SIFMA & SIFMA Asset Management Group

The Dodd-Frank Underpinnings of the Securities and Exchange Commission's Safeguarding Proposal:

Status Quo Rather than an Expanded Mandate

May 2024

SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

SIFMA's Asset Management Group (SIFMA AMG) brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms that manage more than 50% of global AUM. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg.

INTRODUCTION AND BACKGROUND

Over a year has passed since the Securities and Exchange Commission ("SEC" or "Commission") proposed Rule 223-1 (the "Proposal" or the "Safeguarding Rule").[1]

The Proposal, if adopted, would amend and redesignate current Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to new Rule 223-1 entitled "safeguarding client assets" and impose a wide range of new requirements on registered investment advisers. The Proposal would also impact a wide range of other market participants, including clients, custodians, and broker-dealers. In comment letters to the Commission, SIFMA and the Asset Management Group of SIFMA and others provided extensive feedback.[2]

The Proposal relies heavily on authority the Commission references in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and decades of adviser regulation by the Commission. However, neither mandate or warrant the overhaul of adviser custody.

---

[1] Safeguarding Advisory Client Assets, Investment Advisers Act Release No. IA-6240, February 15, 2023, 46 FR 14672 (Mar. 9, 2023) ("2023 Proposing Release").

[2] See letters from SIFMA and SIFMA AMG, each dated May 8, 2023, and the joint supplemental letter from SIFMA and SIFMA AMG dated October 30, 2023. SIFMA is the leading trade association for broker-dealers, investment banks, and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly one million employees, we advocate on legislation, regulation, and business policy affecting retail and institutional investors, equity and fixed income markets, and related products and services. SIFMA serves as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. SIFMA also provides a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (the "GFMA").

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms that manage more than 50% of global assets under management. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

EXECUTIVE SUMMARY

The Proposal is inconsistent with Dodd-Frank statutory authority and historical precedent for adviser custody regulation in four significant ways:

- The legislative history of Dodd-Frank shows that Section 411 was not a mandate or grant of authority to overhaul adviser custody regulation, but instead was a codification of measures the Commission took in 2009.
- The legislative history of Section 411 shows that there was no Congressional intent to expand the scope of adviser custody beyond "funds and securities" and, therefore, the Commission's intent to regulate such "assets" exceeds its statutory authority.
- Deeming advisers with discretionary trading authority to have "custody" for purposes of the Advisers Act has no legislative foundation and is contrary to over 80 years of investment adviser regulation.
- The Proposal's written agreement and reasonable assurances requirements exceed the Commission's rulemaking authority under the Advisers Act and Dodd-Frank.

SECTION 411 OF THE DODD-FRANK ACT DID NOT GRANT THE COMMISSION ADDITIONAL RULEMAKING AUTHORITY OR MANDATE THAT THE COMMISSION OVERHAUL ADVISER CUSTODY REGULATION

The 2023 Proposing Release references "additional authority that Congress has given us under the Dodd-Frank Act to prescribe investment adviser custody rules."[3] SEC officials have made similar comments in public appearances.[4] This runs contrary to the legislative history of Section 411. Rather than granting new authority or mandating the Commission to take action, Section 411 codified the Commission's existing rulemaking authority and the actions taken in the 2009 custody rulemaking. There was no Congressional intent or direction for the Commission to re-consider the overarching principles of adviser custody or re-define the parameters of what adviser activities constitute custody. There was no Congressional mandate for the Commission to reform or change the practices of bank custodians, either directly or through mandatory contract terms with advisers.

Rather than granting new authority or mandating the Commission to take action, Section 411 codified the Commission's existing rulemaking authority and the actions taken in the 2009 custody rulemaking.

[3] 2023 Proposing Release at 14676.

[4] See, e.g., Comments of SEC Chair Gary Gensler, May 8, 2024 at the 2024 Investment Adviser Association Compliance Conference, March 7, 2024: "After the 08 crisis, but before Dodd-Frank was passed – this Congressional mandate – the SEC updated the custody rule in 2009. But even after that, Congress acted and granted new authority. So this was in the aftermath of Bernie Madoff and other problems that some of you lived through; and that new provision actually spoke to the custody of assets – not just securities and funds – but assets. And so when I came to the SEC, it was 11 years after Dodd-Frank passed,and the team in Investment Management - under multiple directors - had been working on how to address the custody rule, or safeguarding rule, with regard to all assets. That was at the core of what we were looking at. (emphasis added)" ("Gensler May 2024 comments").

The Commission has long exercised authority to promulgate custody rules for investment advisers prior to Dodd-Frank, issuing custody regulations in 1962, 2003, and 2009 under Section 206(4) of the Advisers Act.[5] The Commission adopted enhanced custody rules in December 2009 in response to several high-profile enforcement actions brought against investment advisers.[6] The following July, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act.[7]

Section 411 of Dodd-Frank amended the Advisers Act by adding new Section 223: "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."[8]

Congress drafted the language of this section in the context of the existing regulatory landscape and that theme is reflected in multiple stages of the gestation process.

In April 2010, the Senate Banking, Housing, and Urban Affairs Committee reported favorably on the Restoring American Financial Stability Act, which contained the final adopted language of Section 411.[9] The Committee's accompanying report explained that "Section 411 requires registered investment advisers to comply with SEC rules for the safeguarding of client assets and to use independent public accountants to verify assets. The SEC has recently adopted new rules imposing heightened standards for custody of client assets."[10] The Senate Report recognized the SEC's recently adopted 2009 rules and included no language describing a new grant of authority or mandate to overhaul adviser custody regulation.

Senate Banking Chair Chris Dodd further supported a view of codification rather than overhaul during the Dodd-Frank Conference negotiations. Rejecting provisions from the House Bill which would have mandated the Commission to adopt a new custody framework, Chairman Dodd insisted on maintaining the Senate Bill's custody language, which was ultimately adopted as Section 411.[11]

The Senate Report recognized the SEC's recently adopted 2009 rules and included no language describing a new grant of authority or mandate to overhaul adviser custody regulation.

[5] See "Custody or Possession of Funds or Securities of Clients," Investment Advisers Act Release No. 123 (Feb. 27, 1962), 44 FR 2149 (March 6, 1962) ("1962 Adopting Release"); Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003), 68 FR 56692 (October 1, 2003) ("2003 Adopting Release"); Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968 (Dec. 30, 2009), 75 FR 1456 (January 11, 2010) ("2009 Adopting Release").

[6] 2023 Proposing Release at 14674.

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act.

[8] Dodd-Frank Wall Street Reform and Consumer Protection Act Section 411.

[9] S. 3217, Restoring American Financial Stability Act of 2010 Section 411.

[10] Senate Report No. 111-176, at 76 (Apr. 30, 2010).

