May 5, 2023

VIA ELECTRONIC SUBMISSION

Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Safeguarding Advisory Client Assets, File No. S7-04-23

Dear Ms. Countryman:

On February 15, 2023, the Securities and Exchange Commission (SEC or Commission) proposed to amend and redesignate Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940 (Advisers Act). SEC's proposal would replace the Custody Rule with a comprehensive set of new requirements found in proposed Rule 223-1 (Safeguarding Rule). The proposal includes corresponding amendments to Rule 204-2 (Recordkeeping Rule) and Form ADV (together with the Safeguarding Rule, the proposed rules). On March 9, 2023, SEC published the proposed rules, titled Safeguarding Advisory Client Assets, in the *Federal Register*.[1] This letter constitutes the Office of Advocacy's (Advocacy) public comments on the proposed rules.

Advocacy is concerned that the disproportionate cost of the proposed rules to small registered investment advisers (advisers) will result in industry consolidation or small firms exiting the market. Among other things, the proposed rules would expand the types of assets subject to regulation, expand the definition of custody to include discretionary trading authority, and include considerable, novel compliance and recordkeeping requirements for advisers. Notably, the rules would transform the relationship between advisers and the qualified custodians entrusted with client assets by requiring written agreements between those parties. Smaller advisers have told Advocacy that while the costs of these sweeping changes will be prohibitive, the benefits to investors with respect to advisers remain unclear.

[1] Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672 (Mar. 9, 2023).

Advocacy believes that the Initial Regulatory Flexibility Analysis (IRFA) inadequately describes the affected small entities and drastically underestimates potential impacts to those entities. In addition, the IRFA does not analyze significant regulatory alternatives for affected small entities which accomplish the stated objectives and minimize the significant economic impact of the proposal. For these reasons, SEC must reassess the economic impact of the proposed rules and consider significant alternatives in a supplemental IRFA.

I. Background

A. The Office of Advocacy

Congress established the Office of Advocacy under Pub. L. 94-305 to represent the views of small entities before Federal agencies and Congress. Advocacy is an independent office within the U.S. Small Business Administration (SBA). As such, the views expressed by Advocacy do not necessarily reflect the views of the SBA or the Administration. The Regulatory Flexibility Act (RFA),[2] as amended by the Small Business Regulatory Enforcement Fairness Act (SBREFA),[3] gives small entities a voice in the rulemaking process. For all rules that are expected to have a significant economic impact on a substantial number of small entities, the RFA requires federal agencies to assess the impact of the proposed rule on small entities and to consider less burdensome alternatives.

The Small Business Jobs Act of 2010 requires agencies to give every appropriate consideration to comments provided by Advocacy.[4] The agency must include a response to these written comments in any explanation or discussion accompanying the final rule's publication in the *Federal Register*, unless the agency certifies that the public interest is not served by doing so.[5]

Advocacy's comments are consistent with Congressional intent underlying the RFA, that "[w]hen adopting regulations to protect the health, safety, and economic welfare of the nation, federal agencies should seek to achieve statutory goals as effectively and efficiently as possible without imposing unnecessary burdens on the public."[6]

B. The Proposed Rules

On March 9, 2023, SEC published a notice of proposed rulemaking that would amend and redesignate certain provisions of the current Custody rule and make corresponding amendments to the Recordkeeping Rule and Form ADV for investment adviser registration under the Advisers Act.[7] The changes included in the proposed rules are expansive and would transform the advisory services industry, including the relationship between advisers and the "qualified custodians" that provide custodial services for client assets. The definition of qualified

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[2] 5 U.S.C. § 601 et seq.
[3] Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq.).
[4] Small Business Jobs Act of 2010, Pub. L. 111-240, §1601.
[5] *Id*.
[6] *Id.*
[7] 88 Fed. Reg. 14672 at 14672.

custodians will continue to include broker-dealers, banks and savings associations, futures commission merchants, and certain foreign financial institutions.[8]

