The Real Estate Roundtable

October 30, 2023

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Proposed Rule on Safeguarding Advisory Client Assets; Rel. No. IA-6240; File No. S7-04-23

Dear Ms. Countryman:

We appreciate the opportunity to comment on how the above-referenced proposed rule ("**Proposed Rule**") would apply to advisory clients' investments in real estate. The Real Estate Roundtable[1] and our members strongly support the goal of the Securities and Exchange Commission ("**Commission**" or "**SEC**") to protect advisory clients' investments, but we believe that the Proposed Rule, if adopted, could severely impact advisory clients' ability to invest in real estate.[2] Retail and institutional investors alike desire to invest in real estate through advisory accounts or funds. In addition to their potential to provide strong investment returns, real estate can help investors diversify their portfolios. Real estate investment through advisory accounts are funds also reduce the research and ongoing monitoring that a direct investment in "hard" real estate demands.[3]

[1] The Real Estate Roundtable and its members lead an industry that generates more than 20 percent of America's gross national product, employs more than 9 million people, and produces nearly two-thirds of the taxes raised by local governments for essential public services. Our members are senior real estate industry executives from the U.S.'s leading income-producing real property owners, managers and investors; the elected heads of America's leading real estate trade organizations; as well as the key executives of the major financial services companies involved in financing, securitizing, or investing in income producing properties.

[2] We previously have written, together with other trade associations, to express our strong concerns with the Proposal. *See* Joint Letter re Negative Impacts of the Safeguarding Proposal on Investors, Market Participants, and the Financial Markets (Sep. 12, 2023), available at: https://www.sec.gov/comments/s7-04-23/s70423-258159-603042.pdf. That letter addressed the negative impacts the Proposal is likely to have on a large array of advisory services and products. This letter focuses exclusively on the impact of the Proposal on real estate assets.

[3] *See*, *e.g.*, Wall Street Journal, *A Real-Estate Primer* (Oct. 29, 2012), available at: https://www.wsj.com/articles/SB10000872396390444734804578062600862061068.

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We believe ample safeguards already exist to promote the safe-keeping of real estate assets held in advisory accounts or funds, which assets are not subject to high risk of loss or theft. The combination of existing protections, with an asset class that presents low "safeguarding risks," obviates the need for the Proposed Rule to apply to real estate at all. Accordingly, we urge the SEC in the strongest possible terms to exclude real estate from the scope of any final rule, assuming the SEC determines to move forward with adopting it.

The SEC has not coherently explained how the Proposed Rule would apply to real estate.

Current Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940 requires an investment adviser to maintain clients' funds and securities with a qualified custodian. When a client receives cash from a real estate investment, which could be a lease payment by a real estate tenant, which cash must be held with a qualified custodian, but the real estate itself is not subject to the Custody Rule because it is not cash or a security.

The Proposed Rule would change the current approach, and require the investment adviser generally to maintain all advisory client assets at a qualified custodian. Recognizing that it is not possible to maintain real estate and certain other investments at a qualified custodian, the Proposed Rule provides a conditional exception for those assets.[4] We discuss the problematic nature of the conditions to the exception below, but an immediate problem for real estate assets is a sentence in the release accompanying the Proposed Rule (the "**Proposing Release**"):

> [I]n the real estate context, a deed or similar indicia of ownership that could be used to transfer beneficial ownership of a property would not qualify for the exception, but the physical buildings or land would qualify.[5]

We do not understand the intent behind this statement. On the one hand, the SEC acknowledges that real estate cannot be held at a qualified custodian, and therefor provides an exception, problematic as it is, from that requirement. On the other hand, the SEC is stating that a deed evidencing real estate ownership does not qualify for that exception. This is confusing, at best.

It would not make sense to require the deed to be held at a qualified custodian **and** the actual real estate to comply with the conditions of the exception. This result would uniquely single out real estate for double coverage by the Proposed Rule – applying the full scope of the rule to the deed and also the conditions to the exception to the underlying real estate. This would be even more surprising an outcome given that a forged or fraudulent deed does not legally transfer any ownership interest, and the fact that real estate deeds and other instruments evidencing ownership of real estate interests, such as easements or ground leases, generally must be recorded by a county, municipal or state government office which maintains records and documents relating to real estate ownership.