[11] Senator Dodd Comments, Conference on Financial Regulations Bill, Day 2, 3:42:32 – 3:43:45, CSPAN https://www.c-span.org/video/?294065-1/conference-financial-regulations-bill-day-2 (Jun.15, 2010); S. 3217, Restoring American Financial Stability Act of 2010 Section 411; H.R. 4173, Wall Street Reform and Consumer Protection Act of 2009, Section 7419; Dodd-Frank Wall Street Reform and Consumer Protection Act Section 411.

Senate Banking Chair Dodd explained the reasoning behind the Senate Bill's custody language:

> "[P]artly in response to the Madoff action, the SEC has already conducted rulemaking in this area. New rules governing the custody of client funds were adopted last December, and we think it would be appropriate to give these new rules a chance to actually work … before we direct the SEC to write some new ones. *The Senate Bill requires investment advisers to follow the new SEC rules, and we believe that's the best approach at this particular junction* (emphasis added)."[12]

Senator Dodd's comments demonstrate that Congress contemplated further substantive changes to the Commission's custody requirements, but decided that the Commission's 2009 rules were sufficient to address custody concerns at the time and the objective was to codify adviser obligations to follow those rules. As Chair of the Senate Banking Committee and titular sponsor of the legislation, Senator Dodd's statement of Congressional intent warrants weight.

"The Senate Bill requires investment advisers to follow the new SEC rules, and we believe that's the best approach at this particular junction."

Further confirming that Congress did not intend expand the Commission's rulemaking authority, the Dodd-Frank Conference Report made no mention of granting additional powers under the Advisers Act. Instead, the Conference Report explained that Title IV of the Dodd-Frank Act "clarifies the SEC's authority to make rules necessary for the exercise of the powers conferred upon the SEC by the IAA."[13] Rather than describing a grant of new or additional authority, the Report explained that the custody provisions of Title IV simply clarified the Commission's rulemaking authority under the Advisers Act. As the Second Circuit has observed, the conference report "is the most persuasive evidence of congressional intent."[14] If Congress intended to expand the Commission's rulemaking authority, the Conference Report would have stated this explicitly.

[12] Senator Dodd Comments, Conference on Financial Regulations Bill, Day 2, 3:42:32 – 3:43:45, CSPAN https://www.c-span.org/video/?294065-1/conference-financial-regulations-bill-day-2 (Jun.15, 2010) (Full quote transcribed: "There are two more provisions that were sent to us by the House. Number eight in their list, for those following this by the list, would strike and replace the Senate provision for custodial assets replaced with the House provision that prohibits an investment adviser from providing custodial services for consumer accounts. The SEC may provide an exception from this prohibition if the consumer assets are verified by an entity that has a fiduciary duty to a client. We in our counteroffer are suggesting, since the House directs the SEC to write rules governing the handling of client funds by investment advisers – this is a very important issue, the Madoff case obviously comes to mind immediately in this particular question – however, partly in response to the Madoff action the SEC has already conducted rulemaking in this area. New rules governing the custody of client funds were adopted last December, and we think it would be appropriate to give these new rules a chance to actually work before we direct the SEC to write some new ones. The Senate Bill requires investment advisers to follow the new SEC rules, and we believe that's the best approach at this particular junction").

[13] H.R. Conf. Rep. 111-517, 2010 U.S.C.C.A.N. 722, 724.

[14] Disabled in Action of Metropolitan New York v. Hammons, 202 F.3d 110, 124 (2d Cir. 2000).

The effect of Section 411 is also memorialized in a November 2010 report issued by the Congressional Research Service. The report, titled "Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act" surveys the rulemaking provisions contained in the Dodd-Frank Act.[15] This report confirms that Section 411 did not contemplate new authority or mandate a material reform of investment adviser custody regulation:

> "Some sections of the Dodd-Frank Act provide financial regulatory agencies with new statutory authority to issue rules. Other sections, however, arguably provide rulemaking authority that the designated agency already possessed. For example, Section 411 of the act amended the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 et seq.) and states that a registered investment advisor 'shall take such steps to safeguard client assets over which such advisor has custody...as the Commission may, by rule, prescribe.' The SEC appears to have had this authority before the Dodd-Frank Act was enacted. *Because the agency's rulemaking authority in this area has not changed, the SEC may decide not to issue any new rules.* On the other hand, the agency may decide to issue new rules in the context of the reforms enacted through the Dodd-Frank Act that are the same as, or similar to, rules that the agency would have issued even if the Dodd-Frank Act had not been enacted (emphasis added)."[16]

"Because the agency's rulemaking authority in this area has not changed, the SEC may decide not to issue any new rules."

Rather than providing the Commission with additional authority, Section 411 delineated rulemaking authority that Commission already possessed. Congress provided that the Commission may prescribe custody rules for investment advisers – as it previously did in 1962, 2003, and 2009. In addition to evidence on the record, there is also a lack of evidence of any other Congressional effort to consider more broadly tackling investment adviser custody. Though Congress held hearings in response to the Madoff Ponzi scheme which addressed concerns regarding affiliated custodians,[17] there were no hearings called or studies conducted specifically on the topic of investment adviser custody that one would expect if Congress intended to significantly expand the Commission's rulemaking authority in this area.

[15] Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congressional Research Service (Nov. 3, 2010).

[16] Id. at 4-5.

[17] Assessing the Madoff Ponzi Scheme and the Need for Regulatory Reform, House Committee on Financial Services (Jan. 5, 2009); Assessing the Madoff Ponzi Scheme and Regulatory Failures, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (Feb. 4, 2009); Oversight of the Securities and Exchange Commission's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance, Senate Banking, Housing, and Urban Affairs Committee (Sep. 10, 2009).

The legislative history of Section 411 shows no evidence that Congress intended to expand the scope of the Commission's rulemaking authority on custody or mandate further rulemaking by the SEC or that the SEC undertake an overhaul of the framework for adviser custody. Instead, the record shows Congressional intent to codify existing rulemaking authority. Describing the Proposal as an effort inspired by or mandated by Section 411 would be misplaced.

Even if Section 411 could be construed to be a mandate, there is no evidence that Congress directed measures of the type and magnitude proposed by the Commission. The Proposal represents a fundamental departure from historical practice and precedent for investment adviser custody regulation with no sign that Dodd-Frank contemplated such a change of course.

The legislative history of Section 411 shows no evidence that Congress intended to expand the scope of the Commission's rulemaking authority on custody or mandate further rulemaking by the SEC or that the SEC undertake an overhaul of the framework for adviser custody.