Relying on its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act,[9] SEC proposes to subject funds, securities and all "other positions held in a client's account" to the Safeguarding Rule's requirements.[10] Although much of the discussion in the proposed rules focuses on digital assets,[11] the rules' enhanced investor protections would apply to all client assets of which an adviser has custody, including derivatives and physical assets like real estate.[12] Further, the proposed rules expand the scope of the definition of "custody" to include discretionary authority.[13] Under the proposal, "discretionary authority" is defined as the "authority to decide which assets to purchase and sell for the client."[14] This change would significantly increase the number of advisers deemed to have custody of client assets. The proposed rules would include an exception from the rules' surprise examination requirement for an adviser whose custody of client assets arises solely from discretionary authority.[15]

As under the Custody Rule, the proposed rules would require advisers with custody of client assets to maintain those assets with a qualified custodian.[16] For the first time, however, banks and other institutions that act as qualified custodians would only be allowed to do so if they have possession or control of client assets pursuant to a written agreement with an adviser.[17] SEC would require that these written agreements include contractual terms addressing "recordkeeping, client account statements, internal control reports, and the adviser's agreed-upon level of authority to effect transactions in the account."[18] The proposed rules would also require advisers to obtain reasonable assurances of certain minimum investor protections from qualified custodians.[19]

In addition to these changes, the proposed rules would require additional accounting, client notification, and other safeguarding requirements for client assets that are not able to be maintained by a qualified custodian.[20] The proposed rules would modify the exception for certain privately offered securities.[21] SEC also proposes to subject advisers to additional recordkeeping requirements, including retention and maintenance of documentation that would allow the Commission to verify advisers' compliance with the proposed rules.[22]

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[8] 88 Fed. Reg. 14672 at 14673-14674.
[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).
[10] 88 Fed. Reg. 14672 at 14677.
[11] *Id*. at 14738.
[12] *Id.* at 14677.
[13] *Id*.
[14] *Id.* at 14783.
[15] *Id*. at 14717.
[16] *Id.* at 14682.
[17] *Id*.
[18] *Id*.
[19] *Id*.
[20] *Id.* at 14758-14760.
[21] *Id. at* 14750-14752.
[22] *Id.* at 14776.

The Commission has prepared an IRFA in accordance with the RFA.[23] In the IRFA, SEC identified an estimated 522 SEC-registered advisers that are small entities.[24] SEC estimates that 480 of these identified small entity advisers (92%) would have investment discretion over client assets, and therefore deemed custody under the proposed rules.[25] All small entities that have deemed custody would be subject to the proposed rules.[26] The IRFA does not break down the identified small entities into smaller size groups for analysis. Nevertheless, SEC estimates a combined annual burden of approximately 50.8 hours per adviser or 19,926.8 hours in aggregate for small advisers associated with the proposed rules. The annual monetized aggregate cost to all small entity advisers associated with the proposed rules is estimated to be $9,574,922.40.[27]

II. Advocacy's Small Business Concerns

Advocacy believes that the IRFA included in the proposed rules is insufficient for two reasons. Under the RFA, an IRFA must contain:

1) A description of the reasons why the regulatory action is being taken.
2) The objectives and legal basis for the proposed regulation.
3) A description and estimated number of regulated small entities.
4) A description and estimate of compliance requirements, including any differential for different categories of small entities.
5) Identification of duplication, overlap, and conflict with other rules and regulations.
6) A description of significant alternatives to the rule.[28]

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[23] *Id*.

[24] For the purposes of the Advisers Act and the RFA, SEC considers an adviser a small entity if it: "(1) has assets under management having a total value of less than $25 million; (2) did not have total assets of $5 million or more on the last day of the most recent fiscal year; and (3) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year." 88 Fed. Reg. 14672 at 14777. Although this definition is legally valid, Advocacy notes that the $25 million threshold has remained the same since 1998. *See* 63 Fed. Reg. 35515. At that time, SEC identified approximately 1,500 registered advisers that would be considered small businesses. *See* 63 Fed. Reg. 35512. As noted above, the proposed rules identify an estimated 522 advisers that are considered small businesses for RFA purposes. The reduction in registered advisers that are considered small businesses is likely due to SEC's static definition and is one indication that the definition may be out of step with today's financial market.

[25] 88 Fed. Reg. 14672 at 14777-14778.

[26] *Id.* at 14777.

