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

Submitted via rule-comments@sec.gov

May 8, 2023

Dear Ms. Countryman,

Safeguarding Advisory Client Assets [File Number S7-04-23]

The Alternative Investment Management Association ("AIMA")[1] and the Alternative Credit Council (ACC)[2] welcome the opportunity to comment on the proposal by the Securities and Exchange Commission ("SEC" or "Commission") to amend and redesignate Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), for registered investment advisers ("RIAs") and to make associated changes to the recordkeeping and Form ADV requirements for RIAs (the "Proposal").[3]

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[1] The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage $800 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

[2] The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 250 members that manage over $800 billion of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

[3] "Safeguarding Advisory Client Assets", SEC Rel. No. IA-6240 (Feb. 15, 2023) (the "Proposing Release").

We agree that the safeguarding of client assets is important and that the Custody Rule has needed improvement for a long time. However, we do not agree that the Proposal is an effective way to achieve our shared goal of appropriately safeguarding advisory client assets. Without identifying a market failure or pervasive deficiency with the current framework, the Commission proposes to expand the current Custody Rule to the entire universe of assets traded by RIAs and their clients. Furthermore, the Proposal should be focused on the risks that RIAs can legally control, not an attempt to address, directly or indirectly, all potential risks in the custody of assets through its regulatory authority over RIAs. We strongly encourage the Commission to reconsider this Proposal, replacing it with one more reasonably designed to the legal and regulatory obligations of RIAs, while protecting the investors they serve.

Notwithstanding RIAs inability to force the industry changes this Proposal would require, we have significant concerns that the Proposal will have negative impacts on funds and investors, as well as likely disrupt certain critical, traditional financial markets in which RIAs and their clients participate. The Proposal would be unnecessarily disruptive and harmful to traditional and emerging markets – including credit markets, over-the-counter ("OTC") derivatives markets, commodities markets (physical and derivative), and prime brokerage arrangements – and is certain to impose significant costs and challenges in transacting in these markets. In many instances, the Proposal would impact markets already subject to comprehensive regulation by other Federal, State or international regulators and that are outside of the Commission's ambit. Furthermore, the Commission engages in no analysis regarding how applying the Proposal would work for a large body of asset classes, instruments and investment practices, seeming to leave this responsibility to the public in a much too short 60-day comment period.

Within the months and weeks prior to issuing such a wholesale reworking of the Custody Rule, the Commission did not hold any public events or roundtables to solicit comments and feedback from SEC registrants as to what aspects of the rule are or are not working and what could be improved. Moreover, and as discussed further below, it appears the Commission also failed to consider and/or at least consult with other financial regulatory agencies as to how the Proposal would impact markets and market participants within their jurisdictions. The Commission presumes that the changes it will require of RIAs can, or will automatically, be accepted as business changes for markets or market participants when there may be no statutory requirement for them to do so. If the Commission had undertaken either of these exercises and not made unwarranted presumptions, it would have hopefully avoided what markets and investors now face with this Proposal.

For some asset types (such as cash, non-securities derivatives, loans and digital assets), the Proposal has the potential to increase, rather than reduce, custodial risks to investors by decreasing the types and number of available custodians and, accordingly, concentrating services in a limited number of custody providers. This would meaningfully increase costs to both RIAs and investors. The reduction in custody providers also has the potential to create additional systemic risks that the SEC actively seeks to avoid, in that the failure of one custodian in a smaller market will have an outsized effect on the rest of the market. The prescriptive operational constraints in the Proposal will also exacerbate

the difficulties presented for non-U.S. managers because of the misalignments in the move to T+1 settlement.

The Proposal vastly expands the definition of custody to include discretionary authority, which consequently expands its application to RIA activities outside of the existing Custody Rule. The Proposal is also much more burdensome than the existing Custody Rule as many more asset classes are included and the detailed operational requirements are insufficiently tailored to address the types of existing assets, much less accommodate new and currently unknown asset types in the future.

Certain assets would be brought under the scope of the rule that a qualified custodian cannot, or most likely would not, hold. When combined with the burdens the Proposal places in connection with assets that cannot be held with a qualified custodian, it effectively limits the types of assets that RIAs (including RIAs dually registered with the Commodity Futures Trading Commission ("CFTC") and other regulators) can trade on behalf of investors. This would have a number of deeply negative impacts, including reducing investor choice and limiting their investment opportunities.

We also have concerns that, if adopted, the Proposal would increase divergence between the position in the U.S. and that of other comparable regimes, which already tend to apply the heaviest safeguarding obligations to financial instruments. The Proposal does not regard or attempt to coordinate with those obligations, which may make doing business in the U.S. less attractive and cause additional difficulties for cross-border arrangements.

Although our concerns with this Proposal are many and varied, our most significant concerns with the Proposal are:

- The Proposal would disrupt critical financial markets.
- The Proposal would disrupt prime brokerage services.
- The Proposal exceeds the statutory authority of Section 223 of the Advisers Act by imposing legal obligations on entities that are beyond the scope of the SEC's jurisdiction. Notably, it does so indirectly through RIAs – who are not clients of the custodian and thus have no owed authority to impose terms and conditions beyond the general duty of care.
- The Proposal's written agreement requirements are overly prescriptive and would likely require the renegotiation of all or most custody and trading agreements across the asset management industry.
- The Proposal's foreign financial institution ("FFI") requirements could prevent RIAs from investing in certain foreign markets.
- The proposed definition of "possession or control" is not a good overarching concept for the safeguarding of client assets, especially as it is conflated with a definition that, by its plain meaning, suggests assets have to be physically maintained by the custodian.

Annex 1 provides further detail on these points and identifies additional concerns.

New asset classes will be particularly challenging to fit into the proposed framework, especially given that the framework does not appropriately deal with existing asset classes, such as digital assets. The safeguarding of client assets and the requirements of this Proposal are a serious concern for our members, and we did not want to risk our response being misinterpreted as a digital assets-specific response. The U.S. needs to remain hospitable to new developments and asset classes rather than forcing them into other, less well developed, less protective markets. This requires a safeguarding regime that allows the SEC flexibility to closely watch the environment and to act if and when needed, while permitting sufficient freedom to allow the safe evolution of the relevant markets. That said, we have included a separate Annex 2 in this letter directed at the specific digital asset-related issues we have noted in relation to the Proposal. While some of these concerns echo the other sections of our response, it is often the case that the nuances of digital assets create additional and specific concerns.

While many of our general concerns (see Annex 1) would also apply to digital assets, our concerns specific to digital assets are:

- SEC examiners should not cite the holding of digital assets in custody outside of a qualified custodian as a violation of the Custody Rule.
- The requirement to continuously hold assets with a qualified custodian without exception is impractical due to digital asset transaction pre-funding requirements.
- A reduction of available qualified custodians to solely Federally chartered firms is untenable due to the resulting lack of competition.
- The proposed definition of "possession or control" would result in fewer options for digital asset trading platforms, which may affect the quality of digital asset markets generally and conflict with an RIA's duty of best execution.
- The Proposal could effectively prohibit staking and the use of decentralized finance (“DeFi”) protocols.
- Because of cybersecurity risks, self-custody with appropriate safeguards may be a safer option in some circumstances and should be treated as a viable option.
- Cybersecurity risks are magnified by the requirement to publicly disclose qualified custodians in Form ADV, especially as it relates to digital asset custodians.

Each of these is discussed in Annex 2.

Finally, as we and other trade associations have recently respectfully submitted to you, we note that this consultation document is 434 pages long and contains 286 multi-part and detailed questions.[4] Accordingly, we believe that the 60-day consultation period provides an insufficient period of time for interested parties to be able to analyze fully the impact of the Proposal with respect to every type of asset and respond to the Proposal in a meaningful way. The Proposal is not the only lengthy and detailed consultation the SEC is currently addressing to the same audience of potential respondents, thereby placing considerable strain on the resources available to most comprehensively and effectively reply to this Proposal.