CONGRESS DID NOT AUTHORIZE THE COMMISSION TO PROMULGATE CUSTODY RULES COVERING ALL CLIENT ASSETS BEYOND FUNDS AND SECURITIES

The 2023 Proposing Release asserts that "Congress authorized the Commission to prescribe rules requiring advisers to take steps to safeguard all client assets, not just funds and securities, over which an adviser has custody."[18] The Proposal references Dodd-Frank Section 411's use of the term "client assets" to show that Congress intended to expand the scope of Commission's rulemaking authority.[19] SEC officials have also referenced Dodd-Frank language as a mandate to expand the scope.[20] However, the legislative history of Section 411 does not support this interpretation.

A. Congress and the Commission Used the Terms "Assets" and "Funds and Securities" Interchangeably

As discussed above, Congress contemplated the Commission's 2009 Custody Rule when drafting Section 411 of the Dodd-Frank Act. Like all Commission adviser custody rulemaking before it, the 2009 Custody Rule amendments governed an adviser's custody of client "funds and securities."[21] In fact, the title of Rule 206(4)-2 and every proposal and adopting release has referenced "funds or securities of clients" since the Rule's inception in 1962.[22]

---

[18] 2023 Proposing Release at 14674.

[19] Id at n. 13.

[20] See, e.g., Gensler May 2024 comments: "After the 08 crisis, but before Dodd-Frank was passed – this Congressional mandate – the SEC updated the custody rule in 2009. But even after that, Congress acted and granted new authority. So this was in the aftermath of Bernie Madoff and other problems that some of you lived through; and that new provision actually spoke to the custody of assets – not just securities and funds – but assets. And so when I came to the SEC, it was 11 years after Dodd-Frank passed,and the team in Investment Management - under multiple directors - had been working on how to address the custody rule, or safeguarding rule, with regard to all assets. That was at the core of what we were looking at. (emphasis added)"

See also comments of SEC Investment Management Director William Birdthistle at the 2024 Investment Adviser Association Compliance Conference, March 7, 2024: "It is a complex area. There's no question. It's very complex. But in many respects, the animation behind the project is somewhat more simple than one might imagine in two respects. The first is keeping people's assets safeguarded is a core tenant. It's exactly what people expect when they're entrusting their assets to an adviser who has a fiduciary obligation. I think that's what people expect. When you have, as was the case when that was approaching the proposal, events like FTX and Silicon Valley Bank, that leads one to great consternation about how much that is happening. Perhaps in particular areas, perhaps in broader ones but that's sort of one animating principle to bear in mind. The other is the Congressional mandate. The language of Section 223 unambiguously uses a phrase that's different. It seems quite obviously broader than funds and securities.(emphasis added)"

[21] 2009 Adopting Release.

[22] See 1962 Adopting Release. See also 2003 Adopting Release and 2009 Adopting Release.

The Commission's own use of the term "client assets" as a shorthand reference to "funds and securities" in the 2009 Custody Rule sets the context within which Congress drafted Section 411. In the 2009 Rule's adopting release, the Commission explicitly stated that:

> "[w]e use the term 'client assets' solely for ease of reference in this Release; *it does not modify the scope of client funds or securities subject to the rule*" (emphasis added).[23]

When the Senate Banking Committee advanced the Restoring American Financial Stability Act in April 2010 (containing the final language of Section 411), it issued an accompanying report.[24] The Committee Report referenced the 2009 Rule, stating "The SEC has recently adopted new rules imposing heightened standards for custody of client assets (emphasis added)."[25] The Committee attached the same meaning to "assets" that the Commission did. If the Committee held a more expansive view of "client assets" beyond funds and securities, its statement would be erroneous, because the Commission explicitly limited the scope of the 2009 Rule to funds and securities. The Senate Banking Committee followed Commission terminology in using the term "assets" as shorthand for "funds and securities."

For justification to expand its scope beyond funds and securities, the Proposal states that earlier versions of Dodd-Frank's custody provisions used the term "funds and securities," referencing Section 419 of the Investor Protection Act of 2009, H.R. 3817.[26] The Proposal suggests that Congress considered retaining the "funds and securities" formulation under this bill, but intentionally opted to enact the more expansive "client assets" language.[27]

However, the legislative history of H.R. 3817 shows that the House also used the terms "funds and securities" and "client assets" interchangeably. The House Committee on Financial Services reported favorably on H.R. 3817 in November 2009.[28] In the Committee's report on H.R. 3817, the Committee summarized Section 419's provisions stating "This section prohibits registered investment advisers from maintaining custody of *client assets* in excess of $10 million dollars, unless the assets are kept by a qualified custodian, maintained in separate accounts under the client's names, or retained in an account of which the investment adviser is the trustee (emphasis added)."[29]

"[w]e use the term 'client assets' solely for ease of reference in this Release; it does not modify the scope of client funds or securities subject to the rule"

If the Committee held a more expansive view of "client assets" beyond funds and securities, its statement would be erroneous, because the Commission explicitly limited the scope of the 2009 Rule to funds and securities.

[23] 2009 Adopting Release at 1456, n.2.

[24] S. 3217, Restoring American Financial Stability Act of 2010 Section 411; Senate Report No. 111-176 (Apr. 30, 2010).

[25] Senate Report No. 111-176, at 76 (Apr. 30, 2010).

[26] 2023 Proposing Release at 14674, n. 16.

[27] Id.

[28] H.R. 3817, Investor Protection Act of 2009, Committee Report at 57.

[29] Id at 86.

The Financial Services Committee used the term "funds and securities" in the bill's text but used the term "client assets" in reference to that language in the bill's summary. This drafting record demonstrates that the House Financial Services Committee used the term "client assets" as shorthand reference to "funds and securities," similar to the Senate Banking Committee when drafting Section 411 and the Commission when promulgating the 2009 Custody Rule.

As previously discussed, during the Dodd-Frank Conference, Senate Banking Chair Chris Dodd opted to retain the Senate language in the final bill because the House bill would have mandated the Commission to promulgate new custody rules.[30] Chairman Dodd explicitly referenced the Commission's 2009 Custody Rule, stating "the SEC has already conducted rulemaking in this area. New rules governing the custody of *client funds* were adopted last December, and we think it would be appropriate to give these new rules a chance to actually work before we direct the SEC to write some new ones (emphasis added)."[31] There was no commentary on expanding the scope of assets. Instead, Senator Dodd's comments reflect the theme of ensuring compliance with the 2009 Custody Rule - the scope of which was limited to "funds and securities."

