 (1940 Act). Section 17(f) of the 1940 Act establishes custody requirements for registered management companies. Other provisions of the 1940 Act establish custody requirements for other types of investment companies, e.g., section 26(a) for unit investment trusts.

<sup>53</sup> See *supra* note 43.

<sup>54</sup> As discussed below, such a process could include the Commission's reassessment of those rules and whether it should make any revisions.

the protective purposes of the statute.”<sup>55</sup> I am suggesting that Congress should grant the SEC greater flexibility so that its rulemaking authority would better match the evolution of the regulatory framework. The SEC should have greater authority to impose a broader range of prophylactic rules in addition to its<sup>56</sup> antifraud rules. Congress often has accepted suggestions from the SEC for changes to the federal securities laws. I suggest that the Commission should make such a recommendation as outlined above.

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<sup>55</sup> SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963). *See also* Commission Interpretation Regarding Standards of Conduct for Investment Advisers, IA-5248 (June 5, 2019); 84 Fed. Reg. 33669 (July 12, 2019) (hereinafter Interpretive Release). The Interpretive Release at note 20 discusses whether negligence or scienter is sufficient for a violation of section 206:

Claims arising under Advisers Act section 206(2) are not scienter-based and can be adequately pled with only a showing of negligence. *Robare Group, Ltd., et al. v. SEC*, 922 F.3d 468, 472 (D.C. Cir. 2019) (“*Robare v. SEC*”); *SEC v. Steadman*, 967 F.2d 636, 643, n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains*, supra footnote 2) (“[A] violation of § 206(2) of the Investment Advisers Act may rest on a finding of simple negligence.”); *SEC v. DiBella*, 587 F.3d 553, 567 (2d Cir. 2009) (“the government need not show intent to make out a section 206(2) violation”); *SEC v. Gruss*, 859 F. Supp. 2d 653, 669 (S.D.N.Y. 2012) (“Claims arising under Section 206(2) are not scienter-based and can be adequately pled with only a showing of negligence.”). However, claims arising under Advisers Act section 206(1) require scienter. *See, e.g., Robare v. SEC*; *SEC v. Moran*, 922 F. Supp. 867, 896 (S.D.N.Y. 1996); *Carroll v. Bear, Stearns & Co.*, 416 F. Supp. 998, 1001 (S.D.N.Y. 1976).

This article is not urging that the Congress or the Commission reduce the SEC’s antifraud authority. Instead, the Commission should have greater flexibility to characterize some behavior as fraud and other behavior as wrongful, but of less severity. It is interesting that the Interpretive Release does not specifically discuss custody with regard to an adviser’s fiduciary duty. For example, the Interpretive Release provides that an adviser’s fiduciary duty includes the duty of care. It then notes that:

The duty of care includes, among other things: (i) The duty to provide advice that is in the best interest of the client, (ii) the duty to seek best execution of a client’s transactions where the adviser has the responsibility to select broker-dealers to execute client trades, and (iii) the duty to provide advice and monitoring over the course of the relationship.

*Id.* at 33672. Without question, an investment adviser has a fiduciary duty to protect the assets over which it has custody. *Lemke & Lins*, supra note 26.

<sup>56</sup> For example, in 2008, the SEC recommended that Congress enact numerous changes to bolster the Commission’s enforcement authority. On September 11, 2008, the U.S. House of Representatives approved H. R. 6513, the Securities Act of 2008, which included numerous recommendations from the SEC. [Report](#) on the Activity of the Committee on Financial Services for One Hundred Tenth Congress, Report 110-929, 110 Cong. 2d. Sess., at 98. The recommendations included provisions such as granting the SEC authority to impose civil penalties in cease and desist proceedings. *Id.* at Section 2. It also included a provision allowing the Commission to petition a U.S. District Court, and for such court to authorize a subpoena that the SEC may serve in any other district. *Id.* at Section 19. Congress ultimately included these provisions in Title IX of the [Dodd Frank Act](#).

## Conclusion

The SEC has listed a review of the custody rule as a priority on its regulatory agenda.<sup>57</sup> That is a wise decision. More than 10 years have passed since the Commission adopted its last set of amendments to the custody rule. Regulators should reassess any rule after a significant period of time has elapsed to determine what has worked well and what could work better. Even the most brilliantly drafted rule may need adjustments in light of external developments.<sup>58</sup> The forthcoming review of the custody rule will afford the SEC the opportunity to consider suggestions from the public, including those outlined above.

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Thank you for considering my views. I would be pleased to meet with members of the Commission or the Staff to discuss my suggestions.

Sincerely,

/s/

Stuart J. Kaswell, Esq.

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<sup>57</sup> Office of Information and Regulatory Affairs, Office of Management and Budget, Executive Office of the President, Securities and Exchange Commission, Amendments to the Custody Rule, RIN 3235-AM32, Fall 2019. The Division is considering recommending that the Commission propose [amendments](#) to existing rules and/or propose new rules under the Investment Advisers Act of 1940 to improve and modernize the regulations around the custody of funds or investments of clients by investment advisers.

<sup>58</sup> Many investment advisers consider the custody rule to be extremely complex. Lemke *et al.*, *supra* note 27, at § 3:62.