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PUBLIC INTEREST COMMENT

THE ADVISER CUSTODY PROPOSAL EXCEEDS SEVERAL RESTRICTIONS ON THE SEC

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Safeguarding Advisory Client Assets
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This is a comment on the proposal of the Securities and Exchange Commission (SEC) to revise the rule governing an investment adviser's custody of client securities (Proposal).[1] I am a scholar with the Mercatus Center at George Mason University. I taught securities regulation at the University of Virginia School of Law, served as deputy general counsel at the SEC, and practiced securities law. The Mercatus Center is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment is not submitted on behalf of any other person or group.

INTRODUCTION

The Proposal should not be approved. Its breadth and reach are unauthorized and excessive. It would remake the business of custodians around the world, even when they are supervised by other regulators, and would set the rules for adviser custodians for every type of asset rather than just securities. The Proposal would even override an established principle of the international legal system that denies enforcement of a government fine or penalty in a foreign country.

EXTENSION OF THE RULE TO ALL TYPES OF ASSETS

The Proposal planned to apply the custody rule to all client assets, not just funds and securities, over which an adviser has custody. The SEC does not have statutory authority for such an expansion.

1. SEC, Safeguarding Advisory Client Assets, 88 Fed. Reg. 14,672 (Mar. 9, 2023).

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According to a statute added by the Dodd-Frank Act, the SEC may prescribe rules to oblige investment advisers to take "steps to safeguard client assets over which such adviser has custody."[2] The SEC asserted that, with this statute, "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."[3] To the SEC, a custody rule for investment advisers should govern custody of gold, foreign currency, commodity futures, fine art, real estate, and so on.[4]

The SEC's interpretation is not the appropriate way to understand the term "client assets" in the custody statute. The natural way to read the term is to refer to those assets within the scope of the SEC's regulatory power over investment advisers: securities and cash related to buying or selling securities.

The Advisers Act gave the SEC authority to regulate investment advisers in specific ways. Congress restricted the SEC's power over investment advisers by defining an "investment adviser" as a participant in the securities markets. An investment adviser is a person who advises on the value of securities or investments in securities or who issues reports on securities.[5] This definition operates as a fence around the SEC's authority in the area. A person advising a client on the purchase of antiques or diamonds is not an investment adviser under the Advisers Act.

For as long as an adviser custody rule has existed, the SEC has stayed within that fence. The scope of the rule has always been "client funds or securities."[6]

The Dodd-Frank Act did not enlarge the scope of the SEC's authority to regulate an adviser's custody obligations. The text of the custody statute, "client assets," does not show that Congress meant to cover all types of client holdings. The phrase may be read broadly or narrowly; it does not compel a wide definition.

More meaningful is that the custody statute was added to the Advisers Act, and the term "client assets" in the statute must be viewed within the context of the Advisers Act and the Act's close connection to securities.[7] It is a short-form expression for the types of client assets normally handled by an investment adviser as defined by the Act: securities or the funds related to them.

Another statute added to the Advisers Act by the Dodd-Frank Act at the same time as the custody statute supports this limited construction. The other statute concerned the records of a custodian for an adviser's client. It referred to a person having custody of the "securities, deposits, or credits of a client."[8]

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2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 411, 124 Stat. 1376, 1577 (2010) (adding section 223 to the Advisers Act, which provides that "[a]n investment adviser registered under this subchapter 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," 15 U.S.C. § 80b-18b).
3. Proposal at 14,674.
4. *Id.* at 14,679.
5. 15 U.S.C. § 80b-2(a)(11).
6. *See* Proposal at 14,673 & n.2. The correct *Federal Register* citation to the adoption of the first custody rule is 27 Fed. Reg. 2149 (Mar. 6, 1962). The current rule is 17 C.F.R. § 275.206(4)-2.
7. *See* West Virginia v. EPA, 142 S. Ct. 2587, 2607 (2022) ("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.") (quotation marks and citation omitted).
8. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929Q(b), 124 Stat. 1376, 1866 (2010) (codified at 15 U.S.C. § 80b-4(d)(1) (second (d)).

