May 8, 2023

VIA ELECTRONIC SUBMISSION
Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: Proposed Rule Regarding Safeguarding Advisory Client Assets (File No. S7-04-23)

Dear Ms. Countryman:

The American Investment Council (the "AIC")[1] appreciates the opportunity to comment on the proposal (the "Proposal") by the Securities and Exchange Commission (the "SEC") to amend and redesignate Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 ("Advisers Act").[2] We submit this letter on behalf of our members, which are the world's leading private equity and private credit firms, united by their commitment to growing and strengthening the businesses in which they invest.[3]

We and our members strongly support a robust rule protecting advisory clients' funds and securities. Current rule 206(4)-2 under the Advisers Act has generally proven to do just that. Regrettably, the Proposal misses the mark and ultimately will not facilitate enhanced safeguarding of client assets. On the contrary, it is overbroad and includes provisions that do not accurately reflect current or even realistic market practices. The Proposal does not reflect a consideration of the relative risks of misappropriation of different asset classes in light of the significant new costs

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[1] AIC is an advocacy, communications, and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, AIC develops, analyzes, and distributes information about the private equity and private credit industry and its contributions to the U.S. and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council, AIC is based in Washington, D.C. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

[2] Proposed Rule: Safeguarding Advisory Client Assets, Release SEC No. IA-6240, File No. S7-04-23 (Feb. 15, 2023) (the "Proposing Release").

[3] In this letter, we generally refer to private equity and private credit fund advisers as "private equity advisers" and the funds such advisers manage as "private equity funds." When we refer to an "investment adviser" or "adviser," we mean an investment adviser registered with the SEC.

that it would impose on investment advisers, qualified custodians and advisory clients. Indeed, other than with respect to crypto assets, the SEC has failed to give examples of asset classes where additional regulation is necessary to protect against the risk of misappropriation. The Proposal has several other fundamental flaws, which we discuss below. The net result of the Proposal, if it is adopted, is to risk limiting advisory clients' access to the very qualified custodians necessary to safeguard clients' funds and securities and potentially upend entire asset classes that have proven attractive to investors and provide vital capital to the economy.

For the reasons outlined above and explained in more detail below, we implore the SEC to withdraw this Proposal or, in the alternative, urge the SEC not to adopt the Proposal in its current form and instead propose reforms aimed at addressing custody issues for particular assets where there is the clear potential of misappropriation based upon a thorough analysis. Furthermore, the SEC should reevaluate the Proposal given events involving qualified custodians that occurred in March and April 2023 and remain ongoing,[4] and subsequently reissue a proposal for public comment. In re-considering the Proposal, the SEC should also reassess the lack of a grandfathering provision to address existing investments and custodial relationships and the fact that a one-year compliance period is simply an insufficient amount of time to make changes to those existing arrangements to satisfy the proposed rule.[5]

We also wish to reiterate our concern that the SEC continues to provide insufficient time to evaluate and opine upon significant proposed changes to existing law.[6] This Proposal is the latest example of the SEC's onslaught of rule proposals that provide inadequate time for meaningful public comment and implementation. The cumulative effect of this unprecedented volume of rulemaking on industry participants risks meaningful unintended consequences, such as harming, rather than benefiting, investors. Simply put, given the complexity and scope of the Proposal and the industry altering impacts it would have, it is imperative that the public comment period be extended.

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[4] Under the Proposal and the current Custody Rule, a qualified custodian must be a bank or savings association, registered broker-dealer, registered futures commission merchant, or certain type of foreign financial institution that meets specified requirements.

[5] In re-considering the Proposal, the SEC should extend the compliance period to no less than thirty (30) months to allow for an orderly transition.

[6] The AIC and other major trade associations previously submitted a request to extend the comment period explaining the need for careful consideration given the significance of the Proposal. *See* Letter to SEC Chair Gensler from a broad coalition of trade associations, "Request for Extension to the Comment Period for Safeguarding Advisory Client Assets Proposed Rule" (Mar. 3, 2023), available at www.sec.gov/comments/s7-04-23/s70423-20164520-334415.pdf. See also Letter to the SEC from the New York City Bar Association's Committees on Private Investment Funds and Compliance (Apr. 14, 2023), available at https://www.sec.gov/comments/s7-04-23/s70423-20164235-334055.pdf ("[T]he Committees are concerned that the Custody Rule Proposal, which would have a profound impact on the private fund industry, does not provide relevant stakeholders with sufficient time to analyze and provide meaningful comment to the Commission and its staff.").

