[Securities Regulation Daily Wrap Up, INVESTMENT ADVISERS—Industry pushes back on safeguarding-of-assets proposal, (May 9, 2023)]

Securities Regulation Daily Wrap Up

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SIFMA and the Investment Company Institute believe an SEC proposal on safeguarding advisory client assets is “unworkable” and will only frustrate its stated goals.

Major players in the investment advisory industry are asking the SEC to revisit its proposal on safeguarding advisory client assets. In February, the Commission voted 4-to-1 to propose amending the Advisers Act custody rule to address the new risks that have arisen in the last 14 years. But SIFMA, its Asset Management Group (SIFMA AMG), and the Investment Company Institute (ICI) believe the rule would be overly burdensome and do little to protect client assets, ultimately harming the investors it aims to protect.

SIFMA and SIFMA AMG filed separate comment letters, with SIFMA speaking on behalf of its members that are (or would need to become) qualified custodians of investor assets, as well as investment advisers and other sell-side constituents. SIFMA AMG commented separately on behalf of its registered investment adviser members, while also agreeing with the SIFMA letter. ICI represents mutual funds, ETFs, closed-end funds, and unit investment trusts in the United States, along with funds offered to investors abroad.

An “unworkable” proposal. ICI wrote that the proposal would newly equate discretionary trading authority with custody and require advisers—not their clients—to contract with the client’s custodian. “Requiring advisers to renegotiate existing custodial contracts for their clients will cause great expense and yet the Commission has failed to ground these consequential changes in thorough evidence and careful study and analysis,” ICI wrote. The group draws a lesson from the SEC’s 1997 effort to require foreign custodians to insure fund assets against the risk of loss. The SEC gave up after custodians refused to cooperate, and there is no indication that things will be any different today. For instance, the proposal requires the adviser to obtain assurances that the custodian will indemnify the client, but most custodians today don’t do this and don’t have insurance arrangements in place to accommodate indemnification.

SIFMA believes that the proposal exceeds the SEC’s regulatory authority by imposing contractual terms and obligations on third-party qualified custodians that lie outside the SEC’s authority; expanding the scope of custody to include discretionary trading authority; expanding the definition of assets beyond just funds and securities; intruding on laws governing foreign custodians; and failing to perform a proper cost-benefit analysis. The letter echoes ICI’s concerns that qualified custodians would not agree to the required terms. The requirement that the adviser monitor and know the business of the qualified custodian would distract advisers from their primary function and be overly burdensome, especially on smaller advisers.

ICI and SIFMA see a result where advisers and custodians reduce services and pass costs through to clients. For example, SIFMA believes that under the amended rule, advisers would decline discretionary authority for certain assets. Or as ICI writes, custodians may refuse to offer services in certain markets or with respect to certain assets. In either case, clients will be left to fend for themselves.

The SIFMA AMG letter highlights some of the ways in which the proposal, in the group’s view, overhauls a well-functioning system without accommodating existing products and practices within that system. AMG writes that the requirement to segregate client assets from custodian assets “ignores practical realities of prime brokerage and banking and will functionally eliminate a qualified custodian’s ability to rehypothecate.” The requirement that a custodian exercise “possession or control” doesn’t work with contract-based instruments like derivatives and loans, nor with physical assets like commodities and real estate.

A compressed timeframe. All three commenters take issue with the proposal's short timelines. As Commissioner Hester Peirce objected in her dissent, the rule had a 60-day comment period and contemplates implementation within a year for large advisers and 18 months for small advisers. ICI wrote, "While we have done our best to analyze the Proposal and provide constructive comments in the time provided, the volume and pace of the Commission's rulemaking hinders the ability of ICI and its members to undertake the comprehensive analysis that a proposal of this significance merits." Should the SEC move forward, ICI recommended a transition period of at least 36 months for all advisers.

SIFMA recommended a comment period of 120 days and said that if the proposal is resubmitted for review, which should only happen if it is substantially amended, the implementation period should be at least three years for all advisers and qualified custodians. SIFMA also suggested a three-and-a-half year period for smaller advisers even while disagreeing with the SEC that larger advisers should have less time. SIFMA AMG also joined the call for a minimum three-year implementation period and said that even this timeframe may become infeasible given the role of parties outside the advisers' control.

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