In addition, the SEC used the phrase "client assets" as a convenient shorthand form for "funds or securities" in a 2009–10 rulemaking, and a Senate Report indicates that Congress probably picked up that usage in the Dodd-Frank custody statute. Just before enactment of Dodd-Frank, the SEC amended the adviser custody rule. The rule before and after amendment referred to "client funds or securities." In discussing the amendment, the SEC used the shorthand "client assets" in place of client funds and securities. The adopting release said that it was addressing the Adviser Act rule "that governs an adviser's custody of client funds and securities ('client assets')." It then had this footnote: "We 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."[9]

That SEC amendment of the adviser custody rule is likely the source of Congress's use of the term "client assets." The Senate Report described the plan to add the adviser custody statute and then said, "The SEC has recently adopted new rules imposing heightened standards for custody of client assets."[10] The Senate Report said that the SEC's amendment applied to "client assets," although the amendment actually applied to client funds or securities, perhaps because the SEC's discussion used the shortened form "client assets." The Senate Report said nothing about extending the adviser custody rule to assets other than funds or securities.

The SEC constructed a paragraph in the Proposal to suggest that the congressional objective of the custody statute was to expand a custody obligation to reach all assets,[11] but that is not correct. It is true that one witness at a Senate hearing on advisers to private investment funds urged that an adviser custody rule extend to different kinds of assets,[12] but the Senate Report did not cite or quote that portion of the witness's testimony.[13] Testimony from a witness at a legislative hearing does not support an argument of statutory interpretation.[14] The thoughts of a witness tell a court nothing about the will or objective of Congress or any member of Congress or congressional staff.

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.

EXTENSION OF REGULATORY CONTROL TO CUSTODIANS

The Proposal would upend the custodial business and exceed the SEC's power to regulate investment advisers by extending controls to custodians. The entire approach should be revised.

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9. SEC, Custody of Funds or Securities of Clients by Investment Advisers, 75 Fed. Reg. 1456 & n.2 (Jan. 11, 2010).
10. S. Rep. No. 111-176, at 76 (Apr. 30, 2010). The Senate Report discussed statutory text identical to the language ultimately enacted as section 411 of the Dodd-Frank Act. See the text of S.3217 ordered to be printed on April 29, 2010, https://www.congress.gov/bill/111th-congress/senate-bill/3217/text/as?q=%7B%22search%22%3A%5B%22s3217%22%5D%7D. The House Conference Report, H.R. Rep. No. 111-517 (June 29, 2010), did not discuss the custody provision.
11. Proposal at 14,674.
12. *See* Regulating Hedge Funds and Other Private Investment Pools, Hearing Before the Subcomm. on Sec., Ins., and Inv. of the Sen. Comm. on Banking, Housing, & Urb. Aff., 111th Cong. 50–51 (2009) (statement of James S. Chanos, Chairman, Coalition of Priv. Inv. Companies). The Proposal tried to quote this testimony, Proposal at 14,674 n.14, but cited a hearing of a House subcommittee rather than a Senate subcommittee.
13. *See* S. Rep. No. 111-176, at 76–77 (Apr. 30, 2010).
14. *See* JOHN F. MANNING & MATTHEW C. STEPHENSON, LEGISLATION AND REGULATION 198 (3d ed. 2017) ("The Supreme Court has frequently expressed deep suspicion about the probative value of statements made during hearings that did not make it into the official committee reports.").

The SEC proposed to add a new item to an adviser's custody obligations in "a substantial departure from current industry practice" and require a written agreement between the adviser and a qualified custodian.[15] The custodian would need to make specified contractual commitments to the adviser and separately would need to give the adviser reasonable assurances in writing about protections to be provided to the client.[16] Custodial customers do not always receive all the specified protections today,[17] which means that the proposed custody rule would set new minimum terms for the custodial business.

The proposed provisions on a custodian's contract and reasonable assurances are a device or artifice to avoid limitations on the SEC's regulatory authority. The Advisers Act does not give the SEC general power to regulate custodians. The Act and the SEC's authority pertain to investment advisers. In particular, the custody statute gives the SEC power to prescribe rules applicable to registered investment advisers, not custodians, and could reasonably be read to permit rules only when the adviser is the custodian. The rules must be limited to "steps to safeguard client assets over which such adviser has custody," and the concept of custody in the statute does not necessarily have the far-reaching definition the SEC now plans to ascribe to it.[18] The Proposal is an attempt to regulate the business of custodians through the guise of regulations telling advisers what a custodian must do.