Below, we provide a summary of our most critical points, followed by a more detailed explanation of our comments.

Key Takeaways

1. We strongly urge the SEC to reassess, and ultimately re-propose the Proposal in light of ongoing recent events in the banking industry, including the failures of Silicon Valley Bank, Signature Bank and First Republic Bank, and the acquisition of Credit Suisse by UBS, in order for the proposal to adequately reflect market realities.

2. We oppose the Proposal's expansion of the types of client assets subject to the Custody Rule from funds and securities to all assets and "positions" (*i.e.*, everything a private fund or other client invests in) because it is overly expansive, and, in many instances, creates compliance requirements that simply cannot be met. In addition to effectively prohibiting crypto assets in advisory accounts, the Proposal effectively bans other investments that provide attractive returns to investors, and has the effect of eliminating sources of capital for investments that help power innovation and job growth in the American economy.

3. We object to the Proposal's lack of a "grandfathering" provision for existing investments and the short, one-year compliance period. In many cases, compliance with the Proposal would require substantial structural changes to existing investments, including amendments to existing contracts (which may not be agreed by all parties to such contracts), and the participation of third parties. Furthermore, the SEC fails to consider that many types of investments will be impossible to custody. As a result, investment advisers may potentially be forced to liquidate investments prior to the expiration of the compliance period under the Proposal at "fire sale" prices, resulting in investor harm.

4. We oppose the Proposal's changes to the "privately offered securities" exception because they are unnecessary and unworkable. The Proposal would require an adviser to obtain a verification by an independent accountant of each purchase, sale or other transfer of ownership of a privately offered security, after notifying the accountant of such transaction within one business day of the transaction. This requirement is impractical, if not impossible, to satisfy given market realities. In addition, the SEC fails to demonstrate that the current "privately offered securities" exception is insufficient and necessitates an amendment. The Proposal also would require an adviser to create a written determination (investment-by-investment) that ownership cannot be recorded and maintained in a way a qualified custodian could maintain possession or control. The unsupportable burden is not tailored to address an identifiable problem that would otherwise jeopardize client assets, and instead appears designed to eliminate an appropriate exception.

5. We object to the Proposal's requirement that a qualified custodian "participate in" and "effectuate" a transaction involving any change in beneficial ownership of any assets the qualified custodian custodies. This new requirement is particularly impracticable in the context of illiquid assets, such as real estate, pools of loans, contractual payments (*e.g.*, royalties), and receivables, where a qualified custodian would have no role in such a transaction. Such illiquid assets will not qualify for the "privately offered securities" exception and therefore will be subject to this requirement.

6. We oppose the Proposal's requirement that an investment adviser establish a contractual agreement with a client's qualified custodian. The SEC lacks the clear legal authority to regulate certain qualified custodians. The SEC cannot regulate these qualified custodians indirectly by requiring commercial terms be included in the agreement, which would not otherwise exist but for the SEC's own proposed regulatory requirement.

7. We oppose the Proposal's declaration that discretionary trading authority alone results in the adviser having "custody" of client assets. This proposed change would increase costs to investors, while failing to add tangible client protections.

<u>Comments</u>

The following is a more detailed explanation of our comments on elements of the Proposal.

1. **We strongly urge the SEC to reassess, and ultimately re-propose the Proposal in light of ongoing recent events in the banking industry, including the failures of Silicon Valley Bank, Signature Bank and First Republic Bank, and the acquisition of Credit Suisse by UBS, in order for the proposal to adequately reflect market realities.**

Because the Proposal was issued in February 2023, it was not informed by the events involving qualified custodians that began in March 2023 and remain ongoing necessitating extraordinary action by the Federal government.[7] If anything, those events call for more flexibility under Rule 206(4)-2 to address challenges at qualified custodians. At a minimum, the SEC must study those events and re-propose its Proposal, with an informed economic analysis that accounts for the events beginning in March and April 2023.

