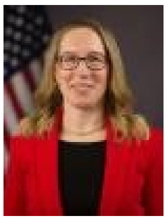
Statement

Statement on Safeguarding Advisory Client Assets Proposal



Commissioner Hester M. Peirce

Feb. 15, 2023

Thank you, Chair Gensler. Safeguarding client assets is at the heart of investor protection. Accordingly, I had anticipated supporting a proposal to amend the custody rule, which, after fourteen eventful years, deserves another update. Significant aspects of the proposed approach and its implementation timeline, however, raise such great questions about the rule's workability and breadth that I cannot support today's proposal. I look forward to hearing from my colleagues today and from commenters during the comment period and hope that I can support the final safeguarding rule.

My first set of concerns is around timing. This rule has broad implications for investors, investment advisers, and custodians. To get it right, we need the thoughtful input of commenters. Comments are due sixty days after publication in the Federal Register, which does not allow the public enough time to analyze all aspects of this proposal, particularly in light of the already loaded rulemaking docket. Moreover, the proposed implementation period—at one year for large advisers and eighteen months for smaller advisers—is too short. This rule will require a lot of work, and a year seems too short to accomplish all of it. I appreciate the extended time for smaller advisers, but even eighteen months seems like an aggressive timeline for the changes contemplated here.

My second set of concerns is around the proposed rule's workability. For example, the rule would require an adviser to enter into a written agreement with and receive certain assurances from the qualified custodian to make sure the qualified custodian provides certain standard custodial protections when maintaining client assets. The Commission "acknowledge[s] that an agreement between the custodian and the adviser would be a substantial departure from current industry practice."[1] Getting custodians to enter into written agreements and provide the required reasonable assurances may be difficult for advisers and costly for clients. Small advisers may have a particularly difficult time complying with these requirements.[2] Another example is the requirement that qualified custodians obtain internal control reports. The release acknowledges that even custodians that now obtain such reports do not necessarily obtain reports that would be broad enough to satisfy our rule. How difficult will it be for qualified custodians to obtain these reports? As a third example, the proposed approach to custody for discretionary trading, whether it settles on a delivery-versus-payment ("DVP") or a non-

DVP basis, is likely to raise significant challenges. Finally, the proposed rule would continue to except privately offered securities from the qualified custodian requirement, but would require the adviser to reasonably determine that ownership cannot be recorded and maintained by a qualified custodian. Proving a negative is difficult; it is unclear how frequently such a determination would have to be made or how far and wide would an adviser have to search for a qualified custodian for these securities?

My third set of concerns is around the proposed approach to crypto custody. The proposal would expand the reach of the custody requirements to crypto assets while likely shrinking the ranks of qualified crypto custodians. By insisting on an asset neutral approach to custody we could leave investors in crypto assets *more* vulnerable to theft or fraud, not less. We run the risk, in the words of the proposing release, of "caus[ing] investors to remove their assets from an entity that has developed innovative safeguarding procedures for those assets, possibly putting those assets at a greater risk of loss."[3] We are instructed not to worry, however, because "[t]hese costs would be mitigated . . . to the extent existing qualified custodians develop, or otherwise acquire, innovative safeguarding procedures for crypto assets, or are able to contract with specialized sub-custodians, as a result of the proposed rule."[4] Other regulatory efforts to dissuade the provision of crypto custody, including Staff Accounting Bulletin 121, would seem to make such developments unlikely.

My fourth set of concerns also relates to crypto. The release seems designed for immediate effect. Specifically, the release states that some advisers "might take the position that crypto assets are not covered by the custody rule at all. This, however, is incorrect because most crypto assets are likely to be funds or crypto asset securities covered by the current rule."[5] The footnote to that statement explains that "The application of the current rule turns on whether a particular client investment is a fund or a security. To the extent there is a question as to whether a particular crypto asset is an investment contract that is a security, the analysis is governed by the test first articulated by the Supreme Court in SEC v. W.J. Howey . . . ."[6] I disagree with the main premise that most crypto assets are securities and the sub-premise that crypto assets sold in a securities offering are necessarily themselves securities. Such sweeping statements in a rule proposal seem designed for immediate effect, a function proposing releases should not play. These statements encourage investment advisers to back away immediately from advising their clients with respect to crypto. More generally, the sweeping "just about every crypto asset is a security" statements also seem to be part of a broader strategy of wishing complete jurisdiction over crypto into existence.