The Supreme Court explained "Where Congress employs a term of art obviously transplanted from another legal source, it brings the old soil with it."[32] The D.C. Circuit also stated that Congress "is presumed to preserve, not abrogate, the background understandings against which it legislates."[33] Additionally, the Second Circuit has observed "we must presume that Congress acted against the prevailing regulatory backdrop[.]"[34] Here, the legislative history and drafting record of Dodd-Frank Section 411 demonstrate that when using the term "assets," Congress contemplated the existing regulatory understanding of the term, which the Commission explicitly limited to "funds and securities" just six months prior to the enactment of Dodd-Frank.[35]

B. Testimony on Asset Scope Cited in the Proposal Was in a Narrow Context of a Hearing on a Different Subject than Investment Adviser Custody

In support of the proposition that Congress intended to broaden the scope of the custody rule beyond funds and securities, the 2023 Proposing Release states that Congress heard testimony leading up to the enactment of Dodd-Frank "that certain client investments were not covered by the custody rule because they were neither funds nor securities, putting them at greater risk of loss, theft, misappropriation, or being subject to the financial reverses of an adviser."[36] The Proposal cites the testimony of a single witness – Mr. James Chanos – to make this point.[37] Mr. Chanos appeared before House and Senate Committees in 2009 on behalf of the Coalition of Private Investment Companies to discuss legislative proposals which would repeal the "private fund exemption" under the Advisers Act.[38] Mr. Chanos argued that "[m]any requirements of the Advisers Act are irrelevant, or would be counter-productive" for private funds.[39] As an illustration, Mr. Chanos described the types of assets not subject to the Custody Rule under the existing framework.[40]

---

[30] Senator Dodd Comments, Conference on Financial Regulations Bill, Day 2, 3:42:32 – 3:43:45, CSPAN https://www.c-span.org/video/?294065-1/conference-financial-regulations-bill-day-2 (Jun.15, 2010).

[31] Id.

[32] George v. McDonough, 142 S. Ct. 1953, 1959 (2022) (Internal quotation marks omitted).

[33] Fisher v. Pension Benefit Guar. Corp., 994 F.3d 664, 671 (D.C. Cir. 2021).

[34] Bloom v. Azar, 976 F.3d 157, 163 (2d Cir. 2020).

[35] 2009 Adopting Release at 1456, n 3.

[36] 2023 Proposing Release at 14674.

[37] Id at n.14.

[38] Regulating Hedge Funds and other Private Investment Pools, Hearing Before the Senate Subcommittee on Securities, Insurance, and Investment, 111 Cong. (2009); Perspectives on Hedge Fund Registration, Hearing Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, 111 Cong. (2009).

[39] Regulating Hedge Funds and other Private Investment Pools, Hearing Before the Senate Subcommittee on Securities, Insurance, and Investment, 111 Cong. at 50 (2009).

[40] "The rules exclude from custody requirements certain types of instruments that are commonly owned by private investment funds, an exclusion that would deprive investors in those funds of the protection that a custodian provides." Id.

Instead of repealing the private funds exemption and requiring private funds to comply with all Advisers Act provisions, Mr. Chanos urged Congress to enact tailored legislation that "offers a creative and flexible approach to regulating private fund managers."[41] Mr. Chanos urged the adoption of a new "Private Investment Company Act, a statute tailored specifically to address the unique nature of private funds."[42] A key element of such a statute would be "provisions to reduce the risk of Ponzi schemes and theft by requiring managers to keep all client assets with qualified custodians and requiring audits by independent public accounting firms overseen by the PCAOB."[43]

The overarching theme of Mr. Chanos' testimony was that a specific and narrowly tailored regulatory framework was necessary for private fund advisers due to the unique characteristics of private funds.[44] Mr. Chanos did not testify in support of a proposal to overhaul investment adviser custody regulation or a proposal to expand the scope of current regulation beyond funds and securities. The hearing was not called to address investment adviser custody regulation.

There may be discussion to be had on the merits of private fund regulation, but hearing testimony from a witness in a separate context is not evidence of Congressional intent to expand the scope of assets covered under the Advisers Act beyond "funds and securities" for all advisers.

C. The Proposed Rule's Interpretation of the Term "Assets" Exceeds the Commission's Statutory Authority Under the Advisers Act

While the legislative history of Dodd-Frank Section 411 demonstrates that Congress did not intend to expand the scope of assets subject to the SEC's rulemaking authority, an expansive interpretation of the term "assets" also cuts against established principles of statutory interpretation. The Supreme Court has explained: "It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme."[45]

The Proposal asserts that the term "assets," contained in Section 223 of the Advisers Act, should be read to grant the Commission authority to regulate "all client assets, not just funds and securities, over which an adviser has custody."[46] However, the overall statutory scheme of the Advisers Act is predominantly concerned with the regulation of *securities*. The initial findings of the Advisers Act discuss investment adviser involvement with *securities*, the Act defines covered investment advisers based on whether their work involves securities, and the Act expressly preserves some state authority over *securities*.[47] Where the Advisers Act uses the term "assets," the relevant assets are securities.[48]

The overall statutory scheme of the Advisers Act is predominantly concerned with the regulation of securities. The initial findings of the Advisers Act discuss investment adviser involvement with securities, the Act defines covered investment advisers based on whether their work involves securities, and the Act expressly preserves some state authority over securities. Where the Advisers Act uses the term "assets," the relevant assets are securities.

---

41 Id at 16 (2009).

42 Id; S. 1276, Private Fund Transparency Act of 2009, Sec. 6.

43 Regulating Hedge Funds and other Private Investment Pools, Hearing Before the Senate Subcommittee on Securities, Insurance, and Investment, 111 Cong. at 16 (2009).

44 Despite his advocacy, a standalone Private Investment Company Act was not enacted by Congress. Dodd-Frank Wall Street Reform and Consumer Protection Act, Title IV.

45 Davis v. Michigan Dept. of Treasury, 489 U. S. 803, 809 (1989); West Virginia v. EPA, 142 S. Ct. 2587, 2607 (2022).

46 2023 Proposing Release at 14674; 15 U.S.C. 80b-18b.

47 15 U.S.C. §§ 80b-1, 80b-2(a)(11), 80b-18a.

48 15 U.S.C. § 80b-3a(a)(3).

Despite this limited scope under the Advisers Act, the Proposal would cover "all client assets" - including assets regulated exclusively under competing statutory frameworks established by Congress. For instance, the Federal Energy Regulatory Commission ("FERC") has "exclusive jurisdiction" over the trading of electricity and natural gas in interstate commerce, and the Commodity Futures Trading Commission ("CFTC") has "exclusive jurisdiction" over "transactions involving swaps or contracts of sale of a commodity for future delivery."[49] However, the Proposal would still cover adviser activities relating to these transactions. If Congress intended to modify these grants of exclusive jurisdiction, it would have done so expressly rather than through an implicit expansion of the SEC's authority under the Advisers Act.