If a bank faces financial distress, an investment adviser may determine that it is in the best interest of its private fund clients to move the cash holdings at the distressed bank to another bank

[7] *See*, *e.g.*, SVB, Signature Bank Depositors to Get All Their Money as Fed Moves to Stem Crisis, Wall Street Journal (Mar. 13, 2023); The Banking Crisis: A Timeline of Silicon Valley Bank's Collapse and Other Key Events, Wall Street Journal (Mar. 27, 2023); Why First Republic Bank Collapsed, Wall Street Journal (May 1, 2023).

or qualified custodian rather than risk client loss or inability to access cash while the bank is being liquidated. This recently has been a very real concern.

The current Custody Rule already imposes significant challenges to transferring client money when a bank faces financial distress. Creating a new account for each private fund and other advisory client frequently takes many days, often weeks. The SEC should consider providing flexibility under the existing Custody Rule if an investment adviser has reasonable concerns about the financial viability of a qualified custodian.

Instead of expediting the transfer to another qualified custodian, the Proposal would prolong and complicate the process of establishing an account at a new qualified custodian. The required terms of a contract between the adviser and the qualified custodian, which the current Custody Rule does not require, will add time and restraints to establishing a new account in exigent circumstances. At odds with client needs during exigent circumstances, the Proposal would increase the likelihood of client loss and delay access to client funds and securities. These outcomes appear clearly inconsistent with the policy goals behind the current Custody Rule.

By imposing new, far-reaching liabilities on banks that serve as qualified custodians, the Proposal, if adopted, also very likely could increase the likelihood of runs on a bank. Among other requirements, the qualified custodian must agree to indemnify the client against the risk of loss of the client's assets maintained with the qualified custodian in the event of the qualified custodian's own negligence, recklessness, or willful misconduct. If a bank is required to recognize a liability as a result of such indemnification, in particular if it affects multiple client accounts, such a liability could hasten the bank's failure. Furthermore, such indemnification provisions would not appear to afford investor protections during a bank's bout of distress. Even worse, if a bank were placed in receivership, such as we saw with SVB in March 2023, the bank's indemnification clause would become moot.

We urge the SEC to carefully study the ongoing events that began in March 2023, together with the appropriate bank regulators and other regulators that oversee qualified custodians, about these potential effects of the Proposal. We further urge the SEC to provide market participants with an opportunity to comment on any changes the SEC chooses to make to the Proposal in light of such events.

2. **We oppose the Proposal's expansion of the types of client assets subject to the Custody Rule from funds and securities to all assets and "positions."**

The Proposal contains a number of conceptual inconsistencies and factual misunderstandings of the markets that make it unworkable, and make its adoption disruptive for investment advisory clients. The Proposal fails to assess how many types of non-security assets noted below, other than crypto assets, are truly at risk of misappropriation such that the heightened requirements of the Proposal should apply to them. In fact, the Proposal seems to ignore the existence of many types of these investments. To the extent the SEC believes that the Proposal is needed to safeguard ***all client assets*** from misappropriation, the SEC must demonstrate that it has conducted a thorough cost-benefit analysis, including of each of the assets that would be subject to the rule, to support its position. This crucial analysis is missing from the Proposal. As we note throughout this letter, the Proposal will impose great costs on advisory clients without proportional benefits.

While the Proposal addresses physical assets, it fails to consider the wide variety of non-security, non-physical assets and positions that are held by investment advisory clients. It is unclear how holdings such as loans, receivables, funding agreements, and royalties, among many others, could be held in a way that satisfies the requirements of the Proposal. These types of assets are not securities, so the "privately offered securities" exemption is not available to them, and providing the contractual documents that memorialize these investments to a qualified custodian will not satisfy the Proposal's requirements. Moreover, even if the SEC were to expand the "privately offered securities" exemption to include these types of assets, these assets may not necessarily qualify for the exception (for example, if the assets are transferable). Without an ability to custody these assets or usable exception, the Proposal would effectively ban many of the non-physical assets and positions that have historically provided attractive returns to investors and funded innovation, while likely forcing the sale of existing investments at prices that may be unattractive given the Proposal's one-year compliance period.