For these reasons, and the reasons discussed in more detail in the Annexes that follow, we believe the Commission should withdraw the Proposal and engage with the industry to consider targeted changes to the existing custody framework. Only after the Commission has identified a specific need for new requirements and has addressed the many fundamental flaws in the Proposal, should it consider proposing a revised framework.

We would be happy to elaborate further on any of the points raised in this letter. For further information please contact Jennifer Wood, Managing Director of Asset Management Regulation and Sound Practices at jwood@aima.org.

Yours sincerely,

Jiří Król
Deputy CEO, Global Head of Government Affairs
Global Head of the ACC

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

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[4] *See* Letter from 13 Trade Associations to SEC, Request for Extension to the Comment Period for Safeguarding Advisory Client Assets Proposed Rule [Release No. IA-6240; File No. S7-04-23; RIN 3235-AM32] (Mar. 3, 2023).

ANNEX 1

General Concerns

Our concerns with the Proposal are set out in more detail below. Defined terms not defined in this letter have the meanings given to them in the Proposal.

1. The Proposal would disrupt critical financial markets.

The Proposal would greatly expand the scope of "assets" covered by the Custody Rule without considering how such markets operate. The Proposal expands the scope of the Custody Rule to apply to all "assets" to include "funds, securities, or **other positions** held in a client's account" (emphasis added).[5] The expansion of the scope of the rule would effectively cut off RIAs' and their clients' ability to invest in significant financial markets, the trading of which occurs in ways that are not commercially viable under the Proposal. The Commission has not considered, for example, how the proposed custody requirements would apply to OTC derivatives contracts, cleared futures and derivatives, commodities, loans, securities financing contracts and prime brokerage agreements. To the extent market participants could implement the proposed requirements in certain markets, doing so would be costly and provide little, if any, marginal benefit. These costs will ultimately be borne by fund investors, and the market inefficiencies caused by the Proposal and disruption to markets could pose broader risks to the overall U.S. economy.

We have included below several examples of markets that will be materially harmed by the Proposal, where the Commission has engaged in little to no analysis regarding the merits, costs or even practicability of applying the Proposal to these markets. For existing contracts that contemplate investment advice with respect to these types of assets, unless the SEC provides for grandfathering of existing arrangements, the RIA would no longer be able to advise on the purchase of such assets since they could not be held in compliance with the Proposal. The SEC is thereby substituting its own judgment for that of an RIA and its client – a notion that contravenes the fiduciary, principles-based regime that Congress designed under the Advisers Act. Moreover, as with the SEC's Private Fund Adviser Proposal,[6] the SEC imposes its own commercial preferences on agreements negotiated by, in many cases, highly sophisticated institutional and high-net-worth investors.

Bilateral OTC derivatives

OTC derivatives are privately negotiated, bilateral contracts between an advisory client and a counterparty. At the end of June 2022, the global OTC derivatives notional value outstanding was

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[5] Proposed Rule 223-1(d)(1).

[6] SEC, "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews", 87 Fed. Reg. 16886 (Mar. 24, 2022) ("Private Fund Adviser Proposal").

$632.2 trillion with a gross market value of $18.3 trillion.[7] These agreements are typically governed by a master agreement published by the International Swaps and Derivatives Association. In an uncleared OTC derivatives transaction, the client of an RIA and the swap counterparty enter into a bilateral agreement and become responsible for making payments or deliveries to one another under the terms of the applicable transaction. Inserting a qualified custodian into these well-established, bilateral transactions would be difficult, if not impossible. Seemingly, to comply with the Proposal, the qualified custodian would need to become a party to the transaction and that qualified custodian's consent would be required to effectuate any change in beneficial ownership on behalf of the advisory client under the agreement. It is not clear what the qualified custodian's obligations and liabilities under such an arrangement would be. It is also not clear whether qualified custodians would even agree to act in such a capacity in connection with such a transaction.

More broadly, we fail to see any benefits for applying the Proposal to these instruments. OTC derivatives do not pose any meaningful risk of loss, misuse, theft or misappropriation. It is not evident how an RIA could use its authority to redirect the financial benefit of such a contract to itself, and the Proposal contains no explanation or example otherwise.

In addition to the operational uncertainty with respect to the financial contract itself, the Proposal would materially harm the economics of these instruments by extending the safekeeping requirements to all underlying collateral, including collateral traditionally subject to rehypothecation. The Proposal's definition of "assets" would also encompass collateral posted in connection with OTC derivatives. As a result, all collateral posted in connection with such a transaction would need to be held in a segregated account with a qualified custodian. This change would be a significant departure from market practices and the uncleared swap margin rules implemented under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[8] Segregation of variation margin would result in increased transaction costs and worse pricing that will ultimately increase hedging costs and reduce advisory client returns.

Futures and cleared swaps

Exchange traded commodity futures contracts (or options thereon) and cleared swaps would be subject to the expanded scope of the rule. However, the Commission did not make corresponding changes to the definition of "qualified custodian" so that futures commission merchants ("FCMs") are qualified custodians with respect to their futures and cleared swaps businesses. Specifically, the Commission decided to limit FCM's ability to serve as qualified custodians to incidental securities business. Under the Proposal, an FCM is a qualified custodian, "but only with respect to clients' **funds and security futures**, or **other securities** incidental to transactions in contracts for the purchase or

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[7] ISDA, "Key Trends in the Size and Composition of OTC Derivatives Markets in the First Half of 2022" (Dec. 2022), available at https://www.isda.org/a/L6xgE/Key-Trends-in-the-Size-and-Composition-of-OTC-Derivatives-Markets-in-the-First-Half-of-2022.pdf.

[8] Public Law 111-203, 124 Stat. 1376 (2010).

sale of a commodity for future delivery and options thereon" (emphasis added).[9] The Commission failed to analyze how the Proposal would impact the futures and cleared swaps industry, leaving a gap for the ability of an FCM to act as a qualified custodian with respect to transactions and related collateral held by an FCM in relation to cleared swaps and futures. RIAs that trade futures and cleared swaps on their clients' behalf through FCMs would therefore be prevented from doing so under the Proposal because FCMs would not meet the requirements to be considered qualified custodians for such purposes.

Even if the Commission revised the definition of qualified custodian to include FCMs for futures and cleared swaps, it is unclear whether FCMs would agree to provide the representations required by the Proposal (or whether they could do so in compliance with their own applicable regulatory requirements).[10]

Commodities

The Proposal would require an RIA to implement certain procedures for clients' physical assets that cannot be maintained with a qualified custodian. These procedures provide, among other things, for the RIA to enter into a written agreement for an independent public accountant to verify any purchase, sale or other transfer of beneficial ownership of such assets, for the RIA to notify the independent public accountant of the transaction and the independent public account to notify the SEC of any discrepancies within one business day.

This requirement is unworkable for many types of tradeable commodities, including metals, energy, renewable energy certificates and other environmental commodities. It is questionable whether it would be even possible for independent public accountants to hire, train and make available cadres of personnel with the expertise or bandwidth to provide such services, which would require highly specialized technical and engineering capabilities for different commodities markets, or that the charges for providing such services (which presumably would be ultimately borne by the RIA's clients) would be sustainable. Moreover, the costs are increased to the extent that such services are considered non-audit services and therefore would require a different independent public accountant than the one performing the audit. In many jurisdictions, the number of firms that will meet the requirements to be an "independent public accountant" will be limited and finding providers sufficient for fund audits and adviser audits is already a significant challenge without a mandate for non-audit services as well. In sum, the Proposal's application to commodities is unworkable, and, as a result, the promised alternative for physical assets from the qualified custodian requirement is illusory.

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9 Proposed Rule 223-1(d)(1).