[27] SEC estimates costs associated with the following provisions of the proposed rules: (1) a new annual burden of approximately 28.4 hours per adviser, or 9,116 hours in aggregate for small advisers associated with the Safeguarding rule, resulting in an annual monetized aggregate cost $5,371,008; (2) an increased annual burden of approximately 21 hours per affected adviser, or 10,080 hours in aggregate for small advisers with custody of client assets associated with amendments to the Recordkeeping Rule, resulting in an annual monetized aggregate cost of $3,971,520; and (3) an increased annual burden for advisers of approximately 1.4 hours per adviser, or 730.8 hours in aggregate for small advisers associated with the proposed amendments to Form ADV, resulting in an annual monetized aggregate cost to small advisers of $232,394.40. *Id*. at 14777-14778.

[28] 5 U.S.C. § 603.

Advocacy is concerned that the IRFA does not adequately describe the regulated small entities and potential impacts to those entities. Advocacy further believes the IRFA does not adequately discuss specific alternatives that might reduce that economic impact to small entities.

A. SEC Underestimates the Economic Impact of the Proposed Rules to Small Entities

The IRFA found in the proposed rules does not adequately estimate the economic impact to small entities. First, the IRFA estimates that the proposed rules would apply to 522 advisers that are small entities.[29] It does not, however, provide adequate economic characteristics of the affected small entities or break them down into smaller size groups based on total regulatory assets under management to understand how the rule may impact small entities of different sizes. Advocacy recommends that SEC revise its IRFA and provide such information to better describe the distribution of regulated small entities.

Second, the IRFA does not adequately analyze the relative impact of costs to small entities. The Commission has acknowledged that "[t]o the extent the proposed rule would create new fixed costs of providing advisory services, those fixed costs would disproportionately impact small or newly emerging advisers."[30] Despite this admission, SEC does no analysis of the relative impact of the regulation based on entity size in the IRFA. SEC's discussion of costs to small entities in the IRFA is limited to calculating estimated costs based on industry averages.[31]

In preparing these comments, Advocacy spoke with the Investment Adviser Association (IAA) and several of its smaller members. The small firms stated that they do not generally hold or have access to client assets and are not considered to have custody over the vast majority of accounts under the existing regulations. Each of the advisers stated that their firms would be deemed to have custody over substantially all the assets in their clients' accounts under the proposed rules. Small advisers told Advocacy that they would incur significant costs from the proposed rules. They could not pinpoint, however, specific problems the regulations were designed to correct in relation to advisers. Instead, many of the proposed changes appear to be aimed at correcting issues with qualified custodians.

The advisers expressed that the disproportionate relative costs of the proposed rules would put them at a competitive disadvantage. In addition, they believe that the cost estimates in the proposed rules are inaccurate for smaller firms. Smaller advisers believe their costs will be higher than those of larger firms because of their operational scale.

For instance, SEC estimates an internal burden of one hour for advisory firms initially entering into written agreements with qualified custodians.[32] This estimate disregards the realities of the market, some of which were acknowledged by SEC in the proposed rules. Per the Commission, "under existing market practices, advisers are rarely parties to the custodial agreement, which is

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[29] 88 Fed. Reg. 14672 at 14776.
[30] *Id.*
[31] For example, SEC's estimates of the relevant wage rates appear to be based on average salary information for the securities industry compiled by the Securities Industry and Financial Markets Association. *See Id.* at 14770.
[32] 88 Fed. Reg. 14672 at 14736.

generally between an advisory client and a qualified custodian."[33] SEC has allotted one internal burden hour to the combined work of locating the proper contact at a qualified custodian to begin negotiations, the negotiation process, and drafting and finalizing written agreements. A single hour to complete these processes is likely insufficient regardless of the size of a firm.