The Proposing release states that "physical assets, including artwork, real estate, precious metals, or physical commodities (*e.g.*, wheat or lumber), would be within the scope of the proposed rule."[8] Importantly, the Proposal fails to accurately contemplate the real-world challenges of finding qualified custodians that are both willing and able to maintain those physical assets in a manner compliant with the Proposal. For example, qualified custodians for real estate do not exist today and will not exist in the future. It is disingenuous to present this as a viable option when it is not a commercially realistic one. However, it appears that the SEC recognizes this by suggesting that an alternative method of compliance with the custody requirement is for an investment adviser to avail itself of the proposed "privately offered securities" exception with respect to such physical assets. As explained in the next section, the SEC's proposed changes to the "privately offered securities" exception make this completely unworkable too. Consequently, the SEC is creating a situation in which an investment adviser would be unable to comply with the law for the custody of certain physical assets. The SEC is doing so without sufficiently demonstrating the benefits of such a proposal and adequately reflecting the unknowable, but presumably incredible, costs of the untenable situation.

[8] Proposing Release at 28.

The Proposing Release states that crypto assets generally already are subject to the current Custody Rule.[9] But the Proposing Release contains no clear, coherent legal determination that specific crypto assets are in fact securities or funds. Instead, it provides only generalized, unattributed and vague ruminations on the characterization of crypto assets as funds and securities. If the SEC believes specific crypto assets are funds or securities, such a determination should be clear and analytical. It should also be focused on specific crypto assets, not crypto assets as a broad category. Only an analysis and determination by the SEC of the status of specific crypto assets as funds or securities is sufficient to bring those assets within the boundaries of the current Custody Rule, and such analysis should not be conducted within the confines of an unrelated proposed rulemaking. It appears, however that the SEC is seeking instead to subvert this process by asserting broadly that crypto assets already are subject to the Custody Rule, and then proposing to apply the rule to all assets to avoid having to do the hard work of determining whether crypto asset are or are not securities or funds.

The SEC purports that Congress made it clear that the SEC must require investment advisers to maintain custody of all assets when Congress adopted the Dodd-Frank Act. Specifically, the SEC argues that Congress authorized the SEC to promulgate rules to "take steps to safeguard client assets over which advisers have custody."[10] To support its assertion, the SEC cites to a set of settled SEC enforcement cases. Even putting aside that the SEC settled enforcement actions have no precedential value, it is important to recognize that the settled enforcement cases that are identified in the Proposing Release all relate to the alleged misappropriation of client funds and securities and not physical assets or other non-security, non-physical assets. Indeed, other than an attempt at doing so for crypto assets, the Proposing Release

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[9] Proposing Release note 29 and accompanying text ("[C]rypto assets are likely to be funds or crypto asset securities covered by the current rule."). The SEC further identifies short positions and written options for the reason it seeks to apply the Proposal to "other positions," not just assets. *See* Proposing Release note 56 and accompanying text. This is because short positions and written options are not necessarily recorded as assets for accounting purposes. We note that short positions and written options also are subject to the existing Custody Rule, making the distinction between assets and other positions irrelevant as it relates to them.

[10] Proposing Release note 55, citing note 11. The Proposing Release states that Congress authorized the SEC "to promulgate rules requiring registered advisers to take steps to safeguard ***client assets*** over which advisers have custody by adding section 223 to the Advisers Act in the Dodd-Frank Wall Street Reform and Consumer Protection Act." (emphasis added). We note that Congress did not extend this rulemaking authority to "positions" which the SEC recognizes in the Proposing Release are not assets. As a result, we believe the SEC's authority to extend the rule to "positions" is highly suspect. The SEC must also carefully consider commenters assertions that the SEC does not have the authority to extend the Custody Rule beyond funds and securities. *See*, *e.g.*, Public Interest Comment Letter from the Mercatus Center at George Mason University (Apr. 7, 2023), available at https://www.sec.gov/comments/s7-04-23/s70423-20163827-333933.pdf (upon a review of the Dodd-Frank Act and its legislative history, the letter concludes that "the SEC does not have an adequate legal basis to extend the adviser custody rule to any asset not directly within the scope of regulation of investment advisers. That scope depends exclusively on securities and may be widened only slightly to reach cash an adviser receives to buy securities for a client or cash an adviser receives after selling securities for a client.").

does not identify any marketplace failure involving advisory clients' assets that are not funds or securities. As such, the SEC's purported justification for this aspect of the Proposal does not exist.