The Supreme Court has recently held that agencies must demonstrate "clear congressional authorization" when asserting rulemaking authority in instances of great "economic and political significance."[50] As we have raised in previous comments, the proposed Safeguarding Rule's regulation of "all client assets" would have substantial economic ramifications for clients, financial markets, and the asset management industry more broadly.[51] Additionally, the Proposal's attempt to regulate all client assets held by investment advisers is of significant political interest given broader ongoing policy debate regarding the proper treatment of certain digital assets.[52] Given this economic and political significance, the lack of clear congressional authorization to regulate all client assets is salient, especially as the overall statutory context of the Advisers Act focuses on "securities" rather than "assets."

If Congress intended to modify these grants of exclusive jurisdiction, it would have done so expressly rather than through an implicit expansion of the SEC's authority under the Advisers Act.

[49] Hughes v. Talen Energy Mktg., LLC, 578 U.S. 150, 153 (2016); Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 300-01 (1988); 7 U.S.C. § 2(a)(1)(A); Hunter v. FERC, 711 F.3d 155, 158 (D.C. Cir. 2013).

[50] *West Virginia*, 142 S. Ct. at 2608, 2609.

[51] See SIFMA AMG Comment Letter Re: Safeguarding Advisory Client Assets at 6 (May. 8, 2023); SIFMA Comment Letter Re: Safeguarding Advisory Client Assets at 15 (May 8, 2023).

[52] Jason Brett, *Congress Has Introduced 50 Digital Asset Bills Impacting Regulation, Blockchain, and CBDC Policy*, Forbes (May. 19, 2022), https://www.forbes.com/sites/jasonbrett/2022/05/19/congress-has-introduced-50-digital-asset-bills-impacting-regulation-blockchain-and-cbdc-policy/?sh=bfdf7a94e3f0; FACT SHEET: White House Releases First-Ever Comprehensive Framework for Responsible Development of Digital Assets, The White House (Sep. 16, 2022) https://www.whitehouse.gov/briefing-room/statements-releases/2022/09/16/fact-sheet-white-house-releases-first-ever-comprehensive-framework-for-responsible-development-of-digital-assets/.

D. Rulemaking Considerations from an Expansive Scope

Even if the term “assets” were to be construed beyond “funds and securities,” the Commission would still be required to assess whether applying the requirements of a proposed rule to each individual class of assets is necessary and appropriate. This is especially relevant considering the various safeguarding requirements that certain asset types are already subject to under other regulatory regimes. In promulgating a broad definition of the term “assets,” the Commission would thus be required to weigh the costs and benefits of applying the Proposal’s requirements to the various types of assets captured under such a definition.

Any final rule adopted must be consistent with the requirements of the Administrative Procedure Act. As recently put by the D.C. Circuit, “To comport with the APA’s notice-and-comment requirements, an agency’s final rule must be a logical outgrowth of the version set forth in its notice of proposed rulemaking.”[53] Modifications to the scope of assets in a final rule must be a logical outgrowth of the Proposal. A final rule that attempts to establish varying requirements for asset classes would risk adopting substantively new requirements without providing the opportunity for notice and comment. Such changes would not be a logical outgrowth of the Proposal.

RE-DEFINING CUSTODY TO INCLUDE DISCRETIONARY TRADING AUTHORITY HAS NO BASIS IN CONGRESSIONAL INTENT OR HISTORICAL PRECEDENT

Dodd-Frank Section 411 authorized the Commission to prescribe rules to safeguard client assets “over which such adviser has custody.”[54] The language includes no mandate to expand the concept of “custody” or what it means for an adviser to have “custody.” Rather, the clause “over which such adviser has custody” serves as boundary to the Commission’s rulemaking authority under Section 411. Congress authorized the Commission to promulgate new rules to safeguard client assets, provided that the assets in question are held in the custody of an investment adviser. By expanding the definition of custody to include discretionary trading authority, the Proposal would reverse long held SEC interpretations and exceed the understanding of the term held by Congress at the time of Section 411’s enactment.

As referenced above, the legislative history shows the intent to codify the SEC’s existing authority and approach in the 2009 Custody Rule. Accordingly, Section 411 continues the SEC’s historical approach rather than authorizing or mandating a materially different approach. In particular, re-defining “custody” to include discretionary trading authority would be a material departure from decades of investment adviser regulation and conflates the role of providing advice with the role of holding funds and securities. There is no support in the history of adviser custody regulation for the proposition that discretionary trading authority should constitute custody. To the contrary, the SEC previously considered and rejected such an approach.

In particular, re-defining “custody” to include discretionary trading authority would be a material departure from decades of investment adviser regulation and conflates the role of providing advice with the role of holding funds and securities.

[53] *Brennan v. Dickson*, 45 F.4th 48, 69-70 (2022).

[54] Dodd-Frank Wall Street Reform and Consumer Protection Act Section 411.

The long held regulatory understanding of adviser custody should not be reversed absent a compelling need or mandate. No such mandate is found in Dodd-Frank Section 411. Rather, Congress's explicit use of the term custody in reference to the limit of the Commission's rulemaking authority further cemented the understood regulatory definition at the time. The Proposal's expanded definition of custody not only reverses long established understandings, but also exceeds the authority described under Section 411.

A. 1940 – Custody Before and After Passage of the Investment Advisers Act

Before the Investment Advisers Act of 1940, investors sought financial services from investment banks, brokerage houses, trust companies, and lawyers. Investment advice was considered ancillary to other services. Broad public investing expanded in World War I with issuance of Liberty Bonds and the post-war boom. Investors wanted a service analogous to legal services – a professional adviser on technical matters for their holdings or potential trades and investments.[55]

Advisers provided services to investment companies or commingled funds but also to banks, life insurance companies, non-profit organizations, corporate clients, and private/individual clients. Some advisers had discretionary trading authority, but not all.

Securities took the form of paper certificates and bearer bonds. Advisers almost never held client assets. Advisers preferred to provide investment advice and let the client arrange with their bank or broker to hold their funds and securities. Holding money and certificates added needless risk for the adviser.[56]

When the Investment Advisers Act of 1940 was passed, the regulatory framework for advisers focused on registration, records, advisory contracts, and prohibited transactions and conduct. The Advisers Act had no custody provisions at inception. There was no need. Section 206(4) provided legal authority for the SEC to address acts that would be fraudulent, deceptive, or manipulative but said nothing specifically about custody.

B. 1962 – The SEC Adopts the First Custody Rule

In 1962, the SEC adopted Rule 206(4)-2 that directly addressed adviser custody practices for the first time.[57] The new rule was grounded on the SEC's Section 206(4) anti-fraud authority and formalized best practices for the few advisers that had assumed actual custody.