10 In this regard, the SEC should consider providing the type of flexibility and contractual alternatives to the one-size-fits-all "possession or control" and contractual requirements in the Proposal currently provided in Rule 17(f)-6 under the Investment Company Act of 1940, as amended (the "1940 Act"), in relation to arrangements with FCMs and commodity clearing organizations.

In addition, many commodities markets are regulated pursuant to other Federal statutory frameworks, often by agencies to which Congress has given exclusive jurisdiction, or they are subject to intrastate administrative or common law. The SEC's attempt to regulate commodities outside of the its competence and also not contemplated by its organic statutes would confuse and upset these existing regulatory and legal frameworks and could harm the broader U.S. economy.

Private securities

Even though the SEC considered and rejected the idea of eliminating the exception for privately offered securities altogether, the new requirements make the exception nearly impossible to rely upon, which may ultimately have a similar effect. To that end, the SEC has not offered a compelling argument that the existing exception is insufficient or that client assets are at risk.

The proposed definition of "private securities" is too narrow. For example, for some asset classes, there will be questions about whether they can even meet the threshold definition of "privately offered securities", much less the detailed procedural requirements for each transaction.

A direct loan originated by a fund (a client of the adviser) would presumably meet the definition's first requirement to be "acquired from the issuer in a transaction or chain of transactions not involving any public offering",[11] but maybe not.

The third prong of the definition (i.e., that the securities are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer) would presumably rest on the terms of the loan, but often loan agreements will contain, at the very least, terms allowing for transfers to successors and assigns. It is not clear whether that sort of up-front contractual consent satisfies (or not) the third prong and whether a more general up-front consent to transfer to third parties would be permitted. The SEC should clarify that blanket up-front consent is sufficient. If it is not sufficient in the SEC's view, it should consider that consent of the borrower or the borrower's shareholders will not foreclose inappropriate transfers to adviser-related entities. Moreover, requiring that consent for legitimate transactions inappropriately interposes regulatory outcomes in commercial transactions, thereby allowing borrowers effectively to hold transfers of loans to ransom, and would likely disrupt the credit markets on which many borrowers rely for their operations.

With respect to the procedural aspects of the exception, RIAs need more detailed guidance from the Commission and the staff about how to make a reasonable determination that either custody cannot be recorded or maintained (as the Proposal states) or that available custody arrangements do not provide protections appropriate to the relevant asset(s) and/or investor(s).

As described above, the proposed independent account verification requirements would also be impractical to administer and likely engender significant costs and delays for certain RIAs, particularly credit fund managers. Over the course of a fund's lifecycle, the fund manager will transfer a significant

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[11] Proposing Release, *supra* note 3, at 129.

volume of loans, including uncertificated loans that would be considered privately offered securities under the Proposal. This could occur in connection with the origination process (e.g., where one fund originates the loan and syndicates a portion of the loan to another fund or party) or where a strip of loans is sold in the ordinary course. Involving an independent public accountant to sign off on each transfer would impose significant administrative burden and cost. The industry has been functioning well without these requirements in place, and there is little concern among practitioners or investors about the custody or safeguarding of these assets. Verification of the assets and cash flow monitoring has been occurring without the intervention of an independent public accountant at each transfer.

Cash

Cash needs to be excepted from the written agreement requirement that the qualified custodian segregate all client assets from its proprietary assets and liabilities. Segregation of cash is problematic as fiduciary bank accounts will significantly increase the amount of cash that must be held intra-day to fund settlement and will significantly increase the cost to investors of maintaining the account. The economics of the arrangement for the bank will be significantly different as the custodian will lose the interest benefits it receives currently from cash accounts, and it will have to hold more capital against the fiduciary cash accounts than it currently does, both of which make it more expensive for the bank to provide that account. Those costs will be passed along to clients. While the fiduciary treatment of cash seems like an idea that will protect clients and investors, we are concerned that, in addition to being more expensive, the treatment of advisory client cash in this manner means that if the bank fails, advisory clients will get all of their cash back before any retail depositor over the FDIC limits (where those apply), which seems a large reputational risk for the industry.

Other

RIAs could also be effectively prevented from trading in other assets classes or transaction types, including participating in repurchase agreements ("repos"), tri-party repos and security forwards. The Commission failed to provide evidence that extending the safeguarding requirements to the above instruments and related collateral is necessary to address a market failure or will meaningfully contribute to investor protections in these markets. Moreover, the Commission's approach of broadly defining "assets" will likely capture many additional assets and markets that have not been considered and, because of the brevity of the comment period, market participants were unable to identify by the comment deadline.

Given the above, the Commission should withdraw the Proposal and engage with the industry to determine targeted improvements that can be made to the existing custody framework.

2. The Proposal would disrupt prime brokerage services.

As discussed above, the Proposal includes a new requirement that RIAs obtain reasonable assurances from the qualified custodian that "the qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified

custodian's proprietary assets and liabilities."[12] This requirement, which does not permit a client to authorize any other practice, would prohibit a broker-dealer or bank acting as a qualified custodian from rehypothecating client assets, which is currently permitted under applicable SEC and banking regulations. Specifically, Rule 15c3-3 under the Securities Exchange Act of 1934, as amended, requires fully paid-for securities to be segregated and kept within a broker-dealer's possession and control but permits *margin securities* (securities held in a margin account) to be de-segregated and rehypothecated to fund cash margin loans to customers. Requiring RIA clients to maintain assets in a segregated account would significantly reduce prime brokers' ability to provide intra-day liquidity and would result in a dramatic repricing of prime brokerage services. The Commission provides no analysis regarding the Proposal's impact on prime brokerage agreements and the potentially disastrous impact this could have on market efficiency.

The Proposal tries to clarify that securities lending and margin accounts (i.e., an account in which a broker lends cash to a client to allow the client to purchase securities) should still be permissible because the SEC has provided a client consent exception to the requirements for the account to remain free from any right, charge, security interest, lien or claim of any kind in favor of the custodian, the RIA, its related persons or their creditors.[13] The ability to authorize liens, however, does not alleviate the other problems created by the Proposal that would disrupt traditional prime brokerage arrangements such as the segregation requirement described above and the requirement that client assets be maintained in a bankruptcy remote account.

In addition to the issues already noted, the Commission must, at a minimum, continue to permit securities lending collateral and margin accounts. The Commission must also permit assets to be hypothecated, pledged or placed in escrow for the account of the client and assets in transit in connection with transactions in assets in the ordinary course of business related to the management of those assets. This should include sales, exchanges, redemptions, maturity, conversions, exercise of rights and warrants, assents to changes in terms or rights and any other type of necessary transaction. Without this type of carveout, many aspects of market infrastructure could grind to a halt as many more market intermediaries (for example, and without limitation, executing brokers, clearing brokers and exchanges) will have to be custodians themselves or a custodian will have to be contractually involved at each in transit step. This would be significantly more custodial intervention than a client could expect when investing without the assistance of discretionary investment advice, and the direct and indirect costs to investors of that extra protection could be high, especially to the extent certain markets and transaction types become inaccessible as a result of the requirements.

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

[13] Proposing Release, *supra* note 3, at 167-68.

3. **The Proposal exceeds the statutory authority of Section 223 of the Advisers Act by imposing legal obligations on entities that are beyond the scope of the Commission's jurisdiction. Notably, it does so indirectly through RIAs who are not clients of the custodian and thus have no authority to impose terms and conditions beyond the general duty of care.**

Section 411 of Dodd-Frank added Section 223 to the Advisers Act, which provides that an RIA shall take steps to "safeguard client assets over which such [RIA] has custody, including, without limitation, verification of such assets by an independent public accountant." Armed with this language, additional legislative context and industry developments that have occurred in the 13 years since Dodd-Frank became law,[14] the SEC has now issued this Proposal in an attempt to "reconsider the important prophylactic protection of the custody rule and to address certain gaps in protections."[15] In doing so, however, the SEC has drastically exceeded its statutory authority under Section 223 by imposing legal obligations on entities over which it has no regulatory jurisdiction.