When Congress wanted to permit the SEC to exercise authority over custodians, it said so explicitly. In the Dodd-Frank Act, the same law adding the custody statute on which the SEC relied for the Proposal, Congress said that the SEC could examine and request information from a person having custody for an adviser's client.[19] Congress did not permit the intrusive and extensive regulation of custodians that the SEC seeks in the Proposal.

The SEC's reason for regulating custodians is likely that the SEC must dictate the behavior and duties of custodians to regulate the custodial practices of investment advisers, but the Supreme Court does not allow an agency to stray too far from the terms of a statute. An indirect and distant connection between statutory language and an agency directive is "markedly different from the direct targeting" of measures identified in a statute.[20]

If the SEC may regulate custodians because it may regulate investment advisers, then the SEC could claim the authority to regulate the subcustodians a custodian uses. In fact, the Proposal did that too. The Proposal would require that the adviser obtain reasonable assurances in writing from the qualified custodian that the existence of any subcustodial arrangements for a client's assets will not excuse any of the qualified custodian's obligations to the client.[21] The Proposal explicitly sought to forbid standard practices in the business of subcustodians.[22] That reasonable assurance will soon blossom into extensive contractual provisions covering a subcustodian's duties to a custodian and

15. Proposal at 14,682, 14,691.
16. *Id.* at 14,692, 14,780–81. For example, in the written agreement, the custodian must promise to provide account statements to the adviser and client and provide an internal control report. Reasonable assurances must cover due care, indemnification, and segregation of client assets from custodian property.
17. *Id.* at 14,691.
18. *See id.* at 14,679–80 (discussing the proposed definition of "custody").
19. *See* note 8.
20. Ala. Ass'n of Realtors v. HHS, 141 S. Ct. 2485, 2488 (2021) (on application to vacate lower court stay).
21. Proposal at 14,694.
22. *Id.* at 14,695.

to the advisory client, and the statutes that give the SEC the authority to regulate investment advisers will have metastasized into authority to regulate custodians and subcustodians.

Where does this reasoning end? If an adviser statute permits the SEC to regulate custodians and to interfere with standard practices in the subcustodial market, the SEC may regulate any third party having a relationship with an adviser, custodian, or advisory client. For example, an adviser could be ordered to obtain reasonable assurances from a custodian that the utility providing electricity to the custodian has state-of-the-art protection against cyber attacks and disruption to the electrical grid.

The SEC asserted policy reasons for grasping to control custodians and subcustodians,[23] but policy aspirations are not enough. The agency must stay inside of the authority Congress gave it; adopting the rules in the Proposal would be an end run around statutory limits. The SEC should recast its custody proposal to address the custody conduct of investment advisers.

EXTENSION OF SEC CONTROL TO CUSTODIANS REGULATED BY OTHERS

The Proposal would usurp the regulation of custodians by other federal regulators and foreign authorities. The SEC is bent on setting standard custodial protections around the world.[24]

The Proposal would continue to require an investment adviser to use a "qualified custodian" as defined in the regulations.[25] A "qualified custodian" could be a bank or savings association, registered broker-dealer, registered futures commission merchant, or certain foreign financial institutions (FFI),[26] as long as any of these entities also met additional SEC requirements.

The SEC admitted that these entities "operate under regular government oversight [and] are subjected to periodic inspection and examination"[27] but considered the custodial rules of other regulators to be inadequate. Other regulators did not have all the requirements that the SEC wanted to see as minimum standards:

- A bank or savings association would not be good enough, because such entities are not obliged to hold client assets in an account protected from the insolvency or failure of the financial institution.[28]
- Foreign regulation is not good enough either, and therefore FFIs must "satisfy seven new conditions" to serve as a qualified custodian.[29] The SEC recognized that "FFIs are subject to a broad range of regulatory regimes,"[30] but the diversity was off-putting. The SEC wanted to impose its system "to promote more comparable investor protections to those assets held with U.S. financial institutions" and to make the worldwide custody system "more uniform."[31]
- Sometimes other regulators had rules that would not conflict with the SEC's desired approach, but the SEC just wanted its own universal custodial standards. At one point, the Proposal said that "functional regulators have not defined possession or control in the

