The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 35292

May 8, 2023

ICI Files Comment Letter on SEC's Proposal on Safeguarding Advisory Client Assets

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TO: ICI Members
Chief Compliance Officer Committee
Derivatives Markets Advisory Committee
Investment Advisers Committee
SEC Rules Committee
Securities Operations Advisory Committee SUBJECTS: Investment Advisers
Derivatives
Compliance
Operations RE: ICI Files Comment Letter on SEC's Proposal on Safeguarding Advisory Client Assets

On May 8, ICI filed the attached comment letter on the SEC's proposal on Safeguarding Advisory Client Assets, issued by the SEC on February 15, 2023. The SEC's proposal would amend and redesignate Rule 206(4)-2 under the Advisers Act rule as new rule 223-1 under the Advisers Act, would expand the types of investments covered by the rule and make explicit that custody includes discretionary trading authority.

We stated in our letter that the proposal places onerous new responsibilities on custodians and advisers and provides little evidence that the proposed changes will better protect client assets. For the first time, the Commission would equate an adviser's discretionary trading authority over client assets with having custody of those assets and require advisers, rather than their clients, to enter into a contract with the client's custodian. Our letter opposed these changes because doing so is unnecessary and yet will create a significant number of practical difficulties.

The letter also recommends in several places that the Commission examine and defer to existing regulatory regimes that already adequately protect client assets. For example, the letter encourages the Commission to acknowledge CFTC requirements with respect to derivatives.

Our letter noted several concerns raised by the proposal and offered recommendations that

would protect client assets and better reflect the operational and practical realities associated with safeguarding client assets. ICI's letter made the following recommendations:

- For the first time, the Commission would equate an adviser's discretionary trading authority over client assets with having custody of those assets. We oppose this change because doing so is unnecessary and yet will create a significant number of practical difficulties. Equating discretionary trading with custody could cause advisers to be deemed to have custody over thousands of additional client accounts despite no change in the adviser's relationship with the client. If the Commission nonetheless determines that additional protections should accompany discretionary trading, we recommend that, at a minimum, the Commission:
  - not treat discretionary trading authority as custody provided that an adviser, in reliance on its experience and expertise, designs policies and procedures under rule 206(4)-7; and
  - exempt accounts which are subject to a distinct regulatory regime.
- For the first time, the Commission would require advisers, rather than their clients, to enter into a contract with the client's custodian. We recommend that this element of the rule be eliminated from any final rule. However, if the Commission determines that protections over and above those provided by currently applicable regulatory regimes are necessary, ICI believes that those protections would be most effectively addressed by appropriate policies, procedures, and controls that are reasonably designed, in reliance on the adviser's experience and expertise, to mitigate the risk of misappropriation of client assets.
- The Proposal would require the written contract to specify the adviser's agreed-upon level of authority to effect transactions in the account. This proposed requirement can be read, for the first time, to require the qualified custodian to monitor the adviser's trading activities to ensure consistency with the investment management agreement. We recommend that the proposed requirement for a custodian to monitor an adviser's trades be eliminated from any final rule. This level of custodial oversight would be entirely unworkable, in addition to being unnecessary.
- The Proposal would require an adviser to obtain from custodians certain reasonable assurances - including that they will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the custodian's negligence. We recommend that guidance be provided both as to the scope and amount of coverage that would be required for protection to be deemed "adequate." In this regard, we urge the Commission to carefully consider the reasonable likelihood that such coverage will be commercially available, as well as the anticipated cost of obtaining it. Finally, we recommend that the Commission should allow an investor to waive this requirement.
- The Proposal would require that the adviser obtain written reasonable assurance that the use of any securities depository will not excuse any of the qualified custodian's obligations to the client. The letter points out that qualified custodians are unlikely to agree to provide this assurance. We therefore recommend that this be removed from any final rule. In its place, we suggest that the Commission could adopt an approach similar to the one in Rule 17f-7, which requires a fund's custodian to analyze and monitor the custody risks of using the eligible securities depository.
- The Proposal would modify the conditions for a foreign financial institution to be deemed a qualified custodian, however, the Proposal does not account for the practical realities in foreign markets, which ultimately will reduce investment opportunities and increase costs for investors. We recommend that the Commission

eliminate certain requirements regarding the assessment of foreign financial institutions from any final rule. In its place, we suggest that the Commission could adopt an approach similar to the one in Rule 17f-5.

- The Proposal would define "assets" to mean "funds, securities, or other positions held in a client's account" including financial contracts. There is no practical way for a custodian to "have or otherwise evidence possession or control" of financial contracts themselves based on current market practice. In contrast, client assets maintained in connection with such financial contracts (i.e., margin) can generally be custodied in the traditional sense. The ICI therefore recommends that the Commission not include financial contracts in the definition of "assets."
- The Proposal would require that an independent public accountant verify any purchase, sale or other transfer of beneficial ownership of privately offered securities. This will significantly increase the costs associated with retaining, and strain the capabilities of, independent public accountants. We therefore recommend that this requirement be eliminated from any final rule.
- We support the Commission excepting the accounts of registered investment companies from any final rule and recommend that business development companies and college savings plans should be similarly excepted.
- We recommend that the Commission should except from any final rule shares of any other registered investment company (including shares of closed-end investment companies, shares of interval funds and unit investment trusts) and business development companies held at a transfer agent. Similarly, the Commission should except from any final rule interests in college savings plans.
- We recommend that the Commission allow for a transition period of a minimum of 36 months for all advisers.
- We conclude by encouraging the Commission to engage with ICI and its members, advisers generally, global custodians, independent public accountants and other marketplace participants as it continues to consider how best to protect advisory client assets from theft, loss or misappropriation.

Joshua Weinberg
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