As discussed above, many aspects of the Proposal could result in a de facto ban on RIAs advising clients with respect to certain asset classes. There is nothing in the statutory language of Section 223 or its legislative history that suggests Congress intended the provision to give the SEC the authority to indirectly ban RIAs from advising on particular asset classes, especially those outside the SEC's jurisdiction, e.g., derivatives, insurance products and non-security digital assets. Therefore, if the SEC moves forward with this Proposal as is, we believe it will be exceeding its statutory authority under the Advisers Act.

Moreover, the Proposal would create a new requirement that a qualified custodian enter into a written agreement with the RIA – who is not the custodian's client – that includes several provisions, most of which direct the qualified custodian to comply with certain requirements and to provide and obtain certain reports and/or records.[16] As the Proposal explains, qualified custodians include State and Federally chartered trusts, banks and savings associations, broker-dealers, FCMs and certain FFIs.[17]

Notwithstanding our concerns with the scope and requirements of the qualified custodian-RIA written agreement, it is surprising to think that the SEC can extend its regulatory powers to entities over which it has no authority. Banks and savings associations are subject to extensive regulation and oversight by Federal or State banking regulators, e.g., the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency ("OCC") or the New York Department of Financial Services, and it is highly unlikely that Congress intended to extend authority over these types of financial institutions to the SEC.

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[14] *See* Proposing Release, *supra* note 3, at 11-12.
[15] *Id.* at 12.
[16] *See* proposed Rule 223-1(a)(1).
[17] Proposing Release, *supra* note 3, at 256. In fact, a small number of large financial institutions dominate the global custodial industry, with four large U.S. banks servicing around $114 trillion of global assets under their custody. *Id.*

4. The Proposal's written agreement requirements are overly prescriptive and would likely require the renegotiation of all or most custody and trading agreements across the asset management industry.

The written agreement requirements are overly prescriptive, and the Commission failed to analyze how the requirements would apply to existing asset classes. This will lead to a shrinking number of available service providers, thus concentrating systemic risk.

The requirements for a written agreement with a custodian are overly prescriptive, and they will be difficult, if not unworkable, and extremely costly to implement. A single fund could have hundreds of custody and trading agreements where the expanded definition of "assets" scope in the rule would require the fund and its adviser to renegotiate existing agreements. If an RIA manages multiple private funds, each of the funds could have different arrangements, multiplying the relevant number of custodians. If it is not possible for some providers to enter into the required agreements, those providers will leave the marketplace, resulting in fewer providers participating in the marketplace and willing to serve as qualified custodians.

We disagree with the Commission's premise that providing a standard set of requirements for agreements will automatically increase the bargaining power of funds and RIAs and that custodians will simply accept these terms. We believe there will be a cost to their acquiescence that will ultimately be harmful to the interests of clients and investors. It may come as a price increase to the client or fund in real dollars. It may come as a withdrawal from servicing certain asset classes or assets from specific countries. It could even come as an overall reduction in the number of available custodians.

RIAs may find it difficult to renegotiate for off-market provisions, such as the Proposal's indemnification provisions, with some custodians. Custodians will be reluctant to accept a negligence standard of liability, especially in relation to their sub-custodial networks. Furthermore, FFI's may be unwilling to accept the requirement to allow the SEC to enforce judgments against them, especially where the entities are not currently in the SEC's direct regulatory jurisdiction. If this happens in a jurisdiction where there are only a limited number of potential providers, even absent the written agreement requirements, clients in those jurisdictions may not be able to have both a custodian in their home jurisdiction and an RIA, effectively curtailing RIAs' and investors' access to investing in such jurisdiction.

The problem is exacerbated with respect to entities which currently do not need to be considered qualified custodians but who will need to be qualified custodians if the Proposal is adopted as is because of common trading, margin and collateral practices. Such entities may be unwilling to engage with the required agreement provisions without revisiting the balance of the terms and pricing for their relationships with the fund and the RIA.

The segregation provisions will break the current methods of holding cash, even in a regular checking account. To be segregated, the cash account must be a special fiduciary type account that will be treated as a liability of the bank and have net capital consequences for the bank. The banks would

also have to forego the interest earned on the deposits. These factors mean that these special segregated accounts are likely to be both expensive and scarce. Moreover, these accounts would have to remain fully funded intra-day to facilitate all pending transaction settlements – a costly exercise exacerbated by the move to T+1 settlement.

The Commission failed to analyze how the written agreement requirements would apply to a variety of asset classes that are now within scope of the rule. For certain specialist asset classes, the handful of existing qualified custodians who provide services for those specialist assets could leave the market entirely with respect to RIA accounts as a result of these overly burdensome requirements. Such an outcome would reduce investor choice while increasing the concentration of systemic risk in the even smaller number of remaining qualified custodians. Rather than achieving its intended goal of protecting investors from loss, the Proposal could harm investors by either increasing the counterparty risks for some strategies or by reducing the number of strategies and investment options they have.

The requirement that all custodians would need to have insurance to indemnify RIA clients for all losses for any negligence, in addition to an agreement for indemnification, is probably infeasible for most asset classes, and we are unaware of any providers with 100% insurance coverage and an indemnity. In particular, with respect to the digital assets market in its current state, the requirement is completely infeasible. The digital assets insurance market is nascent, and no custodians have close to 100% asset coverage.

Qualified custodians should not be liable to the client for negligent acts or omissions of reasonably selected sub-custodians, especially those that are mandatory securities depositaries.

Making the primary custodian liable to the fund at a negligence standard for the acts and omissions of sub-custodians will cause some qualified custodians to significantly curtail the breadth of their custody networks available to the clients of RIAs. Where this retraction includes mandatory securities depositaries in various countries, it will effectively foreclose investments in those markets as RIAs will not be able to deal with such entities directly, and they certainly will not individually be able to get them to agree to the terms required to be considered a direct qualified custodian.

5. The Proposal's FFI requirements could prevent RIAs from investing in foreign markets.

The Proposal would impose costly and potentially unworkable new requirements on FFIs serving as qualified custodians. The requirements would likely limit the number of FFIs eligible to serve as qualified custodians and would allocate significant risks to RIAs related to the client's FFI.

For example, the Commission proposes to require an RIA to determine that its client's FFI holds assets for its customers in an account designed to protect such assets from creditors of the FFI in the event of the insolvency or failure of the FFI.[18] This requirement places on RIAs the responsibility of analyzing

[18] *See* proposed Rule 223-1(d)(10)(iv)(D).

foreign bankruptcy regimes and determining that their client would be able to recover all of their assets in the event of the insolvency of its foreign custodian. This is a significant undertaking and likely subject to ambiguity, even in countries with developed legal and regulatory frameworks.

Similarly, the Proposal would require RIAs to determine that the Commission is able to enforce judgments, including civil monetary penalties, against the FFI.[19] It is unclear how the Commission intends RIAs to make this determination. It would be a significant and costly undertaking to analyze whether FFIs can meet the obligations set forth in the Proposal, to the extent doing so is even possible, which can be expected to disadvantage foreign custodians and disincentivize RIAs and their clients from participating in foreign markets.

The proposed conditions for FFIs exceed the conditions set in the rules under Section 17(f) of the 1940 Act and therefore will unnecessarily limit the markets available to clients. While the newly proposed requirements for FFIs are similar in nature and scope to those set out in Rule 17(f)-5(c)(1) under the 1940 Act, e.g., with respect to enforceability of judgments and requisite financial strength, the Proposal treats these as mandatory requirements as opposed to risk factors to be assessed in the way that Rule 17(f)-5(c)(1) does. This means that there is much less flexibility for RIAs and their clients to use certain FFIs even if the risks have been identified and properly disclosed.

