Statement

Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets

Commissioner Mark T. Uyeda

Feb. 15, 2023

Thank you, Chair Gensler. Section 223 of the Investment Advisers Act of 1940 ("Advisers Act") was added in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] It is deceptively simple:

> 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.[2]

Today's proposal is built on the long-standing and complicated existing custody rule first adopted in 1962[3] under the antifraud provisions of Section 206(4) of the Advisers Act.[4] The Commission amended this rule in 2003[5] and in 2009.[6]

The custody rule is intended to protect investors from theft or misappropriation by imposing substantive requirements on the conduct of investment advisers who have custody of client funds or securities.[7] For example, the current rule requires an investment adviser to maintain those funds and securities at a "qualified custodian"[8] and to have a reasonable basis for believing that the custodian sends quarterly account statements to advisory clients.[9] The current rule also requires a surprise annual examination by an independent public accountant with respect to the client funds and securities over which it has custody, subject to certain exceptions.[10]

Over the years, the Commission's staff has issued dozens of frequently asked questions on the custody rule.[11] These questions range from matters as basic as what it means to have "custody" to more complex matters regarding what type of security is a "privately offered security." The answers to these questions can determine how an investment adviser must comply with respect to particular funds or securities.

One goal of this proposal is to address the numerous interpretive questions and the changes in technology, advisory services, and custodial practices that have developed since 2009.[12] While codifying staff guidance and plugging regulatory gaps are worthwhile efforts, I question whether the proposal arrives at the correct outcome in several areas.

First, after making clear that crypto assets are covered by the proposed rule, the proposing release questions whether an investment adviser could ever satisfy the proposed requirements for crypto assets. For example, the proposed rule requires a qualified custodian to maintain possession or control of assets over which an investment adviser has custody. However, the proposing release states that "it may be difficult [for a custodian] to *demonstrate* exclusive possession or control due to [crypto assets'] specific characteristics."[13]

Moreover, the proposing release takes great pains to paint a "no-win" scenario for crypto assets. While banks have developed custodial practices for crypto assets, the proposing release quotes a joint statement from banking regulators that identifies "safety and soundness concerns" with respect to "business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-sector."[14] In other words, an adviser may custody crypto assets at a bank, but banks are cautioned by their regulators not to custody crypto assets. The proposing release further questions whether state-chartered trust companies providing crypto asset custody services – "offer, and are regulated to provide, the types of protections [the Commission believes] a qualified custodian should provide under the rule,"[15] as if to suggest that state-regulated banking entities are less trustworthy than federally-chartered ones.

The proposing release also explicitly states that – because crypto assets trade on platforms that are not qualified custodians – an adviser that trades crypto assets on a platform would violate the proposed rule.[16] Hence, the preamble in the proposing release indicates that it is unlikely that crypto assets can be maintained at qualified custodians or traded on crypto trading platforms in compliance with the proposed rule. How could an adviser seeking to comply with this rule possibly invest client funds in crypto assets after reading this release?

This approach to custody appears to mask a policy decision to block access to crypto as an asset class. It deviates from the Commission's long-standing position of neutrality on the merits of investments. Nevertheless, I prefer having a discussion about crypto assets in the context of notice and comment rulemaking as opposed to enforcement actions. For too long, the Commission's approach to crypto asset regulation has been to use enforcement actions to introduce novel legal and regulatory theories.

Second, this proposal imposes significant new conditions on the types of entities that can qualify as foreign financial institutions. The proposing release states that the conditions are drawn from Rule 17f-5 under the Investment Company Act of 1940, but reflect enhanced investor protections based on the Commission's understanding of market developments.[17] For example, this proposal requires that the Commission be able to enforce judgments, including civil monetary penalties, against a foreign financial institution, which goes beyond what is required by Rule 17f-5. Commenters should provide feedback as to how these enhanced conditions might impact an investment adviser's ability to invest in foreign securities. It would be unfortunate if this provision forces advisory clients to execute trades of foreign securities on their own, without the intermediation of the investment adviser managing their assets.

Third, this rule comes on the heels of a separate Commission proposal regarding outsourcing by investment advisers.[18] The outsourcing proposal introduces a new regulatory regime prescribing the specific manner in which an investment adviser must oversee its service providers. A sentence in the outsourcing proposing release indicates that certain custodial relationships in which an advisory client directly contracts with a custodian would not be covered by the rule.[19] However, that exclusion might be gutted by the proposed custody rule, which requires investment advisers to enter into direct contractual relationships with their advisory clients' custodians.[20] Since the custody proposing release makes no reference to the proposed outsourcing rule, it is unclear if custody is an outsourced function that should be subject to both proposed rules. In the Commission's rush to promulgate a plethora of rules, it would appear on the surface that little thought has be given to how one change interacts with another. At a minimum, the Commission should re-open the comment period of the outsourcing proposal to take feedback on the interaction between the two proposals.

Finally, the proposed rule would require investment advisers to demand certain contractual terms and obtain certain reasonable assurances from qualified custodians. These requirements might disadvantage smaller advisers who may have a more difficult time with implementation. The proposal contemplates a staggered compliance date for smaller advisers and I encourage commenters to provide information as to whether the asset threshold for qualifying for relief, as well as the staggered compliance date itself, are appropriate. For example, at a $2.5 billion threshold, over 95% of total regulatory assets under management held by nearly 2,700 advisers would be covered by the initial compliance date, while the over 12,000 smaller advisers with the remaining 5% would have more time to comply.

Despite these concerns, the safeguarding of client assets is a fundamental provision of the Advisers Act. The Commission should make changes through notice and comment rulemaking. Accordingly, I am supporting this proposal, even though I disagree with a number of provisions contained therein. I encourage commenters to provide views and information on whether the Commission needs to change its approach. I thank the staff in the Divisions of Investment Management and Economic and Risk Analysis, as well as the Office of the General Counsel, for their efforts.

---

[1] Section 411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] 17 CFR 275.223.

[3] Custody or Possession of Funds or Securities of Clients, Investment Advisers Act Release No. 123 (Feb. 27, 1962) [44 FR 2149 (Mar. 6, 1962)].

[4] 17 CFR 275.206(4).

[5] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003) [68 FR 56692 (Oct. 1, 2003)], available at https://www.sec.gov/rules/final/ia-2176.htm.

[6] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1455 (Jan. 11, 2010)], available at https://www.sec.gov/rules/final/2009/ia-2968.pdf.

[7] *See, e.g.,* Investor Bulletin: Custody of Your Investment Assets (Mar. 1, 2013), available at https://www.sec.gov/investor/alerts/bulletincustody.

[8] 17 CFR 275.206(4)-2(a)(1).

[9] 17 CFR 275.206(4)-2(a)(3).

[10] 17 CFR 275.206(4)-2(a)(4) and (b).

[11] *See* Staff Responses to Questions about the Custody Rule, *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm.

[12] *See* Safeguarding Advisory Client Assets, Investment Advisers Release No. 6249 (Feb. 15, 2023) ("Proposing Release"), available at https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

[13] *Id.* (Emphasis in the original.)

[14] *See* Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan 3, 2023), *available at* https://occ.treas.gov/news-issuances/news-releases/2023/nr-ia-2023-1a.pdf

[15] *See* Proposing Release, *supra* note 12.

[16] *Id.*

[17] *Id.*

[18] *See* Outsourcing by Investment Advisers, Investment Advisers Act Release No. 6176 (Oct. 26, 2022) [87 FR 68816 (Nov. 16, 2022)], available at https://www.sec.gov/rules/proposed/2022/ia-6176.pdf.

[19] *Id.*, at 21.

[20] *See* Proposing Release.