3. **We object to the Proposal's lack of a "grandfathering" provision for existing investments and the short, one-year compliance period.**

The Proposal only provides for a short one-year compliance period for many investment advisers. As proposed, during this time, investment advisers will have to renegotiate all of their custodial arrangements to include the SEC's required provisions and independent public accountants will need to provide verification of existing holdings. This will certainly contribute to imbalances in pricing power and risks introducing general disarray during the compliance period.

As detailed above, existing qualified custodians may simply refuse to accept the SEC's required provisions and independent public accountants may not be sufficiently resourced to meet the demand. If either of these service providers is unable or unwilling to fulfill those requirements, investment advisers would need to scramble to find an alternative service provider, presumably at a severely disadvantaged negotiating posture, or simply dispose of such holdings.

The SEC's lack of viable pathways for satisfying the revised custody requirements with respect to non-security, non-physical client assets will also mean that investment advisers may need to sell any such assets on behalf of their clients within the one-year compliance period. The timing of these sales may be inopportune and the implicit effective requirement to sell such assets by a date certain will likely result in investments being sold at below market value and/or at a loss, which would harm clients.

We urge the SEC to consider grandfathering in existing custodial arrangements and existing investments and to extend the compliance period following a market study of qualified custodians and independent public accountants.

4. **We oppose the Proposal's changes to the "privately offered securities" exception because they are unnecessary and unworkable.**

Although we recognize that the SEC contemplates expanding the "privately offered securities" exception to include certain physical assets, the proposed exception would be conditioned on such problematic requirements, that the exception would be rendered unworkable even for privately offered securities.

- ***The exception could place an investment adviser in an untenable position – choosing between fiduciary duties or compliance with the requirements of the exception.*** To qualify for the exception, an investment adviser must reasonably determine, and document in writing, that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets. It is not clear how this requirement will operate in practice. For example, it is not clear whether the exception would be available if there is the potential for the ownership to be maintained at a qualified custodian, but only at a prohibitive cost. It also is unclear whether the exception would be available if the investment adviser has concerns about the claimed capability or capacity of all available qualified custodians to maintain the assets. These situations place an investment adviser, as fiduciary, in an untenable position – choosing between undue cost or harm to the client that could come with using such a custodian or the risk of being sanctioned for not complying with the Proposal.

- ***It is not clear how an investment adviser can satisfy the safeguarding condition for certain assets.*** Another condition to the exception requires the adviser to reasonably safeguard the assets from loss, theft, misuse, or misappropriation. While such a condition is intuitive, it is not clear how the adviser would satisfy it for some assets. As just one example, it is not clear for land whether the adviser must hire security teams to protect the property from trespassers, even though they may cause no actual harm to the land. While the exception is conditioned by "reasonableness," that standard can be viewed differently through the perfect lens of hindsight. It is unclear what the SEC expects an investment adviser must do to safeguard the assets against highly unlikely events – such determinations are best made contractually between an investment adviser and its clients (who ultimately pay the cost for the protections), not imposed through vague regulatory requirements.