The impact of this difference in approach will be felt most acutely in emerging markets, which have less developed legal and regulatory frameworks than more developed markets. Unless another qualified custodian is willing to have the FFI as a sub-custodian (which is not a certainty given the proposed liability and indemnification standards), clients may be required to forego investment opportunities in markets with the highest potential for growth and have less diversified portfolios overall if they take: (i) no advice; (ii) only the advice of advisers outside the U.S., where this option is available to them; or (iii) only non-discretionary advice. None of these seem like reasonable options, as (i) and (ii) would generally result in clients not being afforded the substantive protections of the Advisers Act at all and (iii) requires the client to take the investment decision out of the hands of the very investment professional they are paying for their professional investment advice. Investors should have access to RIAs for advice, and they should be able to purchase any asset they are qualified to buy. Moreover, they should be able to make informed decisions about taking the relevant risks regarding enforcement of judgments and more.

For prime broker accounts, the requirement that an FFI hold financial assets in an account designed to protect assets from its creditors may be likewise problematic.[20] First, as part of their prime broker business model, FFIs may need to maintain the right to rehypothecate those securities in order to provide financing to their customers, which is not an issue unique to FFIs and would also apply to U.S. prime brokers. As a result, a customer may be an unsecured creditor with respect to the securities held in its prime broker account. Prime brokers have advised us that this is the case, for example,

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[19] *See* proposed Rule 223-1(d)(10)(iv)(A).

[20] Proposing Release, *supra* note 3, at 48.

when the securities are held in a UK bank/dealer that is subject to a title transfer arrangement. Second, it is not clear that all FFIs in all jurisdictions require segregation of client assets from their proprietary assets even for fully-paid securities. Finally, even if there is segregation of assets, the customer may share in any pro rata losses with respect to the FFI's other customers, and, depending on the jurisdiction, it is unclear whether the customer would be protected from claims of other creditors.

The Commission failed to perform any analysis regarding the application of these requirements to various jurisdictions. Nor did the Commission provide market participants adequate time to engage in such analysis. We believe, however, that these requirements would impose significant costs on RIAs and their clients and are likely unworkable in various foreign jurisdictions.

6. **The proposed definition of "possession or control" is not a good overarching concept for the safeguarding of client assets, especially as it is conflated with a definition that, by its plain meaning, suggests assets have to be physically maintained by the custodian.**

The Proposal defines "possession or control" as:

> "***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 the qualified custodian's involvement is a condition precedent to the change in beneficial ownership." (emphasis added)[21]

By using the overarching "holding" concept at the start, the SEC is treating this more like "possession and control" rather than "possession or control", conflating the concept into effectively just "possession". A common synonym of "possession" is "hold", but "hold" is not a common synonym of "control".

The dictionary definitions are also illuminating:

- "Possess" is defined as "to have as belonging to one; have as property; own".[22]
- "Hold" is defined as "to have or keep in the hand; keep fast; grasp" or "to set aside; reserve or retain".[23]
- "Control" is defined as "to exercise restraint or direction over".[24]

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[21] Proposed Rule 223-1(d)(8).
[22] First definition of "possess" when used as a verb as shown at https://www.dictionary.com/browse/possess.
[23] First definition of "hold" when used as a verb used with an object as shown at https://www.dictionary.com/browse/hold.
[24] First definition of "control" when used as a verb used with an object as shown at https://www.dictionary.com/browse/control.

Therefore, the proposed definition falls back entirely on "possess" and "hold" concepts and does not address whether there are appropriate controls that could be used in lieu of "possession" as the "or" in the rule's defined term implies should be possible.

By using terms like "possession" and "holding assets", the SEC has fallen back on concepts that were realistic for custody when the Advisers Act became law in 1940 or when the Custody Rule was first adopted in 1962, periods when client assets were maintained as paper certificates locked in a vault (and counted physically). Either way, they are concepts that are inapplicable to the way assets are maintained today.

Words like "possession" and "hold" do actually mean something, but that cannot be applied to intangibles or contracts such as derivatives that cannot be "possessed" or "held" by the custodian in the common sense. Using these terms guarantees misunderstanding and confusion and runs the risk that they may eventually influence court decisions that do not make any sense in the real world.

7. The concept of "safeguarding" client assets under Dodd-Frank did not mandate a general requirement to have a qualified custodian actually "hold" the assets in physical custody, and the SEC failed to consider other viable potential options to fulfil its Congressional mandate.

We reiterate our request that the Commission withdraw the Proposal and engage with industry on targeted changes to the existing custody framework. Nevertheless, assuming the Commission moves forward with the Proposal, at a minimum, any final rule must include a workable alternative custody framework for assets that cannot be "held" by a qualified custodian. This solution should focus on alternative methods of achieving safeguarding, e.g., through policies and procedures reasonably designed by the RIA to safeguard client assets. This may include, for example, implementation of processes to verify the existence and ownership of particular assets or monitoring cash flows. This may also be accompanied by recordkeeping obligations designed to provide the Commission with evidence that the RIA is complying with its policies and procedures for safeguarding assets.

Section 223 of the Advisers Act states: "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" (emphasis added).

What it means to "safeguard" is not defined in Section 223 or elsewhere in the Advisers Act, and the SEC makes no effort to define it or to differentiate the term from the definition of "custody" or the generic concept of "maintaining client assets" carried over from the Custody Rule and maintained in the Proposal.

Although Section 223 speaks to the RIA having custody, it does not require that another entity have *physical possession* (or true custody) of the assets where the RIA has been deemed to have custody –

it requires "safeguarding" of client assets where the RIA has custody. Moreover, the mandate to "safeguard client assets" does not, on its face, require the definition of "possession or control".

An RIA, for example, could tailor policies and procedures to a specific asset designed to reasonably monitor: (i) the existence of the underlying asset; (ii) transfer of ownership of the asset; (iii) that the asset is reasonably protected from loss or misappropriation while in transit or at rest; and (iv) receipt of the relevant cash flows. In our view, a better starting point is having two broad concepts:[25]

- *Option 1: Custody with a qualified custodian* – The assets are held in the true custody of a qualified custodian subject to the proposed segregation requirements, and perhaps possession or control as defined (although please see our comments on specific difficulties with the three prongs of that definition); or
- *Option 2: Policies and procedures reasonably designed to safeguard client assets* – While we do not believe the Commission has the authority to impose requirements on assets beyond funds and securities, to the extent the Commission proceeds with such a broad application of the rule, the Commission may consider a principles-based approach, requiring RIAs to develop reasonably designed, written policies and procedures designed to safeguard client assets.

8. The proposed definition of "possession or control" does not clearly articulate how RIAs can properly satisfy each prong, nor does it explain if/how the prongs differ from each other.

The Proposal defines "possession or control" as:

> "holding assets such that **[(i)]** the qualified custodian is required to participate in any change in beneficial ownership of those assets, **[(ii)]** the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and **[(iii)]** the qualified custodian's involvement is a condition precedent to the change in beneficial ownership." (romanettes added for emphasis)[26]

On a plain reading, the three apparent prongs of the definition of "possession or control" appear to overlap and imply an active and perhaps pre-transaction role for the qualified custodian. However, the Proposal states:

> "because the qualified custodian would be required to participate in any change in beneficial ownership of a client asset, 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, the proposed possession or control definition would provide assurance to the client that a regulated party who is hired for safekeeping services by the client to

[25] For all assets except digital assets, which are discussed below in Annex 2.

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

> act for the client is involved in any change in beneficial ownership of the client's assets."[27]

This implies that the only relevant part of the definition is the first apparent prong since the second and third apparent prongs flow naturally from the first. Assuming only the first prong is relevant, we wonder what exactly the SEC intends in terms of activities and controls with respect to the requirement for the qualified custodian "to participate in any change in beneficial ownership".