First, new Rule 206(4)-2 (titled "Custody of Possession of Funds or Securities of Clients") required advisers to segregate client securities to track ownership and keep them in a place reasonably free from the risk of destruction or loss. Second, the adviser was required to deposit client funds into a segregated bank account with records of activity. Third, the adviser was required to tell the client how and where their securities were being held, send regular statements showing funds and securities the adviser held for that client, and arrange for an annual surprise independent audit.

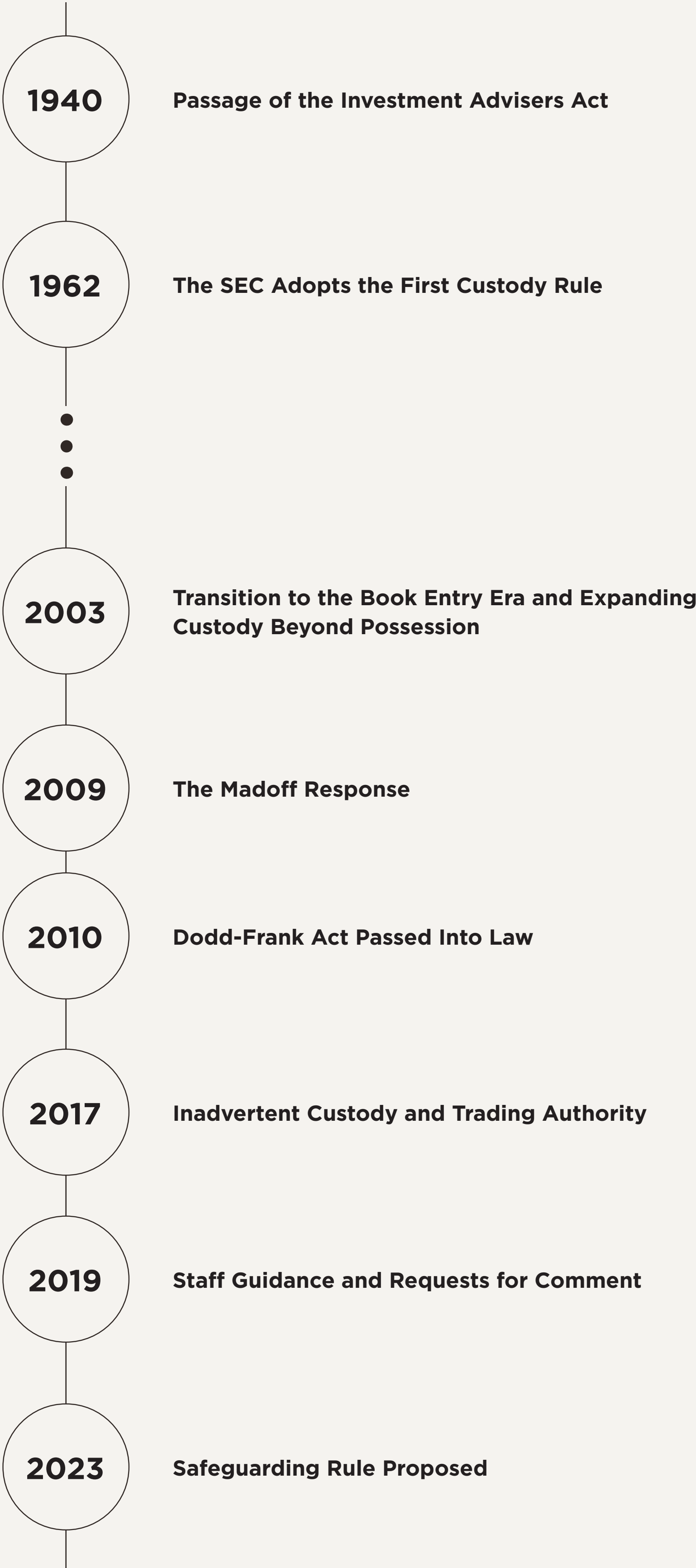
"Custody" required no regulatory definition. The scope was understood to be client funds the adviser had deposited in a bank account and certificates the adviser physically held in a safe or a vault at its office. The surprise exam allowed an independent party to physically inspect certificates which mitigated the risk of mixing or losing certificates that belonged to clients.

[55] See Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939), pages 3-5 ("1939 SEC Report"). See also W.T. Mallison Jr., The Investment Advisers Act of 1940, 1 Vanderbilt Law Review 68 (1947).

[56] 1939 SEC Report, at page 15.

[57] 1962 Adopting Release; See also "Custody or Possession of Funds or Securities of Clients," Proposing Release, 26 FR 10607 (November 10, 1961) ("1961 Proposing Release").

INVESTMENT ADVISER CUSTODY REGULATION TIMELINE



C. 2003 – Transition to the Book Entry Era and Expanding Custody Beyond Possession

Evolutions in business practices and the move away from physical certificates to book entry required adjustments in the following decades. After dozens of no-action letters addressing specific fact patterns, the SEC amended Rule 206(4)-2 in 2003 to codify the SEC Staff's guidance.[58]

The amendments defined "custody" for the first time in an SEC rule. The definition encompassed several ways an adviser could be deemed to have custody. As a nod to a world where physical delivery still occurred from time to time, the rule specified that an adviser that inadvertently received funds or securities would not have custody if it returned them within three days.

Most notably, the amendments established that advisers could have "custody" for purposes of the rule for reasons of authority and control over assets rather than possession. Advisers with the ability to deduct fees or withdraw funds for purposes other than trading would have custody. Advisers with legal ownership of assets such as a general partner in a limited partnership investment vehicle also would have custody.

Since advisers rarely held physical certificates, the SEC looked to "qualified custodians" in the form of banks, broker-dealers, and futures commission merchants to track client ownership. The role of an adviser with "custody" was to ensure that statements were actually being sent. Private securities were excluded from the remit of qualified custodians, recognizing that issuers rather than custodians kept official investor records for investments such as limited partnerships.

In light of the private fund sponsor's role and authority over fund operations and assets, an annual financial statement audit was required, and the results sent to investors. The previous surprise exam requirement was eliminated on the grounds that qualified custodian statements, issuer records, and annual fund financial audits were sufficient.

The changes significantly expanded the population of advisers deemed to have custody and increased the administrative compliance implications of being deemed to have custody. However, the expansion of custody for reasons of authority and control were limited to fee deduction and private fund sponsorship.

The amendments did not expand the concept of custody into discretionary trading authority. In fact, the SEC explicitly rejected the idea that discretionary trading constituted custody. The SEC had proposed the terminology of "possession or control" of client funds or securities[59], but narrowed the terminology to "possession" in response to commenter concerns about ambiguity and the risk of including ordinary trading activity.