[4] Proposed Rule 223-1(b)(2).

[5] Proposing Release at 135.

Requiring a deed to be maintained at a qualified custodian is problematic for a number of reasons. ***First,*** we know of no qualified custodian willing to hold the deed.

Second, the Proposed Rule would require the deed to be subject to that custodian's "possession and control." The Proposed Rule defines "possession or control" as "holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involving the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership." Given those requirements for holding and transfer, the Proposed Rule provides an impractical and unworkable framework for real estate deeds. It would require a fundamental, and unwelcome, change to how real estate investments are made, at least in advisory accounts. The Proposing Release, for example, does not account for the current chain of custody requirements, which varies by state and country, currently applicable to real estate transactions. Indeed, it is not possible to add the qualified custodian to the title or deed, at least under U.S. law and very likely the laws of other countries.

Third, the law applicable to real estate ownership in the U.S. is fundamentally different from that of personal property. Typically, the Uniform Commercial Code (UCC) governs personal property where possession of collateral can play a role in ascertaining relative rights to such property. With respect to real estate, state conveyance and recording statutes augment the common law to incentivize recording to both perfect an interest in the real estate and to provide constructive notice of that interest. Possession of a deed at a qualified custodian would not provide any additional security or evidentiary value as compared to recording the interest with a governmental authority. At the end of the day, moreover, forged deeds do not convey good title to an asset and state laws requiring signature verifications, notarizations and accompanying IDs provide significant hurdles to an attempted fraudulent transfer.

Real estate does not evaluate the risk of misappropriation of real estate in advisory accounts, which risk is theoretical at most.

We understand the goal of the Proposed Rule is to protect assets from loss, theft, misuse, and misappropriation. Accordingly, any assessment of the potential benefits of the Proposed Rule requires an evaluation of the potential risk of loss, theft, misuse, and misappropriation of the assets subject to the rule. If the risk of loss to an asset is low or nonexistent, so too are the benefits of applying the Proposed Rule to that asset.

The Proposing Release contains no evaluation of any risk of loss for real estate assets – it only asserts such risk as a theoretical matter.[6] In terms of potential benefits from applying the Proposed Rule to advisory clients investing in real estate, the Proposing Release provides no example of misappropriation of real estate from an advisory account, nor are we aware of any such instance.

One reason that the risk of misappropriation is low is that a host of gatekeepers already have strong incentives to confirm that real estate is not stolen. Lenders typically have security interests in the real estate to protect them from failure to repay loans. Any inappropriate transfer of ownership of real estate would expose those lenders to risk of substantial loss. Accordingly, they serve to satisfy the SEC's goals of ensuring an intermediary has substantial involvement in real estate investments to protect against misappropriation, albeit only a theoretical risk to begin with.

Invariably in modern real estate transactions in the United States, buyers and lenders obtain title insurance. This commonplace practice requires yet another intermediary, the title insurance company, to engage in substantial due diligence of the chain of ownership to evaluate the marketability of the seller's or borrower's real estate title, and upon closing a title insurance policy is issued insuring the buyer's or lender's interest in the real estate. When conducting due diligence and underwriting of the policy a title insurance company relies on public land records and not the copy of the deed retained by the seller when the previous transfer was completed. State recording acts make these public records supreme for providing constructive notice and whether a buyer will obtain superior rights as a bona fide purchaser for value. Given the role of title insurance policies in provide assurance to parties about marketability of title it is unclear what additional value a qualified custodian would provide to the transaction or security of the asset.

To the extent that the SEC is concerned with the risk of intentional fraud to misappropriate real estate through use of forged deeds, custodying the current owner's deed would have no bearing on the ability of a fraudster to commit such fraud. The custodied deed is not what is used to transfer the real estate interest, but a newly prepared deed, which is given no additional value by referencing the previous deed (the deed in custody).