To "participate" in something means in the normal course "to take or have a part or share, as with others; partake; share (usually followed by in)".[28] This could be read to imply (presumably incorrectly) that the custodian has a proprietary interest (which it clearly does not). It could also be read to imply that either the custodian has no say in whether it participates in making the change (if so, why is this written as if it is a control), or the custodian does have a choice about whether to participate (if it does have a choice, then is that not supplanting the custodian's judgment for the RIA's and would the custodian not be technically acting as an RIA?). Or is this simply to say the custodian must be the one to "push the button" to send cash to buy an asset or to release an asset into the trading process? In any case, this is almost impossible in the context of certain types of assets, where it is difficult to contemplate how a qualified custodian would participate in a transaction involving such assets. For those assets, the possession or control concept should not apply.

9. **The SEC should provide further guidance about how an RIA is meant to determine what is a "reasonable commercial standard" in the exercise of due care by a custodian to safeguard assets, especially in relation to new assets classes where a market standard for "appropriate measures" has not developed.**

The "reasonable assurances" include that the qualified custodian will exercise "due care in accordance with reasonable commercial standards" in discharging its duty and will take "appropriate measures" to safeguard client assets. While the SEC helpfully points to Rule 17f-4 under the 1940 Act, given the scope of assets covered by the Proposal, it fails to provide any further guidance as to what would constitute "due care" (and, in fact, acknowledges that this requirement may impose obligations on qualified custodians beyond what is addressed in the Proposal) and how an RIA is supposed to determine what is a "reasonable commercial standard" of due care for, in particular, new asset classes for which there is not a developed market. Furthermore, the SEC recognizes that "appropriate measures" will vary depending on the asset. This lack of guidance increases the potential enforcement risk to RIAs (as well as commercial, and potentially litigation, risk to qualified custodians given the written agreement requirement). Additionally, it further heightens the possibility of an RIA simply deciding not to offer advice with respect to specific assets for which it determines it cannot reasonably (or even possibly) exercise this type of oversight over, and due diligence of, qualified custodians.

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[27] Proposing Release, *supra* note 3, at 282.

[28] First definition of "participate" when used as a verb as shown at https://www.dictionary.com/browse/participate.

10. A provision needs to be made to facilitate combined quarterly statements from multiple qualified custodians to ensure investor understanding.

Under the Proposal, a single fund could potentially be compelled to have dozens of relationships with qualified custodians. For example, a single fund could have:

- A bank holding cash related to subscriptions and redemptions;
- A bank holding cash related to investment transactions and standing ready to make variation margin payments;
- Multiple prime brokers with various rehypothecation and margin arrangements;
- A tri-party custody relationship with a traditional custodian bank related to securities lending;
- Perhaps multiple FCMs in relation to derivatives trades and/or multiple clearing brokers holding initial and variation margin; and
- Relationships with many bilateral derivatives trading counterparties holding initial and variation margin.

The current Custody Rule, by contrast, results in most funds having only one or two qualified custodian relationships. Therefore, investors only receive one or two quarterly statements. The Proposal would require that each qualified custodian send each client/investor in a fund a quarterly statement identifying each client asset in the account at the end of the period and setting forth all transactions in the account during that period (except in connection with those assets held pursuant to an exception). Under the Proposal, a qualified custodian would not be permitted to "identify assets for which the qualified custodian lacks possession or control, unless requested by the client and the qualified custodian clearly identifies any such assets that appear on the account statement".[29]

If the new requirements result in an increase of the average number of qualified custodians per client/fund from one or two to five or, potentially even ten or more, clients and fund investors would receive multiple quarterly statements for relatively small portions of the total assets of the fund and may struggle to make sense of the bigger picture. If the Commission adopts these requirements as proposed, it should consider allowing a primary custodian to include assets in the quarterly statement that have been verified by another qualified custodian (with the qualified custodian of each included asset identified) and avoiding the result of investors receiving a multiplicity of quarterly statements, as well as relieving any secondary custodian's obligation to send a separate statement on the basis of the primary custodian's compliance with the reporting obligation.

Moreover, by not providing for combined statements, the Proposal increases exponentially the privacy, data and cybersecurity risks related to investors' personally identifiable information, as each

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[29] Proposed Rule 223-1(a)(1)(ii)(B).

qualified custodian will need to maintain the names and addresses of all fund investors in order to send the required statement. The act of providing this data to custodians may also violate the privacy rules of certain jurisdictions, depending on where such custodians are located.

11. The proposed transition period must be substantially lengthened as the workload to amend existing agreements and enter into new agreements as required by the Proposal has been significantly underestimated.

The Proposal offers a 12- or 18-month period to come into compliance, determined by the RIA's regulatory assets under management. Neither period is anywhere near enough time, regardless of whether the RIA is a smaller or larger entity. With respect to written agreements alone, the Proposal estimates that each of the 13,944 existing RIAs will need to enter into an average of four written agreements with custodians and each agreement will only take a total of two hours to put in place (one hour for the RIA and one for the custodian).[30] We believe this is an extraordinary underestimation of the time and resources required for an RIA to comply with this element of the Proposal.

More agreements than estimated will be required given the expanded application of the qualified custodian definition, and it is unclear exactly the extent to which they may need to be revised considering other, outstanding SEC rulemakings.

As discussed above, a single fund could have hundreds of custody and trading agreements (see section 10) due to the expanded "assets" scope of the rule, making the written agreement requirements particularly burdensome. If an RIA manages multiple private funds, each of the funds could have different arrangements, further multiplying the number of custodians with which it must have an agreement (taking the total from dozens to hundreds of agreements). RIAs with several separately managed account clients are highly likely to see arrangements with more than four custodians across all of those client relationships. For many RIAs, this would be the largest re-papering exercise they will have ever had to undertake (perhaps in some cases even overshadowing the re-papering exercise foreseen by the Private Fund Adviser Proposal which is also currently pending), and it will be made more complicated because they will be negotiating off-market terms.

The Proposal also fails to address how its contemplated changes would interact with those outlined in the proposed outsourcing rule (the "Outsourcing Proposal").[31] Among other things, the Outsourcing Proposal prescribes a number of requirements that RIAs must undertake with regard to the outsourcing of certain services or functions. The Proposal does not, however, explain whether custody would be considered an outsourced function, i.e., the interaction between the two rules and their aggregate effect has either not been considered or explained – an unfortunate trend that has been commonplace among the dozens of rulemakings the Commission has issued over the past 16-plus months. A failure to harmonize these two rules will only further exacerbate and complicate the incredible re-papering exercise that the Proposal requires. Therefore, we request that a final

[30] Proposing Release, *supra* note 3, at 352.

[31] SEC, "Outsourcing by Investment Advisers", 87 Fed. Reg. 68816 (Nov. 16, 2022).

safeguarding rule exempt custodians from the scope of the Outsourcing Proposal, or, at a minimum, that a final rule provide some guidance on how these two proposals work together vis-à-vis the RIA-custodian relationship.

It may be inappropriate to cover all RIA client relationships in a single written agreement.

The Proposal also assumes that each agreement with a custodian will cover all of the RIA's clients who contract with that custodian.[32] Some custodians will act in different capacities with respect to different RIA clients. For example, one client might be a wealth management client of the bank for which the bank provides custody for the client's separately managed account, and that same bank may be holding cash in a bank account for a fund advised by the RIA – in other words two different types of clients as far as the bank is concerned. The terms memorialized in the written agreement to allow the RIA to "obtain reasonable assurances" and "maintain a reasonable belief" regarding compliance by the bank could reasonably differ between the types of relationships the RIA's clients have with the bank. In such event, it may be inappropriate to cover all the client relationships related to the bank in a single agreement with the bank.

Agreements are likely to take much longer than two hours to put in place unless the SEC is expecting non-negotiable forms of agreement presented by custodians as contracts of adhesion.