In the adopting release, the Commission explicitly stated that authority to transfer funds for the purpose of "authorized trading" would not constitute custody, explaining "an adviser has custody when it can control client funds or securities *for purposes other than authorized trading* (emphasis added)." The Commission again reiterated, "An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades *does not constitute 'custody* (emphasis added)."[60] As these statements explicitly demonstrate, the Commission did not consider discretionary trading authority to fall under the definition of custody.

---

[58] 2003 Adopting Release.

[59] Custody of Funds or Securities by Clients of Investment Advisers, Investment Adviser Release IA-2044 (July 18, 2022), 67 FR 48579 at 48581 (July 25, 2002) ("2002 Proposing Release").

[60] 2003 Adopting Release at 56692, n.5 ("In our proposed rule, our first example of custody referred to ''possession or control'' of client funds or securities, but commenters suggested that the term ''control'' improperly suggested that an adviser that merely has trading authority over a client's securities account has custody for purposes of the rule. See infra note. We believe that the definition and other examples make it clear that an adviser has custody when it can control client funds or securities for purposes other than authorized trading, and that the word ''control'' is therefore not needed in the first example.") and n.10 ("An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute ''custody.'' Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This ''delivery versus payment'' arrangement minimizes the risk that an adviser could withdraw or mis-appropriate the funds or securities in its client's custodial account.")

D. 2009 – The Madoff Response

In late 2009, the SEC re-visited custody with amendments to Rule 206(4)-2 driven largely by the aftermath of enforcement actions alleging fraud and misappropriation.[61] While the Bernie Madoff ponzi scheme primarily operated under a broker-dealer registration, the SEC applied lessons learned more broadly.

The 2009 changes for advisers primarily re-instituted a surprise verification requirement, extended the reach of adviser custody to include involvement of an affiliate, and added an internal control report requirement if an adviser or a related person acts as the qualified custodian. Form ADV disclosures provided more transparency to clients and the SEC.

In addition, the SEC issued an interpretation for the public accountants that set audit procedure expectations for the independent surprise exams.[62] The SEC focused on sampling client accounts and obtaining custodian records for verification, particularly with respect to privately offered securities.

Based on Form ADV filings, the SEC estimated in its proposing release that almost 85% of advisers reported having custody under the SEC's definitions.[63] The vast majority only had custody due to reasons of authority and control over client accounts. Over 11% had custody because of such authority, but also sponsored private funds. The remainder operated as a qualified custodian or had a related party that serviced in that role or had custody solely due to private fund sponsorship.

E. 2017 – Inadvertent Custody and Trading Authority

A February 2017 Investment Management Staff no-action letter covered standing letters of authorization.[64] The Staff said that standing instructions gave an adviser authority to access a client's account beyond trading authority. The Staff stated that such instructions would constitute custody unless limited in specific ways.

At about the same time, the Investment Management Staff raised the concept of "inadvertent custody" in an IM Guidance Update ("the "IM Guidance Update").[65] The IM Guidance Update cautioned that contract terms between a client and their custodian might contemplate broader adviser roles than were included in the client's agreement with the adviser. Even if the adviser did not perform a custodial role in practice, the Staff said that an adviser might "inadvertently have custody" by virtue of the client's agreement with their custodian. The IM Guidance Update raised concerns by suggesting the contract between adviser and client was not a definitive source of authority. Advisers without a contract directly with the custodian had little ability to force contract changes.

A footnote in the IM Guidance Update suggested that certain trading authority granted by a client to an adviser could result in an adviser having custody.[66] "Delivery versus payment" ("DvP") trade instructions from the adviser directs the custodian to transfer funds or securities from a client account only upon a corresponding transfer of funds or securities into the account. Some trades, such as private placements, loans, and derivatives, move funds without a corresponding transfer by the custodian. The footnote suggested that custody could arise if the client granted authority to the adviser for non-DvP trades.

---

[61] 2009 Adopting Release.

[62] "Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940," SEC Commission Interpretation, 75 FR 1492 (Jan 11, 2010).

[63] Custody of Funds or Securities by Investment Advisers, Investment Advisers Act Release IA-2876 (May 20, 2009), 74 FR 25354, at 25363 (May 27, 2009) ("2009 Proposing Release").

[64] Investment Adviser Association, SEC Staff No Action Letter, February 21, 2017.

[65] "Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority," IM Guidance Update, No. 2017-01, February 2017.

[66] IM Guidance Update at n.1 ("An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute "custody." Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This "delivery versus payment" arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account. This guidance update contemplates custody arising from authority that goes beyond such arrangements.")

The DvP distinction traces to a footnote in the adopting release for the 2003 custody amendments stating that discretionary trading authority does not constitute custody (often known as the "authorized trading exception.")[67] The footnote said that custodians generally operate on a delivery versus payment basis which minimizes the risk of misappropriation by the adviser. However, the proposing release, adopting release and the 2003 amendments said nothing else about non-DvP trades and implications for adviser custody. An observation in a footnote is not akin to the Commission taking a substantive position in a notice and comment rulemaking or issuing substantive guidance.

The IM Guidance Update generated confusion among investment advisers. It potentially reflected a substantive change to existing adviser custody regulation without amending Rule 206(4)-2. However, as the IM Guidance Update noted, "[t]his IM Guidance Update is not a rule, regulation, or statement of the Commission, and the Commission has neither approved or disapproved of this IM Guidance Update."

F. 2019 – Staff Guidance and Requests for Comment

Questions arising from the IM Guidance Update led to two years of active discussion between the SEC Staff and the asset management industry. In March 2019, the SEC Staff published a letter welcoming further public engagement and suggesting that custody questions should be addressed by the Commission through rulemaking.[68] The letter did not formally withdraw the IM Guidance Update but showed a recognition that the legal issues were not settled.

In the same letter, the SEC Staff highlighted the growing digital asset market and the potential challenge of custody rule application. The letter requested comment on several specific DvP/non-DvP questions and digital asset custody questions. No further Commission rulemaking or guidance or SEC Staff guidance was published until the 2023 Proposing Release was approved for publication by the Commission in February 2023. The 2023 Proposing Release made a single reference to the March 2019 request for information in the context of digital assets but offered no other summary or assessment of comments received.

G. Dodd-Frank was Passed in the Context of Historical Precedent

Changing the definition of custody also finds no support in Section 411 of Dodd-Frank. Though Section 411 authorized the Commission to promulgate rules to safeguard assets *over which an adviser has custody* (emphasis added), such an expansion of the definition of custody is not contemplated by the language of Section 411 or the legislative history.

[67] 2003 Adopting Release at 56693, n.10 ("An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute ''custody.'' Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This ''delivery versus payment'' arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account.")

[68] "Engaging on Non-DVP Custodial Practices and Digital Assets," Letter to the Investment Advisers Association, March 12, 2019.