- ***The requirement that independent public accountants promptly verify the purchase, sale, or other transfer of beneficial ownership of such assets is unworkable.*** Private equity funds frequently invest in privately offered securities and other illiquid or non-tradeable assets. Similar to the difficulties of securing a qualified custodian noted above, it will be impractical for advisers to retain independent public accountants to conduct prompt asset verifications. Due to the sheer volume and unpredictability of when these transactions will occur, independent public accountants effectively would need teams of personnel on standby ready to conduct prompt verifications. Even more troubling, the SEC does not appear to consider that, during the one-year compliance period, independent public accountants will need to verify the existing backlog of assets that are presently held in client accounts. There is simply no reason to impose such an onerous burden on the audit process and the SEC has long recognized an annual audit as sufficient for custody. The Proposal's entire verification construct assumes that independent public accountants will choose to spend the required capital to raise the immense resources to support these activities. Before imposing these requirements, the SEC should consider the likelihood of misuse or theft of these assets. It is hard to understand how privately offered securities representing a controlling stake of a company – a common holding of many private equity funds – can be stolen and misused by the adviser. Certainly, the Proposing Release does not identify and explain any such risk. Similarly, ownership of limited partnership interests (in the case of a fund of funds) or real estate or other physical assets do not lend themselves to theft or misuse. Where the risk of harm is so low, there is no justification to impose burdens to verify the asset or a sale of the asset. The SEC should take a more risk-based approach to the different types of activities that investment advisers undertake for their clients and the relative risk of misappropriation.

- ***The Proposal and the exception do not anticipate many of the types of private equity fund investments, which cannot be maintained by a qualified custodian.*** Many assets held in advisory client accounts would not qualify for the exception because they are not privately offered securities or physical assets. Examples of such assets could include royalties arising from a contractual arrangement, portfolios of loans, and receivables, among others. The Proposing Release does not discuss how such assets should be custodied, or whether any qualified custodian exists for such assets. Based on our members' experiences in seeking custodial arrangements for certain illiquid assets, we believe that qualified custodians would not agree to custody many of these assets. The effect of the Proposal, if adopted, would be to prohibit those assets from client accounts. This is not an appropriate outcome, in particular where the assets are not ones that present risks of theft or misuse.

- ***The requirement that the privately offered security be held in the name of the client in the books of the issuer or transfer agent does not account for the structures in which investments are held.*** Private equity funds frequently invest in assets through special purpose vehicles (SPVs), alternative investment vehicles (AIVs), holding companies and other legal entities that are designed to achieve certain legal, tax or regulatory objectives that are favorable to, and often requested or required by, investors. Without any cogent justification, this new requirement under the Proposal could require investment advisers to use structures that are less favorable and desirable to investors. The SEC did not analyze the costs of these outcomes in the Proposing Release, nor did it identify benefits for doing away with these investment structures. Had the SEC done so, it could only conclude that any potential benefits could not be justified by the disproportionate costs of this aspect of the Proposal. It should be abandoned.

To the extent the SEC wishes to ban certain assets from advisory client accounts, it should do so directly, with ample justification and economic analysis, rather than through vague, unworkable regulatory restrictions.

5. **We object to the Proposal's requirement that a qualified custodian "participate in" and "effectuate" a transaction involving any change in beneficial ownership of any assets the qualified custodian custodies.**

The Proposal would require that an investment adviser maintain client assets with a qualified custodian that has possession or control of those assets. For these purposes, "possession or control" would mean 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.

The Proposing Release states that the qualified custodian must participate in the transaction in a way that it is willing to attest to the transaction on an account statement and for which it customarily takes custodial liability.

This proposed requirement is highly problematic for many types of assets and positions. As explained above, neither the SEC nor we know how a qualified custodian would participate in a transaction evidenced by LLC agreements, LP agreements, loan documents, ISDA agreements, life sciences collaboration agreements, royalty monetizations, funding or royalty agreements, among others. We suspect that it is not possible for the qualified custodian to do so, and that qualified custodians will not agree to such participation. The Proposing Release, however, makes it clear that it would be insufficient for an investment adviser to provide to the qualified custodian the documentation memorializing the arrangement. The proposed requirement that the qualified custodian "participate in" will create uncertainty around the timing of, and even likelihood of closing, a transaction. Furthermore, the sharing of requisite information with qualified custodians, including the underlying contracts, may violate the confidentiality provisions typically found in these types of agreements.