My fifth set of concerns is also jurisdictional. In what is becoming something of a habit,[7] the Commission is once more proposing to dictate contract provisions involving entities the Commission does not regulate. As the release acknowledges, "under existing market practices, advisers are rarely parties to the custodial agreement, which is generally between an advisory client and a qualified custodian."[8] The proposed rule would require that an adviser enter into a written agreement with a qualified custodian and obtain certain assurances, also in writing. The agreement would oblige the qualified custodian to, among other things, send account statements to the client at least quarterly and provide the client with a written internal control report that includes an opinion of an independent public accountant who is registered with the Public Company Accounting Oversight Board, a continuation of our inappropriate attempt to use the PCAOB for a purpose Congress did not assign to it. In addition, the qualified custodian must provide the adviser with reasonable assurance that it will, among other things "exercise due care in accordance with reasonable commercial standards," will indemnify the client against loss of assets in the event of the custodian's negligence, and will segregate "client assets from the qualified custodian's proprietary assets and liabilities."[9] A qualified custodian would have to provide records related to client assets promptly to the Commission upon request. The Commission does not have authority to regulate custodians directly, but we propose to regulate them indirectly. Given our lack of regulatory authority, who would be on the hook if a qualified custodian failed to satisfy these requirements?

A related set of concerns about the proposal arises from overriding private agreements. As we state, “many of these important protections are already provided—through contract or practice—by certain custodians to certain custodial customers in the current market.”[10] In other words, various market participants have negotiated for these conditions, and set their fees based on mutually agreeable allocations of risk and responsibility. We are proposing to insert ourselves into private commercial relationships and, as we say, “formalize the minimum standard of protections to advisory clients’ assets held by qualified custodians in a manner that would provide consistent investor protections across all qualified custodians under our proposed rule.”[11] While our intent is good, the result may impose costs on investors that outweigh the benefits.

Despite my concerns, my admiration and respect for the Commission staff who worked on this initiative remains high. Safeguarding client assets is vital, and the staff’s commitment to ensuring the industry does so is evident in their commitment to this rulemaking. I am grateful for the discussions we had about my many questions and concerns. Thank you to the staff in the Divisions of Investment Management, Examinations, and Economic and Risk Analysis, and the Office of General Counsel. Particular thanks go to Melissa Harke, Chris Staley, and Holly Miller for your patience in our discussions on this rule. As always, I am eager to hear what the commenting public has to say about this proposal, and I hope that I will be able to support this rule on adoption.

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[1] Proposing Release at 77.

[2] *See, e.g.,* Comment letter from the Investor Adviser Association at 8 (Dec. 23, 2022) (“Many large service providers do not offer the option to negotiate their service agreements at all or entertain alternative written documentation that could accommodate the proposed reasonable assurance due diligence requirements. In addition, even in instances where service providers will agree to negotiate terms, many advisers of all sizes and most smaller advisers lack the leverage to negotiate successfully for specific terms.”) https://www.sec.gov/comments/s7-25-22/s72522-20153667-320948.pdf.

[3] Proposing Release at 274.

[4] Proposing Release at 274.

[5] Proposing Release at note 29 and accompanying text.

[6] Proposing Release at note 29.

[7] *See*, *e.g.*, Outsourcing by Investment Advisers, IA Rel. No. 6176 (Oct. 26, 2022); 87 Fed. Reg. 68816 (Nov. 16, 2022), available at: Proposed rule: Outsourcing by Investment Advisers (sec.gov).

[8] Proposing Release at 74.

[9] Proposing Release at 23.

[10] Proposing Release at 42.

[11] *Id*.