As discussed above, Congress enacted Section 411 within the context of the existing regulatory framework ("New rules governing the custody of client funds were adopted last December, and we think it would be appropriate to give these new rules a chance to actually work ... before we direct the SEC to write some new ones").[69] When drafting Section 411, Congress likely contemplated the same understandings of custody that the Commission had historically held and which were memorialized in Rule 206(4)-2 which excluded discretionary trading from the definition.

This distinction does not turn on DvP or non-DvP trading authority. The current Proposal broadly attempts to consider all discretionary trading as custody which is contrary to prior and current understanding of the terminology and investment adviser regulation.

As raised previously in reference to the scope of the term "assets" under Section 411, the Supreme Court recently explained "Where Congress employs a term of art obviously transplanted from another legal source, it brings the old soil with it."[70] The D.C. Circuit also recently observed that Congress "is presumed to preserve, not abrogate, the background understandings against which it legislates."[71]

Congress used the term "custody" in Section 411 in the context of the Commission's existing custody Rule 206(4)-2 and the history of adviser custody regulation which specifically rejected equating discretionary trading authority with custody. There was no Dodd-Frank direction to reverse the SEC's historically understood regulatory definition. If the SEC were to do so, it would risk exceeding the rulemaking authority contemplated by Congress under Dodd-Frank or any other legislative authority.

H. Advice and Discretionary Trading Authority is Not Analogous to Custody

Since before the passage of the Advisers Act, the activities of providing advice and holding funds and securities have been performed by different market participants. Markets have evolved and circumstances of control and involvement other than providing advice have been refined. The Commission itself considered and rejected deeming discretionary trading authority to constitute custody in 2003. There have been no legislative actions or mandates to make such a change.

If the Commission wishes to pivot to a new definition of custody, it must have compelling grounds that address prior and current understandings of custody and its prior positions. To do otherwise, risks adopting a rule on shaky ground.

When drafting Section 411, Congress likely contemplated the same understandings of custody that the Commission had historically held and which were memorialized in Rule 206(4)-2 which excluded discretionary trading from the definition.

[69] Senator Dodd Comments, Conference on Financial Regulations Bill, Day 2, 3:42:32 – 3:43:45, CSPAN https://www.c-span.org/video/?294065-1/conference-financial-regulations-bill-day-2 (Jun.15, 2010).

[70] *George*, 142 S. Ct. at 1959 (2022) (Internal quotation marks omitted).

[71] *Fisher*, 994 F.3d at 671 (D.C. Cir. 2021).

THE PROPOSAL'S WRITTEN AGREEMENT AND REASONABLE ASSURANCES REQUIREMENTS WOULD UNLAWFULLY REGULATE THE CONDUCT OF THIRD-PARTY CUSTODIANS

Under the 2023 Proposing Release, investment advisers would be required to enter into written agreements with custodians and receive certain reasonable assurances from the custodian regarding standards of custodial practices.[72] As discussed above, Section 411 of Dodd-Frank did not expand the Commission's rulemaking authority under the Advisers Act. Though the Commission may issue new custody rules, such regulations must be within the scope of the authority granted under the Advisers Act. The written agreement and reasonable assurance requirements under the Proposal exceed this scope.

The Advisers Act grants the Commission the authority to regulate investment advisers. This authority does not extend to other financial institutions within the custody framework, as Section 223 of the Advisers Act only applies to "an *investment adviser* registered under this subtitle (emphasis added)."[73] Further, Section 206(4) of the Advisers Act, which the Commission promulgated its 1962, 2003, and 2009 Rules under, makes it unlawful for an "*investment adviser*" (emphasis added) to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."[74] In addition, the Act expressly excludes banks and brokers—which frequently are the entities serving as non-adviser custodians—from its definition of "investment adviser."[75]

No provision of the Act grants the SEC the authority to impose such requirements on non-advisers.

As these statutory references demonstrate, the Commission's rulemaking authority under the Advisers Act is limited to investment advisers. Despite this, the Proposal would fundamentally alter the way in which non-adviser qualified custodians operate, including imposing segregation requirements, indemnification and insurance mandates, and a custodian monitoring framework.[76] No provision of the Act grants the SEC the authority to impose such requirements on non-advisers. In fact, the written agreement and reasonable assurances requirements tread on territory long regulated by other federal agencies (such as the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Federal Reserve, FERC, and CFTC) as well as state law and international law. Had Congress intended to authorize the SEC to wade into these well-established regulatory regimes, Congress would have said so clearly and directly, not through a provision authorizing the SEC to impose requirements on *investment advisers*.

[72] 2023 Proposing Release at 14677.

[73] 15 U.S.C. § 80b-18b.

[74] 15 U.S.C. § 80b 6(4); *See supra* n.6.

[75] 15 U.S.C. § 80b-2(1)(11).

[76] 2023 Proposing Release at 14714, 14745, 14677.

Further, the SEC cannot justify the rule by claiming that it does, in fact, only regulate investment advisers by merely dictating which custodians an investment adviser can engage with—i.e., only those custodians that adhere to the rule's requirements. The Fifth Circuit has cautioned that an agency cannot "graft[] novel and extensive duties and liabilities" on entities or conduct that are outside its statutory authority "by writing provisions for . . . contracts" with parties it can regulate.[77] By requiring that a qualified custodian enter into written agreements and provide certain assurances to advisers, the proposed rule does exactly that. For these reasons, the Proposal's written agreement and reasonable assurances requirements exceed the Commission's statutory authority under the Advisers Act.

CONCLUSION

Custody regulation for investment advisers dates to the Commission's first rulemaking in 1962. Since then, the SEC has further refined and adjusted requirements based on Section 206(4) authority. The recent Proposal relies heavily on authority the Commission references in Dodd-Frank and characterizes Dodd-Frank as a grant of new and expanded authority. A deeper look into the legislative history shows that Dodd-Frank affirmed and codified existing authority but was not a mandate or an expansion. In addition, the recent Proposal challenges the SEC's own prior regulatory history.

Any further consideration of investment adviser custody regulation by the Commission will need to acknowledge and remain consistent with its authority. The goal of this paper is to contribute further knowledge and understanding of the historical landscape to better inform the Commission's approach.

A deeper look into the legislative history shows that Dodd-Frank affirmed and codified existing authority but was not a mandate or an expansion. In addition, the recent Proposal challenges the SEC's own prior regulatory history.

[77] *Chamber of Commerce of the U.S. v. U.S. Dep't of Labor*, 885 F.3d 360, 384 (5th Cir. 2018).

Kevin Carroll, Deputy General Counsel, Litigation and Private Client
Kevin Ehrlich, Managing Director and Associate General Counsel, Asset Management Group
Ray Mosca, Senior Associate, Asset Management Group

New York | Washington

www.sifma.org