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[6] Our impression is that the SEC's views of real estate and other assets may rely almost exclusively on testimony of a trade association, which may not be in existence today, about custodial practices. See Proposing Release, notes 14, 221 ("'These instruments are privately issued uncertificated securities, bank deposits, ***real estate assets***, swaps, and interests in other private investment funds, as well as shares of mutual funds, which, under current law, can simply be titled in the name of the private investment fund care of the manager, and the ***evidence of ownership held in a file drawer at the manager of the private investment fund***.'" (emphasis added). To state what we hope is now obvious to the SEC, this statement is simply wrong as it relates to real estate investments and ignores the robust legal framework applicable to real estate investments. Further, the reliance by the SEC on this statement speaks to a broader need for the SEC to carefully analyze the laws applicable to assets to which it seeks to apply the Proposed Rule, and should not apply the rule at all to assets that already are subject to a robust protective legal and commercial framework, which is the case for real estate assets.

In addition, real estate transactions typically require lawyers on behalf of both the buyer and seller to memorialize a transaction. These lawyers provide yet another source of gatekeeper protections.

Furthermore, as noted previously, title to real estate is recorded on the books of governmental entities. Any change to the title would be publicly available and would benefit from the transparency that other assets might not provide.

For all these reasons, any indication of misappropriation of real estate would trigger immediate scrutiny, including if the real estate was transferred to an affiliate of the investment adviser. Moreover, a fund's annual audit would include review of a significant sampling of real estate holdings, as well as lease payments or other distributions required to be made to advisory clients. Any misappropriation or discrepancies are highly likely to be detected by the auditor. Accordingly, the risk as it relates to real estate is not present, and any benefits of the Proposed Rule are theoretical at best.

The burdens imposed by applying the Proposed Rule to real estate, however, are meaningful, severe and highly likely to occur. The Proposed Rule would fundamentally change the ownership and transfer rights of real estate. Based on our reading of the Proposing Release, having a qualified custodian hold a deed in safekeeping will not be sufficient to maintain "possession or control." We do not see any way for a custodian to have "possession or control" in the way the Proposing Release indicates because it is not possible to add a qualified custodian to a title or deed. If it moves forward with this requirement, the SEC must explain how it would be possible to maintain title or a deed with a qualified custodian.

Assuming the SEC can determine a way to make this work, which doubt, , we believe it would only serve to harm advisory clients that invest in real estate. The Proposed Rule would effectively require the qualified custodian's consent to any transaction involving the sale of real estate for an advisory client, which consent might not be forthcoming out of potential liability or other concerns. Even if the custodian provides consent, the marketplace would become far less efficient because a transaction would be unable to occur until the qualified custodian clears internal processes to approve it. This could add weeks and months to a transaction involving real estate and introduce very significant deal risk.

The exemption for real assets provides only costs and no benefits as it applies to real estate.

The Proposed Rule provides a limited, conditional exception for privately offered securities and real estate and other physical assets that are not securities.

The SEC might be tempted to make clear that the conditional exemption described above is available to real estate, because as a physical asset it cannot be maintained with a qualified custodian, and requiring the custody of deeds with a qualified custodian serves no regulatory purpose. This certainly would be a better outcome than requiring deeds to be so custodied. To be clear, however, we do not believe that the requirements under the exemption to notify an auditor of any transfer of an asset and have the auditor verify the asset are necessary for the protection of investors in real estate. Moreover, such verification will be costly, and unworkable in many cases. Given all the external safeguards to detect and prevent misappropriation, as described above, and the low risk of misappropriation to begin with, such an asset verification requirement would simply serve as a drag on investment returns with no benefit to justify the costs.

We respectfully ask that you carefully consider the impact of the Proposed Rule on real estate assets held in investment advisory accounts, and avoid any final rule that would limit clients' access to, or unduly burden, this important investment asset class.

If you have any further questions or comments on this matter, please contact RER's Senior Vice President, Clifton E. Rodgers, Jr., at (202) 639-8400 or by email at crodgers@rer.org.

Sincerely,

Jeffrey D. DeBoer
President & Chief Executive Officer

cc: The Hon. Gary Gensler, Chair
The Hon. Hester M. Peirce, Commissioner
The Hon. Caroline A. Crenshaw, Commissioner
The Hon. Jaime Lizárraga, Commissioner
The Hon. Mark T. Uyeda, Commissioner
William Birdthistle, *Esq.*, Director, Division of Investment Management