SEC Proposal Would Overhaul a System That Works for Investors

Background

In the asset management industry, financial assets are typically held by custodians to protect against theft, loss, or misuse. These assets are often managed by professional investment advisers but are owned by client investors. Existing custody practices are long established and function exceptionally well in protecting assets for the benefit of investors.

In February 2023, however, the Securities and Exchange Commission (SEC) proposed the *Safeguarding Advisory Client Assets* rule that, if implemented in its current form, would impose immense changes on investment advisers and custodians with little evidence that the changes would improve the protection of client assets. The proposal has also sparked bipartisan concerns in Congress over the SEC's lack of coordination with other regulators.

The proposal would be particularly harmful to investors in separately managed accounts (SMAs), which are increasingly popular with retail investors. A retail SMA is a portfolio of assets managed by an investment adviser that can be customized to the individual investor's financial objectives.

Complete Upheaval of a System that Affects Millions

The proposed rule would completely overhaul a system that has worked well for millions of Americans. Among numerous defects, the proposed rule:

- Fundamentally alters the relationships between custodians, advisers, and clients in problematic ways and could conflict with existing regulations.
- Threatens Americans' ability to invest in certain markets and in certain asset classes with the expert assistance of a professional adviser.
- Fails to explicitly exempt business development corporations and college savings plans, which are already subject to a robust custody regime that does not need additional regulation.

Implementation Nightmare

In addition to fundamental flaws in the proposal, many of the new requirements would be onerous, complicated, and expensive to implement. Some particularly troubling elements include:

- **Conflating trading authority and custody:** In the proposal, the SEC wrongly equates an adviser's discretionary trading authority with custody of those assets. One result of this would be to force advisers to renegotiate existing custodial contracts at great expense despite no change in the adviser's relationship with the client.
- **Assurances pitfalls:** Advisers would be forced to obtain assurances from custodians that are inconsistent with current market practices. Many custodians are unlikely to agree to such standards, which, in turn, would place advisers and their clients in a difficult position and could lead to significantly higher costs for custodial services.
- **Lack of cost-benefit analysis:** This rulemaking is the latest in a succession of sweeping SEC proposals that lack a thorough cost-benefit analysis or a well-articulated need.

Necessary Fixes

ICI recommends that the SEC examine and defer to existing regulatory regimes that already adequately protect client assets. ICI's additional considerations for the SEC include:

- Tailoring the scope of any new custody requirements in a manner that reflects practical limitations and existing requirements.
- Eliminating the proposed requirement for a written agreement between the adviser and each client's qualified custodian given its costs, burdens, and substantive issues.
- Comprehensively assessing the burdens it seeks to implement against any perceived benefits to investors.