While we expect that if the Proposal is adopted, traditional custodians will likely create short, standardized agreements that track the Proposal's requirements, these agreements are likely to be the starting point for a negotiation that is likely to take far longer than the two hours estimated by the Commission in the Proposal.[33] Given the need for the RIA to "obtain reasonable assurances" and "maintain a reasonable belief" regarding compliance by the custodian, RIAs and custodians are likely to want to negotiate over what that will look like in practice. The Proposal could also compel RIAs to demand that client agreements be amended to include the required terms as a direct right of action for the client, as this could provide a higher level of assurance that client assets are being properly safeguarded than a contractual promise the custodian would make to the RIA. This could mean each of the approximately 51,000 private funds advised by RIAs[34] could see all of their written agreements with counterparties, of which there are likely to be many, needing to be revised. Amendments to these agreements will almost certainly not be a simple cut and paste exercise, as the terms required (particularly the indemnification/liability standard) will materially change the overall economics and risk/reward calculus of the arrangement for the custodian and, as a result, will drive changes in the scope and nature of the services the custodian is willing to provide and/or the price it demands for those services.

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[32] Proposing Release, *supra* note 3, at 352.

[33] *Id.*

[34] *Id*. at 383.

No estimate for the time needed for, or the cost of, required changes to client custody agreements is made.

The Proposal acknowledges that the reasonable assurances may need to be memorialized in the client's existing custody agreements, stating in relevant part that "[t]he reasonable assurances requirement could also require conforming changes in ***custody agreements between clients and qualified custodians***" (emphasis added),[35] and they "expect that any related changes a qualified custodian makes to ***a custodial agreement*** to reflect the reasonable assurances provided to the RIA would take approximately [one] hour" (emphasis added).[36] First, as noted above, any changes to the underlying existing client custody agreements are likely to involve far more than one hour of work. Second, although the Proposal estimates an hour for the task, it does not estimate the number of client custody agreements affected or, by extension, the estimated cost of the measly one hour of allocated time to be spent amending them. Instead, the estimates in this section focus solely on the 55,776 estimated new agreements between the RIA and the custodian, not the agreements between the custodian and the client that the SEC acknowledges may need to be amended.

The Proposal estimates that there are approximately 51,000 private funds advised by RIAs.[37] It further estimates that there are approximately 52,690,000 non-investment company client accounts advised by RIAs.[38] If a conservative estimate that only 10% of those agreements would need to be adjusted to comply with the requirements of the Proposal, and that the custodian will spend seven and a half hours, the RIA will spend 10 hours and the client will spend two and a half hours revising those agreements, that results in more than an estimated **105 million hours of effort** (5,269,000 agreements x 20 hours each) – all of which is unaccounted for in SEC's cost-benefit analysis, and all of which will affect the ability to get the necessary arrangements in place within the 12- or 18- month window that would be required under the Proposal.

Written agreements with FFIs and entities safekeeping assets that are not currently subject to the Custody Rule will take longer, if agreed to.

Because they are not currently considered custodians under the Custody Rule, and are therefore presumably unfamiliar with its requirements, education of FFIs and entities safekeeping assets not currently subject to the Custody Rule regarding the requirements of the Proposal (and the related agreement negotiations) will take substantially longer that one hour of time for each of the RIA and the custodian.

For non-U.S. RIAs, many of the custodians they work with are likely to be FFIs. The accounts of clients of those non-U.S. RIAs that will be subject to the Proposal will typically represent a small percentage of the custodian's overall business. This will make it relatively more difficult, if not impossible in some

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[35] *Id*. at 288.
[36] *Id*. at 358.
[37] *Id*. at footnote 27 of Table 10 on p. 383.
[38] *Id*. at 255.

cases, for the non-U.S. RIA to convince the FFI to agree to the prescriptive terms set out in the Proposal, and under the terms of U.S. law versus those of the prevailing jurisdiction.

Agreements with sub-custodians will need to be revisited.

With respect to the negligence standard and indemnity provisions that will be required in an agreement if the Proposal is adopted as issued, a custodian will need to revise any agreement with a member of its sub-custodial network that does not require performance to that standard or, in the alternative, be willing to stand surety for the difference in standards if there is an actionable event. This process will be extremely time consuming because sub-custodial networks include dozens of entities in many different jurisdictions.

More time is required.

In the event existing separately managed account arrangements can be exempted from reasonable assurance/reasonable belief requirements, a total of 24 months to come into compliance should be sufficient. If that grandfathering is not provided, given the sheer number of agreements to be changed, we recommend providing up to 36 months to come into compliance.

ANNEX 2

Digital Assets Concerns

We have set out our digital asset-related concerns with the Proposal in more detail below. Defined terms not defined in this letter have the meanings given to them in the Proposal.

The Proposal, if adopted, will have a profound and adverse impact on the ability for digital assets to be held under any advisory relationship in the U.S. While some have suggested that the Proposal could amount to an implicit ban on digital assets, it is instead more likely to divert holdings of these assets into potentially less well-regulated and safe structures.

While many of our general concerns (see Annex 1) would also apply to digital assets, our concerns specific to digital assets are:

- SEC examiners should not cite the holding of digital assets in custody outside of a qualified custodian as a violation of the Custody Rule.
- The requirement to continuously hold assets with a qualified custodian without exception is impractical due to digital asset transaction pre-funding requirements.
- A reduction of available qualified custodians to solely Federally chartered firms is untenable due to the resulting lack of competition.
- The proposed definition of "possession or control" would result in fewer options for digital asset trading platforms, which may affect the quality of digital asset markets generally and conflict with an RIA's duty of best execution.
- The Proposal could effectively prohibit staking and the use of decentralized finance ("DeFi") protocols.
- Because of cybersecurity risks, self-custody with appropriate safeguards may be a safer option in some circumstances and should be treated as a viable option.
- Cybersecurity risks are magnified by the requirement to publicly disclose qualified custodians in Form ADV, especially as it relates to digital custodians.

Each of these is discussed further below.

1. **SEC examiners should not cite the holding of digital assets in custody outside of a qualified custodian as a violation of the Custody Rule.**

In the Proposal, the Commission claims that most digital assets are likely to be securities, thus obligating RIAs to custody them at a qualified custodian.[39] It has come to our attention that SEC examiners have recently begun to cite RIAs for violations of the Custody Rule if they were not holding the digital assets with a qualified custodian. It is patently unfair to cite these violations.

RIAs have managed these instruments for years without regulatory objection; they have conducted appropriate due diligence on these instruments and concluded they are not securities. The SEC should therefore not use its examiners to enforce a requirement – that digital assets must be held with a qualified custodian – because it is one that is only in proposed form and has not been enshrined into law.

Whether an RIA violated the Custody Rule turns on whether its digital asset investments are, in fact, securities. We suggest that an RIA examination is not the appropriate forum to debate whether a particular asset is (or is not) a security, especially given the SEC's refusal to say which digital assets are securities. At a minimum, examiners considering this kind of violation should identify the asset(s) they believe are securities and explain their rationale in detail for discussion/response by the RIA prior to citing a deficiency.

2. **The requirement to continuously hold assets with a qualified custodian without exception is impractical due to digital asset transaction pre-funding requirements.**

The requirement that all assets would need to stay in the qualified custodial environment throughout the lifecycle of the trade is impractical based on the unique technological elements of digital assets. The real-time settlement of digital assets in most cases requires pre-funding on trading venues or with prime brokers, each of which are not currently qualified custodians.

In order to trade client digital assets, the RIA generally would need to take digital assets out of the account at the qualified custodian (which would often be held in cold storage) and put them in a hot wallet at an exchange, which is often not a qualified custodian, and then move settled assets back to the qualified custodian. The SEC should permit some intra-day exposure for such assets, which is consistent with broker-dealer rules regarding in-transit transactions and allows for best execution. Nonetheless, there could still be operational mismatches due to lags at the custodian, which should not trigger violations of the new requirements or liability for the RIA.