Nevertheless, the burden estimate associated with written agreements is likely higher for small advisers. SEC is engaging in indirect regulation of qualified custodians by mandating that, for the first time, advisers enter into written agreements with the custodians that their clients select. Small advisers do not have existing relationships with qualified custodians and do not have the same assets under management of larger firms. Large banks and other qualified custodians have no obligation to commit to the terms of any given written agreement. Qualified custodians may determine that the overhead costs of negotiating agreements with small advisers are too high if the clients of those advisers have insufficient business with their institutions. This power imbalance leaves small advisers with little leverage during negotiations. As a result, small advisers may be forced into a difficult situation where they must either accept terms from custodians that do not comply with SEC's requirements or lose business. Small advisers may also see a reduction in the custodial services available to them. These issues combined could lead to lower demand for advisory services from small firms.

Small advisers also face unique consequences related to the overhead costs of proposed recordkeeping and additional compliance requirements. According to a 2021 report by the IAA, 58% of investment advisory firms have 10 or fewer non-clerical employees.[34] Many firms have a single compliance officer, who may hold additional roles within their organization. The high time burden associated with the proposed rules will disproportionately affect smaller firms. Firms may need to hire additional staff to comply with the regulations. Smaller firms told Advocacy that any attempt to pass on the high overhead costs of the proposed rules to their clients could result in advisers losing accounts.

For the above reasons, SEC must revise its IRFA to address the heightened cost burden faced by small entities. SEC should provide detailed information that will allow the Commission to analyze the relative impact of costs based on entity size. This would help SEC to adequately understand the cost burden faced by small advisers.

B. SEC's IRFA Must Consider Significant Regulatory Alternatives

The IRFA does not contain a description of significant alternatives which accomplish SEC's stated objectives and minimize the significant economic impact of the proposed rules on small entities. The RFA requires that an IRFA consider significant, feasible alternatives for small entities that accomplish an agency's objectives. Consistent with SEC's approach in other recent rulemakings, the IRFA in the proposed rules lists broad categories of potential alternatives to the proposed rules but does not analyze any specific alternative that was considered by the

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[33] 88 Fed. Reg. 14672 at 14690.
[34] Investment Adviser Association and NRS, *Investment Adviser Industry Snapshot 2021*, 40 (July 2021), Investment_Adviser_Industry_Snapshot_2021.pdf (higherlogicdownload.s3.amazonaws.com).

Commission. Instead, the IRFA supplies SEC's reasoning in rejecting each of the categories of potential alternatives.

The IRFA states that SEC "believes that establishing different compliance or reporting requirements for small advisers, or exempting small advisers from the proposed rule, or any part thereof, would be inappropriate under these circumstances."[35] This statement appears to reject all alternatives that would minimize the burden of the regulation on small entities, and conflicts with the requirements of section 603(c) of the RFA.

Advocacy spoke with smaller advisers about potential regulatory alternatives for small entities. Those advisers suggested that SEC should consider extending the transition period for small firms. Although the proposed rules as drafted include an extended compliance date of 18 months for advisers with up to $1 billion in assets under management,[36] smaller firms believe that the transition period is too short. The IAA suggested a compliance date of at least 24 months for smaller firms. In addition, small firms suggested that the rules provide a model written agreement for small advisers to use during negotiations with qualified custodians. A model agreement would clarify and simplify compliance and could provide small firms with additional leverage during the negotiation process.

SEC must revise its IRFA to include specific alternatives which accomplish its objectives for the rulemaking, as required by the RFA. Advocacy encourages SEC to provide a detailed analysis of each potential alternative and to discuss how that alternative may reduce the economic burden on small entities.

III. Conclusion

Advocacy is concerned that the proposed rulemaking and IRFA lack essential information required by the RFA. SEC must provide an adequate description of the affected small entities and a detailed analysis of the impact of the proposed rules to those small entities before proceeding to a final rule. SEC must also explore specific regulatory alternatives that might reduce the significant economic impact to small entities. This analysis should be published in a supplemental IRFA to provide small entities an opportunity to comment. Advocacy urges SEC to consider the potential market consolidation that could result from the proposed rules, and the impact that consolidation would have on advisers and investors.

If you have any questions or require additional information, please contact me or Assistant Chief Counsel Meagan Singer at (202) 921-4843 or by email at meagan.singer@sba.gov.

Sincerely,

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[35] 88 Fed. Reg. 14672 at 14778.
[36] *Id.* at 14732.

/s/
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Deputy Chief Counsel
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