Our members have found that obtaining the services of a qualified custodian can be difficult, even impossible, when assets are not cash or publicly-traded securities. Adding the requirements to participate in and take liability for a transaction just serves to make it more unlikely that the qualified custodian will accept an asset. Many qualified custodians have been unwilling, for example, to take possession of physical documents and act as custodian with respect to asset classes or investments that are not well understood by them. The Proposal would add burdens on the qualified custodian if a change in beneficial ownership is triggered under a funding agreement by the counterparty having reached a certain milestone. In this situation, the qualified custodian would appear to be responsible for interpreting the applicable contractual provisions to confirm the milestone was triggered rather than the investment adviser. We doubt such a requirement will result in qualified custodian becoming willing to custody such an asset. Moreover, given existing investments are not grandfathered into the Proposal, investment advisers likely would be required to amend existing contracts to provide qualified custodians with authority to make these decisions. It is unlikely that third parties would feel incentivized to agree to these changes, which increase investment risk given qualified custodians are not subject matter experts, without receiving additional financial compensation.

This proposed requirement also is highly problematic in light of the ongoing events beginning in March 2023. In practice, the requirement would give a qualified custodian significant control over a transaction that involves moving assets away from the qualified custodian. To the extent the qualified custodian is in financial distress, it would appear to have an incentive not to participate in the transaction, for example a transaction involving a transfer of assets to another custodian. While arguably the beneficial owner is not changing, the qualified custodian may seek to delay or hamper the transfer in an effort to stem its own financial distress.

Based on our review of the Proposing Release, it appears that crypto assets are a significant reason the SEC is seeking to impose the requirement that the qualified custodian participate in a transaction. The Proposal, however, would apply broadly to all assets and positions. As noted above, to the extent that a particular investment is unable to meet all of the criteria set forth in the privately offered securities and physical asset exception, the fund would essentially be unable to invest in that asset class. If the SEC seeks to ban asset classes from investment adviser accounts, it should at a minimum identify those assets, analyze the economic impact of such a ban, and then seek to avoid unintended consequences resulting from application of the rule to assets the SEC did not analyze. The SEC must be upfront and clear in its intentions and analyze the economic consequences of its policy choices. A better option is to not require qualified custodians to participate in transactions involving the assets they maintain.

6. **We oppose the Proposal's requirement that an investment adviser establish a contractual agreement with a client's qualified custodian.**

The Proposal would require an investment adviser to maintain client assets with a qualified custodian pursuant to a written agreement between the qualified custodian and the investment adviser. It would require, among other things, the adviser to obtain reasonable assurances in writing from the custodian regarding certain vital protections for the safeguarding of client assets, the custodian to agree to indemnify clients based on a simple negligence standard, and the adviser to obtain annual internal control reports that include the opinion of an independent public accountant. The Proposal assumes that qualified custodians will agree to these new requirements and develop the necessary capabilities to provide novel custodial services for assets that have not historically been custodied. We question these assumptions and believe that there is the real possibility that the Proposal's effect will be to cause many qualified custodians to stop offering custodial services altogether or only offer them at a price that is dramatically increased when compared to the current market.

As an initial matter, the SEC does not have jurisdictional authority to regulate banks and qualified custodians that are not subject to its regulatory authority. The Proposal seeks to apply back-door regulation to firms outside its ambit by mandating commercial terms between the qualified custodian and an investment adviser, where in practice no contractual relationship would otherwise exist. In our view, this is the very definition of regulatory overreach.

As the Proposal relates to obligations of qualified custodians that are not SEC registrants, it is unenforceable. If the SEC's goal is to have the requisite authority to enforce its rule against these custodians, then it must either work with its regulatory counterparts or seek Congressional authorization. Having apparently done neither, the SEC should abandon or reformulate the effort.

The SEC should not seek to override commercially agreed terms through regulatory fiat. In the Proposing Release, the SEC states that its staff has observed that the clients who are least likely to have bargaining power are often afforded the fewest protections. We agree, yet the effect of the Proposal will be to make the relative bargaining power much worse for investment advisory clients, including sophisticated ones. The Proposal also ignores that many advisory clients and private fund investors are institutional investors or high net worth individuals, and instead would apply a one-size fits all approach as though all such clients are retail investors.