As was noted in section 6 of Annex 1, there should be an exception limited to the in-transit period where assets are permitted to be outside of a qualified custody environment. Without such an exception, the number of available providers will shrink significantly, favoring providers with an affiliated qualified custodian (there are no more than a handful currently at best). This could in turn

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[39] *See id.* at 18, 68.

limit the ability to achieve best execution. Moreover, it would encourage the use of greater leverage as funds may need to rely on borrowed funds extended by the trading platform to conduct trades. Today, the spot digital asset trading market relies on the use of pre-funding, which reduces the need for leverage; however, if pre-funding of trades is effectively banned, then it would increase the need for and the use of leverage. That would make digital asset trading overall riskier, which is unlikely to have been the SEC's intention.

Separately, many custodians currently require 1-2 business days to move assets into or out of cold storage, and the new rule should exempt RIAs from liability for operational delays or contractual deadlines for movement in and out of cold storage imposed by the custodian.

Finally, RIAs have a fiduciary responsibility to seek and obtain best execution for their clients, whether such execution is for securities or non-security digital assets. By requiring that client assets remain in a qualified custodian at all times, the SEC would preclude the use of many digital asset trading venues, including the ones offering best execution. Thus, if adopted as is, the Proposal would force RIAs to violate their fiduciary duties by prohibiting them from obtaining best execution in digital assets for their clients. This was clearly not the SEC's intent; therefore, the Proposal should be revised to allow RIAs to temporarily take digital assets outside of the qualified custodian, thereby allowing them to seek best execution.

3. **A reduction of available qualified custodians to solely Federally chartered firms is untenable due to the resulting lack of competition.**

The question posed by the SEC whether only Federally chartered firms might be considered qualified custodians would create an untenable situation for digital assets investors if addressed in the affirmative. It would also violate longstanding Congressional and Commission policy to treat as equivalent State and Federally regulated financial institutions without justification. As a result, the Proposal generally would raise issues about concentration and competition in this space. Almost no Federally chartered firms offer digital asset custody today, in part because of the onerous capital, accounting and other requirements placed on them for so doing, and the OCC has shown little willingness to grant new Federal charters to digital asset firms. Moreover, the SEC's scepticism of State-regulated entities would appear to be somewhat inconsistent with federalism and the dual banking system.

4. **The proposed definition of "possession or control" would result in fewer options for digital asset trading platforms, which may affect the quality of digital asset markets generally and conflict with an RIA's duty of best execution.**

By narrowing the acceptable execution venues, even for digital assets that are not securities or funds, to an extremely small number that can move assets immediately back and forth to qualified custodians (which in practice is just a handful, if that), investors' ability to get the best price will be negatively impacted. It effectively ensures that investors will not get the benefit of the deepest and most liquid markets since so many execution venues will simply be off limits to them. As of now,

replacing the use of digital assets trading platforms with national securities exchanges or alternative trading systems ("ATSs") to trade digital assets is not possible. There are no national securities exchanges that enable trading in digital assets of any kind. Moreover, existing ATSs have an extremely limited product set (which do not include the vast majority of digital assets that funds would want to trade) that are thinly traded, with very little liquidity in the few tokens they do list.

The definition may also force some otherwise qualified custodians to pull out of certain markets, which will affect availability and cost of custody solutions and, in the extreme, may effectively mean that clients with RIAs will not be able to invest in certain markets. There are today just a handful of qualified custodians that provide services for digital assets. Not enough qualified custodians for digital assets means it would either be impossible or impracticable to pursue many investment strategies involving digital assets, or reliance would have to be placed on the extremely small number of existing qualified custodians, which would concentrate systemic risk in these entities. It would also give these existing qualified custodians even greater market power than they currently have; they already enjoy a near-monopoly, and funds today already have limited options when it comes to engaging qualified custodians in the digital assets space.

On the other hand, allowing non-securities and non-funds digital assets to be held at U.S. domestic regulated digital assets trading platforms (e.g., entities which have obtained a New York Bitlicense and are prudentially regulated in respect of their holding of customer assets) would actually decrease systemic risk by allowing fund assets to be held at a wider number of custodians, thereby diversifying risk, increasing competition and increasing the number of options for funds and their RIAs.

5. **The Proposal could effectively prohibit staking and the use of DeFi protocols.**

The Proposal will negatively affect the ability to stake digital assets on many blockchains and utilize digital assets within DeFi protocols. In particular, the proposed expansion of the Custody Rule to all "assets" would prohibit RIAs from employing direct staking strategies involving self-custody of non-securities/non-funds digital assets. This limits investor choice and instead would force investors and RIAs to use "staking-as-a-service" programs that are operated by third-party qualified custodians who may charge higher fees and may have less technical expertise than the RIA itself has in performing staking activities.

6. **Because of cybersecurity risks, self-custody with appropriate safeguards may be a safer option in some circumstances and should be treated as a viable option.**

For digital assets, where the old saying is "not your keys, not your crypto", in some circumstances it could be safer – and investors may prefer – that an RIA self-custodies digital assets that are not securities or funds in an on-chain wallet with a public key that the RIA discloses to investors and the investors can themselves monitor and verify in real time, rather than depositing the digital assets with a third-party custodian. Assets held at third-party custodians often cannot be verified on-chain, as the assets are typically deposited in omnibus wallets controlled by the exchange as an operational matter; even if the custodian holds them in a segregated wallet exclusive to that investor, the

custodian in some cases may not disclose that wallet's public key to its customers. Given the nascency of the digital asset sector, investors may prefer their RIAs self-custody digital assets that are not funds or securities, given the RIA's technical expertise and personnel who are experienced in handling digital assets, rather than using a third-party qualified custodian that – even if it is licensed and regulated – may not employ policies and procedures or personnel that meet the same standard. An RIA holding private keys is not inconsistent with performance of the fiduciary duty, and denying investors this choice is not ideal and may be contrary to their wishes. Furthermore, permitting an RIA to self-custody digital assets will allow the RIA to trade quickly and efficiently in times of crisis, e.g., the FTX crash.

Today, few, if any, third-party qualified custodians contractually agree to retrieve forked or airdropped assets. Most existing qualified custodians effectively disclaim liability or responsibility to custodial customers in respect of forked or airdropped assets. This is a reasonable commercial imperative for many custodians because they cannot predict in advance how software changes in the blockchain protocol's source code caused by a fork will affect their business or how expensive it will be to build the infrastructure to support the new assets, and they need to protect themselves. But this means that forked assets – which could include the main successor asset – or airdropped assets may simply be abandoned by the qualified custodian with no contractual recourse for either the RIA or the investor. Therefore, requiring RIAs to hold all assets at a third-party qualified custodian at all times would likely mean, in practice, abandoning the forked or airdropped assets. However, permitting RIAs to self-custody forked or airdropped assets would give them greater flexibility to preserve and recover value from these assets for fund investors.

7. **Cybersecurity risks are magnified by the requirement to publicly disclose qualified custodians on Form ADV, especially as it relates to digital custodians.**

The Proposal would require RIAs to identify each private fund's qualified custodians. Given that the concept of "possession or control" appears to favor methods like key sharding or processes where the custodian holds the entire private key, any public disclosure of the identity of the qualified custodian amplifies the cybersecurity (and, frankly, physical security) risks with respect to those digital assets qualified custodians. Why bother with going after funds one by one, when you can seek to steal or misappropriate digital assets from large swathes of the industry at once by targeting a single organization? The disclosure of the identity of the custodians to the SEC on a non-public basis is fine. A requirement to disclose the identity of the custodian to client/investors is also fine. The requirement to disclose this information to the world at large serves no further regulatory or investor transparency purpose and only results in unacceptable cyber risks to clients and investors.