23. *See id.* at 14,690–93.
24. *See id.* at 14,682–83.
25. *Id.* at 14,780.
26. *Id.* at 14,682.
27. *Id.*
28. *Id.* at 14,683.
29. *Id.*
30. *Id.* at 14,688.
31. *Id.*

custody context in a manner identical to our proposed rule," but the SEC insisted on its definition anyway because it viewed its approach to be better.[32]

Even if the SEC has the legal power to displace the regulations of foreign and other U.S. government agencies, asserting preeminence does not serve the U.S. or international regulatory system well. Other regulators developed custodial systems to serve their statutory purposes, and the interjection of SEC requirements could have unpredictable effects. Altering standards in foreign countries without regard for local laws, customs, and conditions would be especially likely to be disruptive. In addition, adding a layer of SEC obligations could confuse users and regulated parties in the other systems and the enforcement and examination programs of the other regulators. How other regulators might react is also uncertain; some could object to the SEC's rules.

The Advisers Act has evidence that Congress wanted the SEC to defer to and respect other regulators of custodians rather than elbow them aside. When the SEC requests an examination of or information from a custodian that is subject to regulation by a different federal financial regulatory agency, the custodian does not need to comply and instead may satisfy the SEC request with a written list of the securities and deposits held in custody.[33]

These are strong reasons for the SEC not to run roughshod over the custody responsibilities of other U.S. and foreign regulators. The SEC should reconsider the intrusiveness of obligations of custodians supervised by other government authorities.

ENFORCEMENT OF SEC FINES IN OTHER COUNTRIES

Another excess in the Proposal is its plan to try to nullify a long-standing rule of the international legal system designed to confine the enforcement actions of the government authorities of a country to their own courts. Toying with international legal practice is well outside of the SEC's competence and remit.

Foreign financial institutions may serve as qualified custodians when they meet requirements specified by the SEC.[34] One of the requirements the SEC proposed was that the SEC must be able to enforce a judgment for civil monetary penalties against the FFI.[35]

The ability of government agencies to enforce their national laws against persons outside of their home territories raises many difficult legal issues. To reduce friction, the general approach has been that enforcement agencies should stay within their own borders absent consent from the authorities of foreign countries:

> Both U.S. practice and customary international law distinguish between enforcement in a state's own territory, which is unproblematic, and enforcement in the territory of another state, which requires the consent of that other state. Violations of customary international law governing jurisdiction to enforce give rise to international responsibility.[36]

Enforcement jurisdiction includes "the performance of coercive governmental functions."[37]

32. *Id.*
33. *See* 15 U.S.C. § 80b-4(d)(2).
34. Proposal at 14,682.
35. *Id.* at 14,684.
36. RESTATEMENT (FOURTH) OF THE FOREIGN REL. L. OF THE UNITED STATES, ch. 3, intro. note, at 291 (2018) (Restatement).
37. *Id.* § 431 rptr. n.2, at 292.

For example, the U.S. and international rule is that a court of one state will not enforce a foreign judgment for a fine or penalty of the other country. The U.S. position is "Courts in the United States do not recognize or enforce judgments rendered by the courts of foreign states to the extent such judgments are for taxes, fines, or other penalties, unless authorized by a statute or an international agreement."[38] This rule has long been accepted in both international and U.S. practice and is followed in many countries.[39] In 1825, Chief Justice John Marshall wrote that the "Courts of no country execute the penal laws of another."[40] "The rules against enforcing foreign tax and penal laws apply to both direct and indirect enforcement."[41]

The Proposal would flout the established international rule by requiring that an FFI must somehow allow the SEC to enforce a judgment for monetary penalties against the FFI, even if the FFI has no real economic presence in the United States. The qualified custodian definition would be an exercise of coercive government action to enforce a fine indirectly. An FFI not engaged in substantial business in the United States should not be forced to give up commonly accepted international legal protections to be able to provide custodial services to a U.S. investment adviser.

CONCLUSION

The Proposal went too far in several ways. The SEC should let the Proposal lapse and confine any reproposal to regulation of custody of securities and related cash and to regulation of advisers rather than custodians. It should also defer to the regulation of custodians by other regulators and refrain from meddling with settled international enforcement rules.

38. *Id.* § 489, at 476.
39. *Id.* § 489 cmt. a, at 477, rptr. n.3, at 480.
40. The Antelope, 23 U.S. 66, 123 (1825); *see* Restatement § 489 rptr. n.1, at 478.
41. Restatement § 489 rptr. n. 5, at 482.