For their part, qualified custodians are likely to resist – understandably – changes to the standard of their liability in custodial agreements, which would effectively require a simple negligence standard to govern these agreements going forward. We strongly suspect that they also will challenge the proposed requirement to indemnify clients for loss. The needlessly prescriptive contractual requirements are inconsistent with market practice and likely to be met with severe resistance by qualified custodians. Investment advisers and their clients will have no way of forcing a custodian to agree to the required terms. Many qualified custodians offer custodial services as an ancillary and non-core product to their main lines of business (*e.g.*, banking or acting as a broker-dealer). To the extent qualified custodians determine that they will not agree to the required terms, they effectively will exit the marketplace for custodial services. This will leave fewer custodians with greater negotiating and pricing power.[11] Hoping for the best that a market will develop should not be the basis for rulemaking that, if the alternative proves to be true, could result in severe investor harm through forced sales or higher custodial fees ultimately borne by clients. It is possible that the unintended consequences of the Proposal severely dislocate the market for custodial services and cause disruption to the entire asset management industry. The

[11] For similar reasons, we also oppose any proposal that would narrow the scope of entities that may serve as qualified custodians (*see*, for example, Question 19). At a minimum, any proposed narrowing should be neutral to the current competitive market for qualified custodians and the definition should be subject to re-proposal and public comment so that the marketplace effect of any such proposal can be evaluated properly.

SEC should, at a minimum, conduct a detailed study of the likely impact of the Proposal on the market for custodial services.

In addition, the Proposal would impose additional conditions on foreign financial institutions ("FFIs") to qualify as "qualified custodians," which would further increase the risk that certain qualified custodians stop offering custodial services altogether or only at a dramatic price increase. FFIs are usually engaged because of regional requirements or restrictions under lending arrangements. The Proposal puts the onus on investment advisers to undertake a qualitative and subjective assessment of these additional conditions (*e.g.*, whether the FFI has in place strong enough procedures designed to ensure the exercise of due care with respect to the safekeeping of client assets) prior to engaging an FFI, which leaves investment advisers at risk of being judged by the SEC in hindsight. For example, if an investment adviser chose Credit Suisse, a reputable and long-standing financial institution, as its qualified custodian, we are concerned that the adviser would then be judged in hindsight given the events affecting Credit Suisse in March 2023. We believe these additional conditions are unnecessary. At the very least, the SEC should limit its proposal to impose additional conditions on FFIs to objective criteria.

7. **We oppose the Proposal's declaration that discretionary trading authority alone results in the adviser having "custody" of client assets.**

The amended custody definition would include any arrangement (including, but not limited to, a general power of attorney or discretionary authority) under which the adviser is authorized or permitted to transfer beneficial ownership of client assets upon the adviser's instruction. As an example, the Proposal contemplates an adviser, using its discretionary authority over a client's assets to instruct an issuer's transfer agent or administrator (*e.g.*, the administrator for a loan syndicate) to sell its client's interest and to direct the cash proceeds of the sale to an account that the adviser owns and controls, thereby depriving the client of ownership, unbeknownst to the client or its qualified custodian. The Proposal would exempt client assets that are maintained with a qualified custodian when the sole basis for the application of the rule is an adviser's discretionary authority that is limited to instructing the client's qualified custodian to transact in assets that settle only on a delivery versus payment (DVP) basis. We note that the Proposal's broad brush approach would encompass many collateral management and separately managed account arrangements unintentionally.

This proposed requirement is not necessary. An adviser already is prohibited under the Advisers Act from misdirecting customer assets to its own account. Extending the definition of custody to discretionary authority alone would seemingly add no additional benefit but would increase costs by requiring entry into a new form of contract with each qualified custodian and audits. If the SEC has observed actual market practices justifying a change to the Custody Rule to address this hypothetical risk, it could address them in a simpler and less costly fashion. The SEC, for example, could require the adviser to provide an attestation to the qualified custodian that the adviser is not the beneficial owner of a receiving account. Any such change, however, should only be considered after the SEC has fully analyzed impact of such a change in events such as the bank failures of March and April 2023.

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The AIC would be pleased to answer any questions that you might have concerning our comments.

Respectfully submitted,

/s/ Rebekah Goshorn Jurata

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